IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

R/TAX APPEAL NO. 1625 of 2007

With
R/TAX APPEAL NO. 1626 of 2007
With
R/TAX APPEAL NO. 1628 of 2007

FOR APPROVAL AND SIGNATURE:

HONOURABLE MR.JUSTICE J.B.PARDIWALA

and
HONOURABLE MR. JUSTICE BHARGAV D. KARIA

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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 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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B NANJI & CO.
Versus
DY COMMISSIONER OF INCOME TAX

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Appearance:
MRS SWATI SOPARKAR(870) for the Appellant(s) No. 1
MRS MAUNA M BHATT(174) for the Opponent(s) No. 1

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CORAM: **HONOURABLE MR.JUSTICE J.B.PARDIWALA**
and
HONOURABLE MR. JUSTICE BHARGAV D. KARIA

Date : 28/01/2020

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COMMON ORAL JUDGMENT

(PER : HONOURABLE MR.JUSTICE J.B.PARDIWALA)

1 As the substantial questions of law formulated in all the captioned Tax Appeals are the same, those were heard analogously and are being disposed of by this common judgement and order.

2 The captioned Tax Appeals are at the instance of the assessee and are directed against the common judgement and order passed by the Income Tax Appellate Tribunal in the Income Tax Appeal No.1549/Ahd/2000 filed by the Revenue for the assessment year 1996-97 along with the Cross Objection No.11/Ahd/2003 and the ITA No.1257/Ahd/2001 filed by the appellant assessee and the ITA No.1330/Ahd/2001 filed by the Revenue for the A.Y. 1997-98 respectively.

3 The Tax Appeals came to be admitted vide order dated 4th December 2007 for the consideration of the following substantial question of law:

> *"Whether, in the facts and circumstances of the case, the Income Tax Appellate Tribunal was right in law in holding that interest paid by the assessee on borrowed capital to the extent it was utilised for purchasing shares was deductible neither under Section 36(1)(iii) nor under Section 57(iii) of the Act?"*

4 For the sake of convenience, the Tax Appeal No.1626 of 2007 is treated as the lead appeal.

5 This Tax Appeal under Section 260A of the Income Tax Act, 1961 (for short, 'the Act, 1961'] is at the instance of the assessee and is directed against the order passed by the Income Tax Appellate Tribunal, Ahmedabad Bench 'A", Ahmedabad dated 15th December 2006 in the ITA

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No.1549/Ahd/2000 for the A.Y. 1996-97.

6 The assessee is in the business of real estate. With the intention to expand the business of real estate, it created a housing arm in the name and style of International Housing Finance Corporation Limited [for short, 'IHFC']. The purpose to create such a housing finance company within the group was to make funds readily available when required for the development of a housing project or to fund any acquisition of real estate. The assessee subscribed 499950 equity shares constituting 99.99% in the total paid up capital of 500000 equity shares in the assessment year 1994-95. The IHFC Limited got registered with the National Housing Bank as an approved housing finance company. The representation of the assessee on the board of IHFC Limited was 100% through its partners who had been appointed as the Directors of the IHFC Limited. The minimum capital requirement to keep the housing finance company registered with the National Housing Bank was increased to Rs.2 crore, and thereafter to Rs.5 crore. In such circumstances, it became necessary for the IHFC Limited to expand its capital. As almost 100% of the capital was with the assessee, with the consent of the partners of the assessee, it was decided to tap the funds from public by way of public issue. As per the public issue guidelines issued by the SEBI, the minimum of 40% of the post public issue capital was required to be brought in by the promoters. Accordingly, to comply with the SEBI guidelines, it was decided that the assessee and its group company M/s. B. Nanji Construction Pvt. Ltd. would bring in the minimum share capital so as to reach 40% of the post issue share capital. With this object, the assessee and M/s. B. Nanji Construction Pvt Ltd borrowed funds and then subscribed the share capital of the IHFC Limited. The interest paid on the said borrowed capital by the appellant came to be disputed by the Revenue.

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7 The Assessing Officer disallowed the deduction of interest claimed in respect of the funds borrowed for the purpose of investment in the shares of the promoted company for the following reasons:

(i) The transaction of obtaining loans, making investment in shares and public issue is outside the ambit of the assessee's business.

(ii) Interest on the funds borrowed is claimed as revenue expenditure.

(iii) Investment in shares is classified as investment in the balance sheet.

(iv) Investment in shares does not constitute stock in trade.

(v) Assessee's stock in trade consists of land and rights in land.

(vi) Loan taken for the purpose of investment is separate form the loan taken for the purpose of business.

(vii) Capital borrowed for the purpose of investment and not for the purpose of business does not qualify to be categorized as capital for the purpose of business.

8 The assessee went in appeal before the CIT(A). While allowing the appeal filed by the assessee, the CIT(A) took the view that the interest cannot be allowed to the appellant under 36(1)(iii) of the Act, but the same should be allowed under Section 57(iii) of the Act. We may quote the relevant observations made in the order passed by the CIT(A):

"22 The contention of the appellant has been carefully considered. From the facts admitted by the appellant it is clear that he had maintained two separate accounts in its books for dealings with I.H.F.C. Ltd. It had paid interest of Rs. 16,49,090/- on the current account @ 22%. The borrowings in the current account had been utilised for the

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purpose of appellant's regular business. One of the reasons for disallowing interest was that the funds borrowed had been invested in acquiring shares of the I.H.F.C. Ltd. Therefore, interest paid on such funds could not be allowed. Taking the above finding of the A.O. to its logical conclusion, the interest paid by the appellant upon the funds borrowed for its regular business will have to be allowed u/s.36(1)(iii) of the I.T. Act. Accordingly, interest of Rs.16,49,090/is directed to be allowed as interest paid on borrowings utilised for the purpose of business u/s.36(1) (iii) .

