Additional Commissioner Of Income-Tax vs Madras Fertilisers Ltd. on 7 December, 1978

JUDGMENT

Ismail, J.

1. The assessee is a public limited company incorporated under the Companies Act, 1956. The company obtained a certificate of commencement of business on December 8, 1966. The major shareholders in the assessee-company are the Government of India and Amoco India Incorporated which is a subsidiary of the American International Oil Company, which again is a wholly owned subsidiary of Standard Oil Company (Indiana). The object of the assessee-company is to manufacture and market ammonia, urea, and other complex fertilizers. The production of these items had not been commenced till March 31, 1970, as the factory itself was under construction as on that date.

2. These references are concerned with the assessment years 1969-70 and 1970-71. The assessee-company which required funds to meet the cost of construction of its plant, apart from its paid-up capital of Rs. 13.6 crores, entered into a loan agreement with the Chemical Bank New York Trust Company in December, 1966 for borrowing 23 million dollars to be drawn in convenient instalments and also borrowed from the Government of India rupee funds to the tune of Rs. 5.5 crores. A copy of the aforesaid agreement entered into between the Chemical Bank New York Trust Company and the assessee-company in December, 1966, has been annexed to the statement of the case submitted by the Tribunal. Section 1.03 of the said agreement is the clause authorising the execution and delivery of debentures up to 5,750,000 dollars as "A" series and up to 1,725,000 dollars as " B " series. The agreement required expending on the part of the company prior to the completion date not less than an amount in dollars equal to the aggregate principal amount of notes issued under the agreement for the purchase of goods and services of source and origin within the United States of America. Section 6.08 required the company to deposit the proceeds of the loans evidenced by the A Notes and the proceeds of the issuance and sale of the B Notes and any dollar proceeds of the issue of shares in the company in a special account to be maintained with the bank and maintain the said account until all funds deposited therein shall have been applied by the company in connection with the project and in accordance with the provisions of Section 6.07. The provision for payment of interest by the assessee-company to the lending company is contained in Section 2.04 under which each note shall bear interest on the unpaid principal amount thereof at the rate of 1/2% computed on the basis of 360 days a year of 12 months (30 days a month) and additional interest as provided by Section 6.05 of the agreement. The interest on each Note shall be payable semi-annually on the first day of January and July in each year, commencing with the first of such dates next following the issuance thereof and at maturity.

3. For the year ending March 31, 1969, the assessee filed a return admitting a net loss of Rs.

20,35,408 to be carried forward as business loss. The assessee claimed a total interest payment of Rs. 35,53,829 and claimed the loss to be carried forward, whereas the ITO was of the view that the total claim was not allowable because the company was still under construction and so the borrowing was only used for capital construction and not for business purposes. The learned counsel for the assessee then required the ITO at least to allow the interest paid for the same period for which interest had been received.

4. Accordingly, he worked out the net interest at Rs. 2,67,735. Adding further interest on the rupee capital, he determined the interest at Rs. 3,26,759 and deducting 20% of the salaries and other expenses as claimed and allowed in the preceding year amounting to Rs. 1,07,368 he fixed the final net income at Rs. 2,19,394. For the year 1970-71 also, he fixed the net interest at Rs. 6,97,428. As against that he allowed an expenditure of Rs. 66,350 which is 20% of the other expenses amounting to Rs. 3,31,750 and he also allowed 1/4th of the salaries of the finance and administration department amounting to Rs. 44,836 and thus the total expenditure allowed by him was Rs. 1,11,186. Finally, he fixed the net income at Rs. 5,86,242.