23 On the other account with I.H.F.C. Ltd, the appellant firm had paid interest of Rs. 68,60,202/-. This accounts represents liability against investment in shares of I.H.F.C. Ltd. On this account the interest has been paid @ 22%. In the immediately preceding assessment year the interest had been charged @ 16%. From the details of accounts it is found that effectively funds remained with I.H.F.C. Ltd only and the appellant did not enjoy this fund at all. It is also interesting to note that most of the borrowings had been affected in the immediately preceding assessment year when the interest had been calculated @ 16%. Since the funds -remained practically with the I.H.F.C. Ltd there was no necessity to service these borrowings therefore, there is no justification in charging interest @ 22%. Therefore interest to the extent of 6% has been charged in excess which needs to be disallowed. This disallowance on the funds invested in the shares amounting to Rs.2,51,21,000/works out to Rs.15,07,260/-. It is further seen that an amount of Rs.38,75,000/- paid by the appellant for share application money remained with I.H.F.C. Ltd, which was returned only during this financial year. Therefore, effectively, there were no borrowings of Rs. 38,75,000/- on which interest had been paid by the appellant @ 22%. Such disallowance @ 22% works out to Rs. 5,31,014/-. It is further seen that an amount of Rs.44,50,000/- included in the borrowing represented in effective funds advanced by the appellant only after borrowing the same from M/s. Sankira Resorts Pvt. Ltd. The above amount which was initial investment does not represent either any asset or investment in shares, therefore, interest @ 22% of Rs..44,50,000/- also has to be disallowed. This works out to Rs. 9,79,000/-. Therefore, out of interest paid to the I.H.F.C. Ltd amounting to Rs.68,60,202/-, interest amounting to Rs. 30,17,274/-(consisting of Rs.15,07,260/- plus Rs. 5,31,014/- plus Rs. 9,79,000) is ordered to be disallowed. Balance of interest cannot be allowed to the appellant u/s.36(1)(iii) but has to be allowed u/s.57(iii) of the I.T. Act. Accordingly, out of total disallowance of Rs.85,09,342/- on account of interest paid to I.H.F.C. Ltd, the disallowance to the extent of Rs.30,17,274/- alone is retained. The appellant gets relief of Rs.54,92,068/-. However, out of relief of Rs.54,92,068/- interest of Rs. 16,49,090/- only would be considered against income from business. Balance of interest would be allowed as deduction to be set off against income from other sources."

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9 The Revenue challenged the deletion of Rs.54,92,068/- by filing appeal before the ITAT (even though in the remand report, the Jt. CIT conceded that the deduction under Section 57(iii) of the Act, 1961 is applicable). In this regard, we may quote the observations of the CIT(A) as contained in para 14 of the order:

> *"14. However, interest on borrowed capital used for purchase of share was allowable expenditure u/s 57(iii). The Supreme Court in the case of CIT vs. Rajendraprasad Mody (1978) 115 ITR 519 (SC) had held that irrespective of receipt of dividend or not, interest on borrowed capital used for purchase of shares was for the purpose of earning dividend. Therefore, interest on borrowed funds was to be allowed u/s 57(iii) against the "income from other sources". In view of the above, the Jt.. C.I.T. S.R. 5, stated that the outright disallowance of interest as made in the assessment order was not correct. The A.O. should have computed the income of the appellant by disallowing interest on borrowed capital out of business income. However, the interest attributable earning of dividend amounting to Rs. 85,07,342/- should have been allowed as income from other sources by virtue of sub-section (iii) of section 57 of the I.T. Act. The Jt. C.I.T, furnished revised computation of income in respect of business income and income from other sources."*

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10 The assessee preferred appeal before the Tribunal against the disallowance under Section 36(1)(iii) of the Act.

11 We may reproduce the relevant observations and the findings recorded by the ITAT in its impugned order:

> *"18 We have carefully considered the rival submission: in the light of material placed before us. The disallowance on account of interest has been deleted by CIT (A) to the extent of Rs.54,92,068/-. So as it relates to disallowance sustained by CIT (A), the assessee is not in appeal. Therefore, there is no dispute to that extent. The disallowance deleted by CIT(A) consists of two elements-one is Rs.16,49,090/- which has been held to be pertaining to regular business of the assessee. No material has been brought to our notice by Id. DR to show that such contention of the assessee is wrong or findings of Id. CIT (A) in this regard are factually incorrect. If such is a position then such interest has to be allowed for the*

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purpose of business under the provisions of section 36(l) (iii) of the Act. Therefore, it is held that Id. CIT (A) was right to that extent that the said interest was allowable on account of borrowed funds having been utilized for purpose of business.

19 Now the question relates to another sum of Rs.38,42,978/- (Rs.54,92,068/- (-) Rs.16,49,090/-) which pertained to borrowings made for the purpose of purchase of shares of IHFCL. Admittedly the business of the assessee does not consist of controlling, acquiring, controlling interest in the companies. The business of assessee is acquiring, controlling interest in purchase and sale of land whereas the business of IHFCL is financing estate development and housing construction. Reference in this regard can be made to the remand report of Assessing Officer dated 6.10.99, a copy of which has been placed before us in the paper book at pages 41-55. It has been the contention of the assessee right from the beginning that the intention of the assessee to invest in the shares of IHFCL was to have controlling interest in the said company so that contact of IHFCL with the same line, of business can be exploited. This contention also found part of the submission of assessee as recorded in the report under the head "contention of the assessee". Thus it cannot be disputed the assessee that its intention to invest in the shares of IHFCL, was to have controlling interest in IHFCL. It has already been pointed out that it is not the business of assessee to keep controlling interest or management over companies. Thus the purpose of assessee in purchasing the shares of IHFCL was not for the purpose of assessee's business which is only sale and purchase of land Thus the money borrowed by assessee for purchasing the shares of IHFCL cannot be said to be for the purpose of business or profession of the assessee. It was only for the purpose of having control over the IHFCL. The main condition for allowability of interest under section 36(1)(1íí) is that interest should be paid in respect of capital borrowed for the purpose of business or profession of assessee. Thus the interest paid by assessee does not fulfill the condition laid down in section 36 (1)(iii).

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20 Now coming to the question that whether or not such interest could be allowed under section 57 (iii) of the IT Act, 1961, It is not the case of assessee that the investment in the shares of IHFCL was made for the purpose of earning dividend. From the submissions made by assessee before Assessing Officer as well as before CIT (A) the purpose of purchasing shares of IHFCL was only to have controlling interest in IHFCL. It has never been the contention of assessee that the purpose of purchasing shares of IHFCL was only to earn dividend income. There is no material on record to come to the conclusion that purchase of shares of IHFCL by the assessee was done for the purpose of earning dividend. In this view of the factual aspect of the matter, it has to be held that interest paid by assessee

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on the borrowings utilized for the purpose of purchase of shares of IHFCL cannot be said to be allowable under section 57(iii) of the Act. Such interest was not incurred, laid out wholly and exclusively for the purpose of making or earning dividend income. Thus the claim of assessee is not allowable even under section 57(iii) of the Act.”

12 The ITAT allowed the appeal preferred by the Revenue and dismissed the cross objection preferred by the assessee. It is important to note that the ITAT disallowed interest under both i.e. Section 36(1)(iii) and Section 57(iii) of the Act, 1961.

13 Being dissatisfied with the order passed by the ITAT, the assessee is here before this Court with the present appeal.

14 Mr. B. S. Soparkar, the learned counsel appearing for the appellant assessee vehemently submitted that the ITAT failed to deal with the contention raised on behalf of the assessee that the Revenue could not have challenged the order of CIT(A) having conceded in the remand report as regards the applicability of Section 57(iii) of the Act.

15 According to Mr. Soparkar, the ITAT committed a serious error in allowing the appeal preferred by the Revenue on the ground conceded by the Revenue. Mr. Soparkar further submitted that before the CIT(A), it was argued that interest is allowable under Section 36(1)(iii) or alternatively under Section 57(iii) of the Act, 1961. The remand report was called for from the Revenue on the issue wherein it was submitted that Section 36(1)(iii) may not be applicable, but the interest is allowable under Section 57(iii) of the Act.

16 Mr. Soparkar submitted that the following was the rationale for borrowing and purchasing the shares of the IHFC Limited:

“1 To retain the controlling interest in the company. Prior to the

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public issue of IHFC limited, the family of the firm owned all the issued shares of IHFC Ltd. They wanted to retain the controlling stake even after the public issue. After the public issue the shareholding became 49.87% from 100%.

2 It was also decided that the assessee firm and B. Nanji Construction P Ltd issues the shares of IHFC Ltd. Assessee came to hold 30 lakhs shares of IHFC Ltd.

3 The partners and family of the assessee firm were also the Directors in the company.

4 Assessee is a real estate developer and IHFC gives housing loans. Business activity of both the entities have synergy for mutual benefit. Prospective customers of the assessee could get credit facilities from IHFC on priority basis."

17 Mr. Soparkar, in support of his submissions, has placed reliance on the following decisions:

[1] S.A. Builders Ltd vs. Commissioner of Income tax (Appeals) [2007] ITR 1 (SC)

[2] Commissioner of Income tax vs. Tulip Star Hotels Ltd [338 ITR 482 (DEL)]

[3] Bright Enterprises Pvt Ltd vs. Commissioner of Income Tax, Jalandhar [2016 (381) ITR 107]

[4] CIT vs. Phil Corporation Ltd [2011] 14 Taxmann.com 58 (Bom)

[5] Commissioner of Income tax vs. Rajendra Prasad Moody [1978] 115 ITR 519 (SC)

[6] Commissioner of Income tax vs. M. Ethurajan [273 ITR 95 (Mad)]

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18 In such circumstances referred to above, Mr. Soparkar prays that there being merit in his appeal, the substantial questions of law may be answered in favour of the assessee and against the Revenue.

19 On the other hand, this appeal has been opposed by Ms. Mauna Bhatt, the learned standing counsel appearing for the Revenue. Ms. Bhatt would submit that no error, not to speak of any error of law could be said to have been committed by the ITAT in passing the impugned order.

20 According to Ms. Bhatt, the interest is not allowable either under Section 36(1)(iii) of the Act nor under Section 57(iii) of the Act. According to Ms. Bhatt, it is not the case of the assessee that the investment in the shares of the IHFC was made for the purpose of earning dividend. The only purpose of purchasing the shares of IHFC was to retain controlling interest in the company.

21 According to Ms. Bhatt, for the purpose of liability of interest under Section 36(1)(iii) of the Act, the interest should be paid in respect of the capital borrowed for the purpose of business or profession of the assessee. The interest paid by the assessee does not fulfill the prerequisite laid down in Section 36(1)(iii) of the Act. Ms. Bhatt submitted that when the purpose of the assessee was not to earn an income, but was to retain further control over the company, the deduction under Section 57(iii) cannot be allowed.

22 In such circumstances referred to above, Ms. Bhatt prays that there being no merit in the appeal, the same be dismissed and the substantial questions of law may be answered in favour of the Revenue and against the assessee.

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● **ANALYSIS:**

23 Section 36(1)(iii) of the Act reads thus:

"36. (1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28 -

*(i) and (ii) ******

(iii) the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession:-

Provided that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized in the books of account or not); for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.

Explanation : Recurring subscriptions paid periodically by shareholders or subscribers in Mutual Benefit Societies which fulfill such conditions as may be prescribed, shall be deemed to be capital borrowed within the meaning of this clause;"

24 The sub-section has three important words or phrases that are important for the purpose of understanding the provision viz. (i) Interest, (ii) Capital Borrowed and, (iii) For the purpose of business or profession. In the following paras we would elucidate the meaning of these with reference to this particular section.

(i) Meaning of "Interest" – The definition of the term "interest" in the Section 2(28A) means the "interest payable in any manner in respect of any moneys borrowed or debt incurred". But for the purpose of Section 36(1)(iii), "interest" is restricted to that on the money borrowed and not on the debt incurred. In simple words, the essence of interest is that it is a payment which becomes due because the creditor has not had his

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money at his disposal. It may be regarded either as representing the profit he might have made if he had the use of his money, or conversely, the loss he suffered because he had not used. The general idea is that he is entitled to compensation for the deprivation.

(ii) Concept of "capital borrowed" – The Provisions of Section 36(1)(iii) concern the capital borrowed and not the other debts or liability. A loan undoubtedly results in a debt, but every debt does not involve a loan. The liability to pay a debt may arise from diverse sources and a loan is one of such sources. The legislature has, under this clause, permitted as an allowance the interest paid on the capital borrowed for the purposes of the business; and the capital, in this context, means the money and not any other asset purchased on credit [**Bombay Steam Navigation Co. Pr. Ltd. v. CIT, 56 ITR 52 (SC)].**

(iii) The phrase "for the purpose of business" – The expression "for the purpose of business" occurs in Section 36(1)(iii) and also in Section 37(1). A similar expression with different wording also occurs in Section 57(iii) which reads as "for the purpose of making or earning income". This issue came up for consideration before the Supreme Court in the case of **Madhav Prasad Jatia V. CIT, (1979) 118 ITR 200** wherein it has been held that the expression occurring in Section 36(1)(iii) is wider in scope than the expression occurring in Section 57(iii). Thus, meaning thereby that the scope for allowing a deduction under Section 36(1)(iii) would be much wider than the one available under Section 57(iii).