5. As against the said two orders of the ITO, the assessee went on appeal to the AAC claiming that the ITO should have allowed the entire interest amount and also the stamp fees and other expenses incurred in respect of the loan agreement and issue of debentures. However, the AAC dismissed the assessee's appeal observing that since the orders of the ITO got merged with the orders of the CIT, he would not be competent to pass any order on appeal against such orders of the ITO. The AAC happened to pass such an order because the Addl. CIT by that time had taken action under Section 263 of the I.T. Act, 1961, to revise the orders of the ITO for the assessment year 1969-70 and enhanced the assessment by a sum of Rs. 13,95,121 for the reason that allowance of proportionate interest and overhead expenses to the extent of 20% of the sums claimed as overhead expenses was erroneous and prejudicial to the interests of the revenue. He further held that the assessee would not be entitled to deduction under Section 57(iii) of the I.T. Act, 1961, since he was of the view that the payment of interest by the assessee to the lending bank had really no direct connection with the interest received and, therefore, the interest paid was in the nature of pre-production expenses and it related to the erection of the factory and purchase of capital goods and, consequently, it had no connection with the earning of interest income. Further, with regard to the first contention about the claim allowed, namely, 20% of the overhead expenses, he gave benefit of 5% and allowed only Rs. 26,481 as against Rs. 1,07,365 allowed originally by the ITO. For the assessment year 1970-71 also, he made a similar order on the same date, namely, 4th September, 1971, and directed enhancement of the assessment by Rs. 11,69,513 which comprised of Rs. 10,86,123, being interest to be disallowed, and Rs. 83,390, being the overhead charges to be disallowed.

6. The assessee then took up the matter in appeal to the Tribunal and there were four appeals, two against the orders of the AAC and two against the orders of the Addl. CIT. The main contention of the assessee's counsel before the Tribunal was that the interest amounts received on the deposits should not have been viewed in isolation but should have been considered as one transaction, namely, that it was part of the loan transaction. In other words, his contention was that the so-called deposits were required to be made only to lessen the liability and, therefore, there was only one transaction of the interest payment at the reduced figures. As against this, the contention of the

department was that there was no nexus between the borrowings and the deposits, as the borrowings were specifically for the purpose of erection of fertilizer plant and purchase of capital goods and the deposits were made only incidental thereto, and that, therefore, the earning of the interest had no nexus to the payment of interest. The further contention of the department was that since the business was not set up, the claim of expenditure should not be allowed as the same could not be considered as expenditure laid out for the purpose of business. The Tribunal by its order dated April 30, 1973, came to the conclusion that the assessee's claim of interest could be confined to the extent of the loans drawn and deposited under Section 57(iii) of the I.T. Act, 1961. It rejected the contention of the assessee's counsel that the interest paid should be allowed on the footing that even the act of borrowing and depositing was in the course of the business. While dealing with the claim made under Section 57(iii) of the I.T. Act, 1961, the Tribunal found that there was no dispute that all the borrowed funds had not been deposited to earn interest, and, therefore, it was of the view that the claim of deduction of entire interest payment could not arise and that only to the extent of the loans deposited, the claim of interest had to be limited. In its view, there was close nexus between earning of the interest and the payment of interest and, therefore, the interest paid by the assessee to the lending bank proportionate to the amount on which it earned interest had to be allowed under Section 57(iii) of the Act. With regard to the amount allowed to the extent of 5% by the Addl. CIT, as against 20% allowed by the ITO, the Tribunal held that 10% of the expenses could be said to be reasonable. It is this order of the Tribunal which has given rise to the two references before us.

7. The department applied for under Section 256(1) of the I.T. Act, 1961, and obtained a reference of the following question for the opinion of this court, which is the subject-matter of T.C. No. 392/74 :

> " Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in holding and had valid material to hold that proportionate interest payments should be deducted from the interest on bank deposits under Section 57(iii) of the Income-tax Act, 1961, and the taxable income from ' other sources ' determined for the assessment years 1969-70 and 1970-71 assessments ? "

8. The assessee also applied to the Tribunal and obtained a reference of the, following two questions for the opinion of this court, which are the subject-matter of T.C. No. 408 of 1974 :