Thus, for the allowance of a claim for deduction of interest under Section 36(1)(iii) of the Act, the following three conditions are necessary:

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(i) The money, that is capital, must have been borrowed by the assessee

(ii) It must have been borrowed for the purpose of business.

(iii) **The assessee must have paid interest on the borrowed amount i.e. he has shown the same as an item of expenditure.**

25 The Supreme Court in the case of **S. A. Builder Ltd (supra)** had the occasion to consider Section 36(1)(iii) at length. In **S. A. Builder (supra),** in the course of assessment proceedings, the Assessing Officer found that the assessee had advanced huge amounts as interest-free loans out of its cash credit account in which there was a huge credit balance. The Assessing Officer disallowed the proportionate interest relating to the said amount out of the total interest paid to the bank, holding that the assessee had diverted its borrowed funds to its sister concern without charging any interest. On appeal, the Commissioner (Appeals) accepted the partial claim of the assessee on the ground that out of the total amount advanced by the assessee only certain sum had a clear nexus with borrowed funds, as the balance amount had been paid out of the receipts from other parties to whom no interest had been paid. However, on the cross appeals, the Tribunal allowed the revenue's appeal. On the assessee's appeal, the High Court held that the order of the Tribunal did not suffer from any factual or legal infirmity, as the amount in question had been advanced by the assessee to its sister concern out of the overdraft account in which there was already a huge debit balance. Thus, the question involved in **S.A. Builder Ltd (supra)** was one about the allowability of the interest on the borrowed funds. The Supreme Court while setting aside the order of the Tribunal held as under:

> *"19 In this connection we may refer to Section 36(1)(iii) of the Income-tax Act, 1961 (hereinafter referred to as the 'Act') which states that "the amount of the interest paid in respect of capital borrowed for the purposes*

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of the business or profession" has to be allowed as a deduction in computing the income-tax under Section28 of the Act.

20. In Madhav Prasad Jantia vs. Commissioner of Income Tax, U.P., AIR 1979 SC 1291, this Court held that the expression "for the purpose of business" occurring under the provision is wider in scope than the expression "for the purpose of earning income, profits or gains", and this has been the consistent view of this Court.

21. In our opinion, the High Court in the impugned judgment, as well as the Tribunal and the Income Tax Authorities have approached the matter from an erroneous angle. In the present case, the assessee borrowed the fund from the bank and lent some of it to its sister concern (a subsidiary) on interest free loan. The test, in our opinion, in such a case is really whether this was done as a measure of commercial expediency.

22. In our opinion, the decisions relating to Section 37 of the Act will also be applicable to Section 36(1)(iii) because in Section 37 also the expression used is "for the purpose of business". It has been consistently held in decisions relating to Section 37 that the expression "for the purpose of business" includes expenditure voluntarily incurred for commercial expediency, and it is immaterial if a third party also benefits thereby.

23. Thus in Atherton vs. British Insulated and Helsby Cables Ltd. (1925)10 TC 155 (HL), it was held by the House of Lords that in order to claim a deduction, it is enough to show that the money is expended, not of necessity and with a view to direct and immediate benefit, but voluntarily and on grounds of commercial expediency and in order to indirectly facilitate the carrying on the business. The above test in Atherton's case (supra) has been approved by this Court in several decisions e.g. Eastern Investments Ltd. vs. CIT (1951) 20 ITR 1, CIT vs. Chandulal Keshavlal and Co. (1960) 38 ITR 601 etc.

24. In our opinion, the High Court as well as the Tribunal and other Income Tax Authorities should have approached the question of allowability of interest on the borrowed funds from the above angle. In other words, the High Court and other authorities should have enquired as to whether the interest free loan was given to the sister company (which is a subsidiary of the assessee) as a measure of commercial expediency, and if it was, it should have been allowed.

25. The expression "commercial expediency" is an expression of wide import and includes such expenditure as a prudent businessman incurs for the purpose of business. The expenditure may not have been incurred under any legal obligation, but yet it is allowable as a business expenditure if it was incurred on grounds of commercial expediency.

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26. No doubt, as held in Madhav Prasad Jantia vs. CIT (supra), if the borrowed amount was donated for some sentimental or personal reasons and not on the ground of commercial expediency, the interest thereon could not have been allowed under Section 36(1)(iii) of the Act. In Madhav Prasad's case (supra), the borrowed amount was donated to a college with a view to commemorate the memory of the assessee's deceased husband after whom the college was to be named. It was held by this Court that the interest on the borrowed fund in such a case could not be allowed, as it could not be said that it was for commercial expediency.

27. Thus, the ratio of Madhav Prasad Jantia's case (supra) is that the borrowed fund advanced to a third party should be for commercial expediency if it is sought to be allowed under Section 36(1)(iii) of the Act.

28. In the present case, neither the High Court nor the Tribunal nor other authorities have examined whether the amount advanced to the sister concern was by way of commercial expediency.

29. It has been repeatedly held by this Court that the expression "for the purpose of business" is wider in scope than the expression " for the purpose of earning profits" vide CIT vs. Malayalam Plantations Ltd. (1964) 53 ITR 140, CIT vs. Birla Cotton Spinning and Weaving Mills Ltd. (1971) 82 ITR 166 etc.

30. The High Court and the other authorities should have examined the purpose for which the assessee advanced the money to its sister concern, and what the sister concern did with this money, in order to decide whether it was for commercial expediency, but that has not been done.

31. It is true that the borrowed amount in question was not utilized by the assessee in its own business, but had been advanced as interest free loan to its sister concern. However, in our opinion, that fact is not really relevant. What is relevant is whether the assessee advanced such amount to its sister concern as a measure of commercial expediency.

32. Learned counsel for the Revenue relied on a Bombay High Court decision in Phaltan Sugar Works Ltd. vs. Commissioner of Wealth-Tax (1994) 208 ITR 989, in which it was held that deduction under Section 36(1)(iii) can only be allowed on the interest if the assessee borrows capital for its own business. Hence, it was held that interest on the borrowed amount could not be allowed if such amount had been advanced to a subsidiary company of the assessee. With respect, we are of the opinion that the view taken by the Bombay High Court was not correct. The correct view in our opinion was whether the amount advanced to the subsidiary or associated company or any other party was advanced as a measure of commercial expediency. We are of the opinion that the view taken by the Tribunal in Phaltan Sugar Works Ltd. (supra) that the

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interest was deductible as the amount was advanced to the subsidiary company as a measure of commercial expediency is the correct view, and the view taken by the Bombay High Court which set aside the aforesaid decision is not correct.

33. Similarly, the view taken by the Bombay High Court in Phaltan Sugar Works Ltd. vs. Commissioner of Wealth-Tax (1995) 215 ITR 582, also does not appear to be correct.

34. We agree with the view taken by the Delhi High Court in CIT vs. Dalmia Cement (Bhart) Ltd. (2002) 254 ITR 377, that once it is established that there was nexus between the expenditure and the purpose of the business (which need not necessarily be the business of the assessee itself), the Revenue cannot justifiably claim to put itself in the arm-chair of the businessman or in the position of the board of directors and assume the role to decide how much is reasonable expenditure having regard to the circumstances of the case. No businessman can be compelled to maximize its profit. The Income Tax Authorities must put themselves in the shoes of the assessee and see how a prudent businessman would act. The authorities must not look at the matter from their own viewpoint but that of a prudent businessman. As already stated above, we have to see the transfer of the borrowed funds to a sister concern from the point of view of commercial expediency and not from the point of view whether the amount was advanced for earning profits.

35. We wish to make it clear that it is not our opinion that in every case interest on borrowed loan has to be allowed if the assessee advances it to a sister concern. It all depends on the facts and circumstances of the respective case. For instance, if the Directors of the sister concern utilize the amount advanced to it by the assessee for their personal benefit, obviously it cannot be said that such money was advanced as a measure of commercial expediency. However, money can be said to be advanced to a sister concern for commercial expediency in many other circumstances (which need not be enumerated here). However, where it is obvious that a holding company has a deep interest in its subsidiary, and hence if the holding company advances borrowed money to a subsidiary and the same is used by the subsidiary for some business purposes, the assessee would, in our opinion, ordinarily be entitled to deduction of interest on its borrowed loans."

26 Thus, the Supreme Court in **S. A. Builders Ltd (supra)** has interpreted Section 36(1)(iii) of the Act to observe that the interest paid on the capital borrowed for the purpose of business is to be allowed as a deduction in computing taxable income. The expression "for purposes of

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business or profession" occurring in Section 36(1)(iii) of the Act is wider in scope than the expression "for the purpose of earning income, profits or gains". Accordingly, the expenditure voluntarily incurred and meeting the "commercial expediency" test is to be allowed as a deduction. It is immaterial if a third party also benefits by the said expenditure. The expression "commercial expediency" is again of wide import and once it is established that there was a connection and nexus between the interest paid claimed as expenditure and the business of the assessee the purpose of business need not be the business of the assessee, for the deduction under Section 36(1)(iii) of the Act to be allowed. Further, the Revenue cannot assume the role and occupy the armchair of a businessman to decide whether the expenditure was reasonable. The Revenue cannot look at the matter from its own standpoint, but opinion and decision of a businessman on the "business expediency" matters. The money borrowed even when advanced to a subsidiary for some business purpose would qualify for deduction of interest. However, if the money borrowed is utilised by the assessee for personal benefit and not for business purpose, the interest paid on that money would not satisfy the test of "commercial expediency". [See (2018) 409 ITR 587 (Delhi)].

27 In the context of the present case, the purpose for borrowing and purchasing shares of IHFC Ltd was as under:

> *"1 To retain the controlling interest in the company. Prior to the public issue of IHFC limited, the family of the firm owned all the issued shares of IHFC Ltd. They wanted to retain the controlling stake even after the public issue. After the public issue the shareholding became 49.87% from 100%.*
>
> *2 It was also decided that the assessee firm and B. Nanji Construction P Ltd issues the shares of IHFC Ltd. Assessee came to hold 30 lakhs shares of IHFC Ltd.*
>
> *3 The partners and family of the assessee firm were also the Directors in the company.*

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4 Assessee is a real estate developer and IHFC gives housing loans. Business activity of both the entities have synergy for mutual benefit. Prospective customers of the assessee could get credit facilities from IHFC on priority basis.”

28 Having regard to the facts in this case, the findings recorded by the Tribunal that the test of “commercial expediency” was not satisfied is not tenable in law.

29 A Division Bench of the Punjab and Haryana High Court in the **CIT vs. Marudhar Chemicals & Pharmaceuticals (P) Ltd. (2009) 319 ITR 75 (P&H)** held:

"*15. Section 36(1)(iii) of the Act provides that "the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession" has to be allowed as a deduction in computing the income under section 28 of the Act. The expression "for the purpose of business" has been held to be wider in scope than the expression "for the purpose of earning income, profits or gains". It has been held in S.A. Builders Ltd.'s case (supra) that when the assessee borrowed the fund from the bank and lent some of it to its sister concern as an interest free loan, then the real test to allow the interest as deduction under section 36(1)(iii) of the Act is whether this was done as a measure of commercial expediency. It has been held that in order to claim a deduction, it is enough to show that the money is expended, not on necessity and with a view to direct and immediate benefit, but voluntarily and on account of commercial expediency and in order to indirectly to facilitate the carrying on the business. The expression "commercial expediency" is an expression of wide import and includes such expenditure as a prudent businessman incurs for the purpose of business. The expenditure may not have been incurred under any legal obligation, but yet it is allowable as a business expenditure if it was incurred on grounds of commercial expediency. In S.A. Builders Ltd.'s case (supra), it was held that in order to decide whether it was for commercial expediency, the authorities and the courts should have examined the purpose for which the assessee advanced money to its sister concern and what the sister concern did with the money. It was further held that it is not relevant whether the assessee has utilized the borrowed amount in its own business or has advanced the same as interest free loan to its sister concern. What is relevant is whether the amount, so advanced was as a measure of commercial expediency or not. It is not necessary that the amount so advanced is earning profit or not but there must be some nexus between expenses and the purpose of business.*"

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30 It is important to note that the Division Bench in arriving at its aforenoted conclusion followed the judgment of the Supreme Court in **S.A. Builders Ltd. (supra).** The Division Bench, in fact, after remanding the matter, expressly directed the Tribunal to consider the matter in the light of the principles laid down by the Supreme Court in **S.A. Builders Ltd. (supra).**

31 We shall now consider Section 57(iii) of the Act, 1961, which reads thus:

> *"**Deductions***
> *57. The income chargeable under the head "Income from other sources" shall be computed after making the following deductions, namely:-*
>
> *****
>
> *(iii) any other expenditure (not being in the nature of capital expenditure) laid out or expended wholly and exclusively for the purpose of making or earning such income."*

32 A bare perusal of the aforesaid provision would indicate that in order to grant deduction of interest paid by the assessee, it would be necessary to determine the dominant purpose for which the expenditure was incurred, meaning thereby that if the expenditure incurred is not to earn the income, then such expenditure would not be allowable as deduction under Section 57(iii) of the Act. In the facts of the case, the JCIT in the remand report as well as the CIT(A) found that the interest borrowed for the purchase of shares was allowable expenditure under Section 57(iii) of the Act without taking into consideration as to whether the capital borrowed for the purchase of shares by the assessee was for the purpose of business or for the purpose of earning income.