> " 1. Whether, on the facts; and in the circumstances, of the case, the Tribunal was right in law in holding that the assessee had received any income during the previous years relevant to the assessment years 1969-70 and 1970-71 by depositing Dollar Funds with the Chemical Bank of New York ?
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> 2. Whether the Tribunal was right in law in holding that the interest on the dollar deposits was income from any source other than business so that the total interest paid by the assessee during the year was not a permissible deduction against such income ? "

9. Before we proceed to deal with these questions which are the subject-matter of these two references we shall make one position clear, namely, that the amount involved in the present references is the interest paid by the assessee to the Chemical Bank New York Trust Company on the borrowings made by it and that too is restricted to the amount which was deposited in a special account in the said bank under Section 6.08 of the agreement and which yielded interest income to the assessee. We are logically taking first the questions referred to this court at the instance of the assessee because if the assessee is to succeed with reference to those questions it will become unnecessary to consider the question covered by the other reference.

10. From what we have pointed out already, the stand of the assessee as embodied in the first question referred to this court is that the interest received by the assessee from the Chemical Bank New York Trust Company in respect of the amount deposited in a special account with that bank is not an income at all. We asked the learned counsel for the assessee to support that contention with reference to any authority, having regard to the fact that admittedly there was a deposit and admittedly there was receipt of interest by the assessee during the two years in question. The learned counsel for the assessee was not able to sustain the contention either on principle or on the basis of any authority. In view of this, we answer the first question in T.C. No. 408 of 1974 in the affirmative and against the assessee.

11. With regard to the second question, the only argument advanced by the learned counsel for the assessee was that during the two years in question, the assessee engaged in putting up the plant and that formed part of the carrying on of the business by the assessee and that, therefore, the interest income earned during the relevant years must be treated as business income. As we have pointed out already, the object of the assessee-company was to manufacture and market ammonia, urea and other complex fertilizers and this finds a place in the agreed statement of the case submitted to this court by the Tribunal. Equally admittedly the production of these had not been commenced till March 31, 1970. In such a context the question for consideration is, whether the interest received by the assessee from the bank can be said to be its business income at all. Setting up of a factory may be a preliminary step and it is an indispensable and essential step for the purpose of carrying on the business of manufacturing and marketing ammonia, urea and other complex fertilizers. But it cannot be said to be carrying on the business itself. Here again we asked the learned counsel for the assessee to substantiate the contention put forward by him with reference to any authority and the learned counsel frankly admitted that he could not lay his hands on any authority. In view of this, with regard to this question also, our answer is in the affirmative and against the assessee.

12. Then we take up the question which is the subject matter of T.C. No. 392 of 1974. For the purpose of answering the said question, it is necessary to refer to the language employed in Section 57(iii) of the I.T. Act, 1961, dealing with the computation of income under " other sources ". Section 57(iii) with which alone we are concerned states :

> " 57. The income chargeable under the head ' Income from other sources ' shall be computed after making the following deductions, namely :--...

(in) 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. "

13. It is with reference to this section that the Tribunal granted relief to the assessee. For this section to apply, the following conditions must be simultaneously satisfied :

(1) there must be an expenditure not being in the nature of capital expenditure ;

(2) such expenditure must be laid out or expended wholly and exclusively ; and (3) such expenditure must be laid out or expended wholly and exclusively for the purpose of making or earning such income.

14. If all these three requirements are not simultaneously satisfied, the provisions in this section will not be attracted. As far as the present case is concerned, we have to consider two crucial questions, namely :

(1) Whether the interest paid by the assessee to the Chemical Bank New York Trust Company was an expenditure laid out or expended wholly and exclusively in connection with the receipt of interest from the deposits in the special account with that bank ? and (2) Whether that expenditure was laid out or expended for the purpose of earning that interest ?