33 This High Court in ***Padmavati Jaykrishna vs. CIT*** (1981) 131 ITR 653 has held that in order to decide whether an expenditure is a

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permissible deduction under section 57(iii), the nature of the expenditure must be examined. This High Court in the case of ***Sarabhai Sons (P) Ltd. vs. CIT*** (1993) 113 Taxation 407, 201 ITR 464 has held that if the dominant purpose for which the expenditure was incurred is not to earn the income, the expenditure incurred in that behalf would fall outside the purview of Section 57(iii) of the Act. Where the dominant purpose of the assessee in taking overdrafts was not to earn income but to meet the personal liability, the interest payment on the overdrafts was held to be not allowable deduction under Section 57(iii) of the Act *(H. H. Maharaja Martand Singh Ju Deo Vs. CIT* (1989) Taxation 92(3)-199, 174 ITR 515 (MP): *Padmavati Jai Krishna Vs. Addl. CIT* (1987) Taxation 86(2)-1: 166 ITR 176 (SC)). The connection between the expenditure and earning of income need not be direct and it may be indirect. But, since the expenditure must have been incurred for the purpose of earning that income, there should be some nexus between the expenditure and the earning of the income *[Addl. CIT vs. Madras Fertilisers Ltd.* (1980) 122 ITR 139 (Mad.) : *Vijaya Laxmi Sugar Mills Ltd. vs. CIT* (1991) 191 ITR 641 (SC): *CIT vs. Dwaraka Chit Funds Pvt. Ltd.* (1996) 132 Taxation 109 (Mad.).

This High Court in *Virmati Ramkrishna vs. CIT* (1981) 131 ITR 659, has laid down the following propositions in respect of deduction of an expenditure under sec. 57(iii) of the Act (See also *Eastern Investments Ltd. vs. CIT (1951)*20 ITR 1 (SC), *Seth R. Dalmia vs. CIT (1977)* Taxation 49(3)-57, 110 ITR 644 (SC) :

(1) in order to decide whether an expenditure is a permissible deduction u/s. 57(iii), the nature of the expenditure must be examined.

(2) the expenditure must not be in the nature of capital

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expenditure or personal expenses of the assessee;

(3) the expenditure must have been laid out or expended wholly and exclusively for the purpose of making or earning "income from other sources";

(4) the purpose of making or earning such income must be the sole purpose for which the expenditure must have been incurred, that is to say, the expenditure should not have been incurred for such purpose as also for another purpose, or for a mixed purpose;
(5) the distinction between purpose and motive must always be borne in mind in this connection, for, what is relevant is the manifest and immediate purpose and not the motive or personal considerations weighing the mind of the assessee in incurring the expenditure;

(6) if the assessee has no option except to incur the expenditure in order to make the earning of the income possible, such as when he has to incur legal expenses for preserving and maintaining the source of income, then undoubtedly, such expenditure would be an allowable deduction; however, where the assessee has an option and the option which he exercises has no connection with the making or earning of the income and the option depends upon the personal considerations or motives of the assessee, the expenditure incurred in consequence of the exercise of such option cannot be treated as an allowable deduction;

(7) it is not necessary, however, that the expenditure incurred must have been obligatory; it is enough to show that the money was expended not of necessity and with a view to an immediate

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benefit to the assessee but voluntarily and on the ground of commercial expediency and in order indirectly to facilitate the making or earning of the income;

(8) if, therefore, it is found on the application of the principles of ordinary commercial trading that there is some connection, direct or indirect, but not remote, between the expenditure incurred and the income earned, the expenditure must be treated as an allowable deduction;

(9) it would not, however, suffice to establish merely that the expenditure was incurred in order indirectly to facilitate the carrying on of the activity which is the source of the income; and nexus must necessarily be nexus must necessarily be between the expenditure incurred and the income earned;

(10) it is not necessary to show that the expenditure was a profitable one or that in fact income was earned;

(11) the test is not whether the assessee benefited thereby or whether it was a prudent expenditure which resulted in ultimate gain to the assessee but whether it was incurred legitimately and *bonafide* for making or earning the income;

(12) the question whether the expenditure was laid out or expended for making or earning the income must be decided on the facts of each case, the final conclusion being on of law.

34 In context with Section 57(iii) of the Act, we may refer to and rely upon the decision of the Supreme Court in the case of **Rajendra Prasad**

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Moody (supra). We quote the relevant observations :

> *"The determination of the question before us turns on the true interpretation of S. 57 (iii) and it would, therefore, be convenient to refer to that section, but before we do so, we may point out that S. 57 (iii) occurs in a fasciculus of sections under the heading 'F-Income From Other Sources'. Section 56 which is the first in this group of sections enacts in sub-sec. (1) that income of every kind which is not chargeable to tax under any of the heads specified in S. 14, Items A to E shall be chargeable to tax under the head 'Income From Other Sources' and sub-sec. (2) includes in such income various items, one of which is 'dividends'. Dividend on shares is thus income chargeable under the head 'Income From Other Sources'. Section 57 provides for certain deductions to be made in computing the income chargeable under the head "Income From Other Sources" and one of such deductions is that set out in Cl. (iii) which reads as follows :*
>
> > *"Any other expenditure (not being in the nature of capital expenditure) laid out or expended wholly and exclusively for the purpose of making or earning such income."*
>
> *The expenditure to be deductible under S. 57 (iii) must be laid out or expended wholly and exclusively for the purpose of making or earning such income. The argument of the Revenue was that unless the expenditure sought to be deducted resulted in the making or earning of income, it could not be said to be laid out or expended for the purpose of making or earning such income. The making or earning of income, said the Revenue, was a sine qua non to the admissibility of the expenditure under S. 57 (iii) and, therefore, if in a particular assessment year there was no income, the expenditure would not be deductible under that section. The Revenue relied strongly on the language of S. 37 (1) and contrasting the phraseology employed in S. 57 (iii) with that in S. 37 (1), pointed out that the Legislature had deliberately used words of narrower import in granting the deduction under S. 57 (iii). Section 37 (1) provided for deduction of expenditure laid out or expended wholly and exclusively for the purpose of the business or profession in computing the income chargeable under the head 'Profits or gains of business or profession'. The language used in S. 37 (1) was "laid out or expended ... ... for the purpose of the business or profession" and not "laid out or expended.....for the purpose of making or earning such income" as set out in Section 57 (iii). The words in S. 57 (iii) being narrower, contended the Revenue, they cannot be given the same wide meaning as the words in S. 37 (1) and hence no deduction of expenditure could be claimed under S. 57 (iii) unless it was productive of income in the assessment year in question. This contention of the Revenue undoubtedly found favour with the High Court (sic) (two High Courts ?) but we do not think we can accept it. Our reasons for saying so are as follows.*

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3. What S. 57 (iii) requires is that the expenditure must be laid out or expended wholly and exclusively for the purpose of making or earning income. It is the purpose of the expenditure that is relevant in determining the applicability of S. 57 (iii) and that purpose must be making or earning of income. Section 57 (iii) does not require that this purpose must be fulfilled in order to qualify the expenditure for deduction. It does not say that the expenditure shall be deductible only if any income is made or earned. There is in fact nothing in the language of S. 57 (iii) to suggest that the purpose for which the expenditure is made should fructify into any benefit by way of return in the shape of income. The plain natural construction of the language of S. 57 (iii) irresistibly leads to the conclusion that to bring a case within the section, it is not necessary that any income should in fact have been earned as a result of the expenditure. It may be pointed out that an identical view was taken by this Court in Eastern Investments Ltd. v. Commissioner of Income-tax, 20 ITR 1 : (AIR 1951 SC 278) where interpreting the corresponding provision in S. 12 (2) of the Income-tax Act, 1922 which was ipsissima verba in the same terms as Section 57 (iii), Bose, J., speaking on behalf of the Court observed : "It is not necessary to show that the expenditure was a profitable one or that in fact any profit was earned".

It is indeed difficult to see how, after this observation of the Court, there can be any scope for controversy in regard to the interpretation of S. 57 (iii).

4. It is also interesting to note that, according to the Revenue, the expenditure would disqualify for deduction only if no income results from such expenditure in a particular assessment year, but if there is some income, howsoever small or meagre, the expenditure would be eligible for deduction. This means that in a case where the expenditure is Rupees 1,000/-, if there is income of even Re. 1/-, the expenditure would be deductible and there would be resulting loss of Rs. 999/- under the head 'Income From Other Sources'. But if there is no income, then, on the argument of the Revenue, the expenditure would have to be ignored as it would not be liable to be deducted. This would indeed be a strange and highly anomalous result and it is difficult to believe that the Legislature could have ever intended to produce such illogicality. Moreover, it must be remembered that when a profit and loss account is cast in respect of any source of income, what is allowed by the statute as proper expenditure would be debited as an outgoing and income would be credited as a receipt and the resulting income or loss would be determined. It would make no difference to this process whether the expenditure is X or Y or nil; whatever is the proper expenditure allowed by the statute would be debited. Equally, it would make no difference whether there is any income and if so, what since whatever it be, X or Y or nil, would be credited. And the ultimate income or loss would be found. We fail to appreciate how expenditure

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which is otherwise a proper expenditure can cease to be such merely because there is no receipt of income. Whatever is a proper outgoing by way of expenditure must be debited irrespective of whether there is receipt of income or not. That is the plain requirement of proper accounting and the interpretation of S. 57 (iii) cannot be different. The deduction of the expenditure cannot, in the circumstances, be held to be conditional upon the making or earning of the income.

5. It is true that the language of Section 37 (1) is a little wider than that of S. 57 (iii), but we do not see how that can make any difference in the true interpretation of S. 57 (iii). The language of S. 57 (iii) is clear an unambiguous and it has to be construed according to its plain natural meaning and merely because a slightly wider phraseology is employed in another section which may take in something more, it does not mean that S. 57 (iii) should be given a narrow and constricted meaning not warranted by the language of the section and in fact, contrary to such language.

6. This view which we are taking is clearly supported by the observations of Lord Thankerton in Hughes v. Bank of New Zealand, (1938) 6 ITR 636 where the learned Law Lord said :

> *"Expenditure in the course of the trade which is unremunerative is none the less a proper deduction, if wholly and exclusively made for the purposes of the trade. It does not require the presence of a receipt on the credit side to justify the deduction of an expense."*

We find that the same view has been taken by the Madras High Court in Appa Rao v. Commr. of Income-tax, (1962) 46 ITR 511 and Mohamed Ghouse v. Commr. of Income-tax, (1963) 49 ITR 127 the Bombay High Court in Ormerods (India) Private Ltd. v. Commr. of Income-tax, (1959) 36 ITR 329, the Allahabad High Court in Chhail Beharilal v. Commissioner of Income-tax, (1960) 39 ITR 696, the Madhya Pradesh High Court in Commissioner of Income-tax v. Dr. Fida Husain G. Abbasi, (1969) 71 ITR 314, the Kerala High Court in M. N. Ramaswamy Iyer v. Commr. of Income-tax, (1969) 71 ITR 218 and the Orissa High Court in Commissioner of Income-tax v. Gopal Chand Patnaik, 111 ITR 86 : (1976 Tax LR 443). This view is eminently correct as it is not only justified by the language of S. 57 (iii) but it also accords with the principles of commercial accounting. The contrary view taken by the Patna High Court in Kameshwar Singh v. Commr. of Income-tax, 32 ITR 377 : (AIR 1957 pat 400) and the Calcutta High Court in Madanlal Shohanlal v. Commissioner of Income-tax, (1963) 47 ITR 1 must in the circumstances be held to be incorrect."

35 Thus, it is evident from the plain and natural construction of the

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language of Section 57(iii) of the Act, 1961 that to bring a case within that section, it is not necessary that any income should in fact have been earned as a result of the expenditure. What Section 57(iii) of the Act, 1961 requires is that the expenditure must be laid out or expended wholly and exclusively for the purpose of making or earning income. Section 57(iii) does not require that this purpose must be fulfilled in order to qualify the expenditure for deduction. It does not say that the expenditure shall be deductible only if any income is made or earned.

- **Section 36(1)(iii) vis-à-vis Section 57(iii):**

36 Where the borrowings are made for the purchase of shares, a question that would often arise is whether the interest paid should be allowed as deduction under Section 36(1)(iii) or under Section 57(iii). At this stage, it is worthwhile to mention that the income by way of dividends on shares, whether held on investment portfolio or as stock-in-trade, is specifically assessable, under Section 56(2)(i), as the "**Income from other sources**". Although the shares are held, on the investment portfolio, as an integral part of the business, yet the interest on such borrowings is allowable under Section 36(1)(iii). Thus, the qualifying factor in this case is to ascertain whether the borrowings for purchasing shares is an integral part of the business of the assessee.

The interest can be allowed under Section 36(1)(iii) only if the assessee proves that, it was paid in respect of capital borrowed for the purpose of business. But if the shares are acquired not as an investment for earning income therefrom, the inference may well be different as was found in **CIT Vs. Amritaben R. Shah 238 ITR 777 (Bom),** where it was held that a taxpayer borrowing money to **acquire controlling interest in a company would not be entitled to deduction of interest on borrowings.** This High Court in **Sarabhai Sons (P) Ltd. V. CIT 201 ITR**

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464, found that where the dominant purpose of expenditure is not for earning income, it could not be allowed as a deduction. In **Chinai and Co. Pvt. Ltd. V. CIT 206 ITR 616 (Bom), the** expenses incurred in fighting another group of shareholders to protect the investments in erstwhile managed company was held to be not admissible as business expenditure.

37 The appellant assessee had borrowed the capital to purchase the shares of the IHFC Ltd so as to have effective control of the IHFC Ltd in order to expand its real estate business. Thus, the investment in share was nothing but the expansion of business of the assessee. Therefore, all the conditions necessary for deduction under Section 36(1)(iii) were *prima facie* satisfied by the appellant assessee. The CIT(A) was, therefore, not justified to allow deduction under Section 57(iii) of the Act as the appellant assessee did not borrow the capital for earning dividend or for making profit and gains. The dominant purpose of the appellant assessee to borrow the capital was to acquire the shares to have effective control over the IHFC Ltd so as to expand the business of the assessee. In that view of the matter, the CIT(A) was not justified in granting deduction of interest paid by the assessee under Section 57(iii) of the Act. But the assessee is entitled to deduction of interest paid on capital borrowed for investment in the shares of IHFC for the purpose of expansion for its business under Section 36(1)(iii) of the Act.

38 The Tribunal was, therefore, not justified in holding that the purpose of the assessee for purchase of shares of IHFC was not for the purpose of business of the assessee as the business of the assessee was only sale and purchase of land.

39 Therefore, the question of law as framed is answered in favour of the assessee and against the Revenue. The assessee is entitled to

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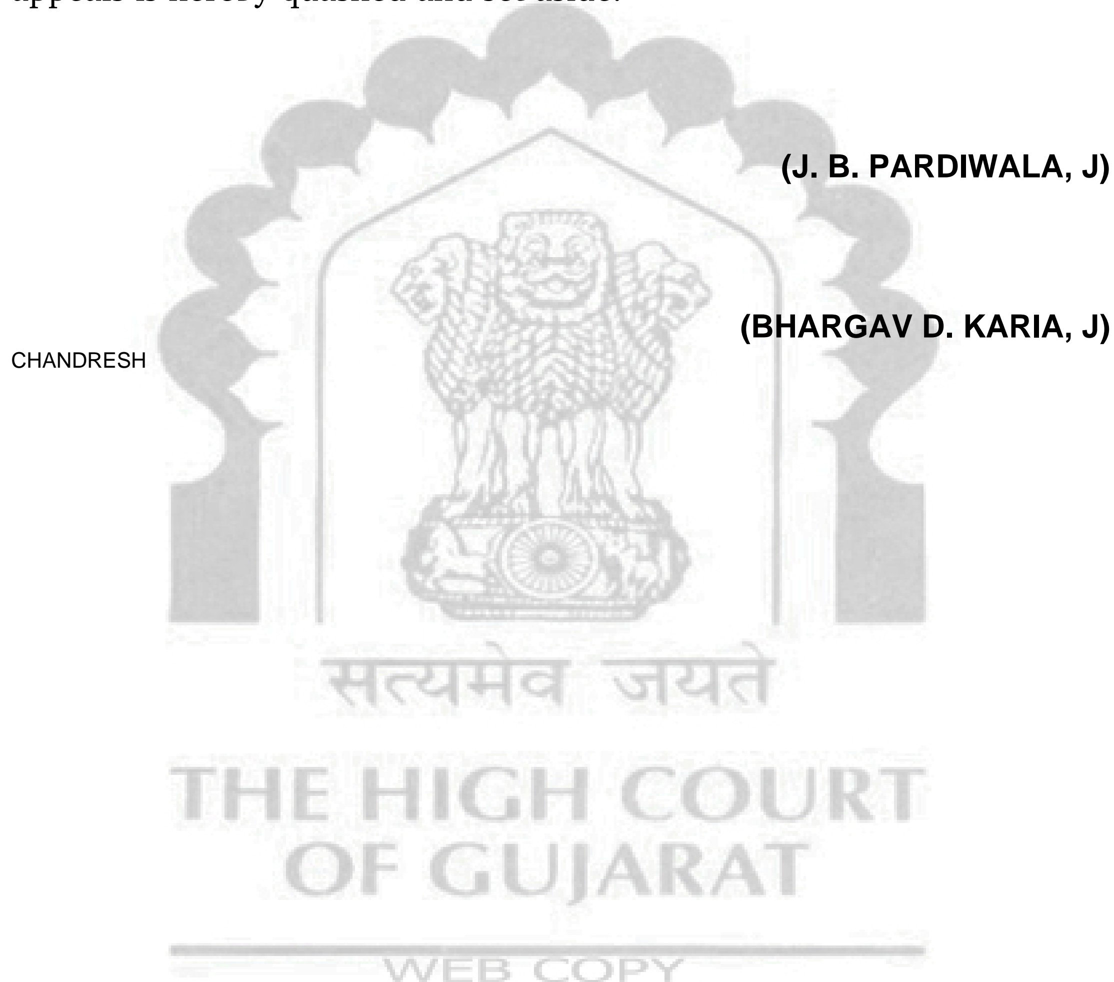
deduction of interest paid on borrowed capital to the extent it was utilized for purchasing shares of IHFC Ltd under Section 36(1)(iii) of the Act, 1961.

40 In the result, all the three appeals succeed and are hereby allowed. The impugned order passed by the Tribunal in each of the appeals is hereby quashed and set aside.



(J. B. PARDIWALA, J)

(BHARGAV D. KARIA, J)

CHANDRESH

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