15. If neither of these requirements is satisfied, the assessee will not be eligible for the deduction which it claimed.

16. In our opinion, having regard to the facts of this case, as revealed from the terms of the agreement entered into between the parties which has been annexed to the statement of the case, these requirements are not satisfied. We have already referred to the fact that the contention of the assessee was that the deposit of the amount lent by the Chemical Bank New York Trust Company in the special account with that bank itself formed part of the same transaction and the earning of interest by the assessee from the deposit in the special account was not an independent transaction and that the interest was adjusted against the interest payable by the assessee to the bank with the result the assessee happened to pay a reduced interest than what it would have paid otherwise. The same contention was repeated before us and we are unable to agree with that contention.

17. We have already referred to Section 2.04 of the agreement dealing with the payment of interest by the assessees to the bank, that is, semi-annually. On the other hand, with reference to the deposit to be made by the assessee in a special account with the bank under Section 6.08, there is no provision with regard to the rate of interest payable as well as the periodicity of payment. The learned counsel for the assessee himself had to admit that the agreement itself did not fix the rate of interest or periodicity of payment with regard to such deposit. In such a context, it is impossible to accept the contention put forward by the learned counsel for the assessee that, under the terms of the agreement, the interest payable by the bank to the assessee with reference to the deposit in the special account was adjusted against the interest payable by the assessee to the bank and the

assessee had to make a smaller payment of interest, the whole thing constituting only a single transaction. It is clear from the language of Section 6.08 that the amount was borrowed only for the purpose of erecting the plant and for purchasing the capital goods and that till the money was utilised for the said purpose, the lending bank required the assessee to keep the money deposited with the said bank itself in a special account. There is no dispute that the amount was borrowed only for the purpose of putting up the plant and purchasing the capital goods and the investment of the money in the special account was only during the interregnum, that is, till the money was utilised for the purpose of putting up the plant or purchasing the capital goods. Therefore, the borrowing itself was not for the purpose of depositing the money and earning interest, but only for the purpose of putting up the plant and purchasing the capital goods. The interest paid on the amount so borrowed, therefore, cannot have any direct connection with the deposit of the amount in the special account and the earning of interest. Even assuming that the object of borrowing was not the sole object of putting up the plant and purchasing capital goods, but an intermediary object of depositing the same with the lending bank itself in a special account, still it cannot be held that the interest paid by the assessee to the bank was an expenditure laid out or expended wholly and exclusively for the purpose of earning interest from the deposit which the assessee had made in the special account. Therefore, we are of the opinion that with reference to the facts of this case, there is no direct connection between the payment of interest made by the assessee to the bank and the receipt of interest by the assessee from the same bank with reference to its deposit in the special account. It has to be noticed that the section has imposed two requirements to be simultaneously complied with, namely, the expenditure must be laid out wholly and exclusively for the purpose in question and the purpose in question must be the making or earning of income with reference to which the expenditure is claimed to have been incurred. On the facts to which we have drawn attention, it is clear that there is no direct nexus or connection between the payment of interest by the assessee on the loan which is received from the Chemical Bank New York Trust Company and the interest which it earned on the deposit made in the special account with the same bank.

18. Our attention was drawn to a few decisions bearing on the scope and construction of Section 57(iii) of the I.T. Act, 1961, corresponding to Section 12(2) of the Indian I.T. Act, 1922. A Bench of this court had occasion to consider the scope of Section 12(2) of the Indian I.T. Act, 1922, in CIT v. S. Devaraj [1969] 73 ITR 1 (Mad). At page 3 of the report, this court stated :

> " It seems to us that the scope of Section 12(2) presents not much difficulty, but its application to particular facts is a matter of nicety. Broadly speaking, income-tax is a charge not on gross receipts but on the net income. And so, allowance has been provided for in the Act, in the form of deduction, in the computation of the total income, or in the form of rebates. An examination of the provisions of the Income-tax Act, relating to such allowances, discloses that the expenditure or outgoing sought to be deducted should bear a character, which has a connection with, or relation to, the particular character of the activity which produces the income or constitutes its source. That, broadly, is the feature of the provisions providing for such allowance, but subject to that, there are additional limits or qualifications introduced in order to define as also to circumscribe the scope, character and eligibility of the allowance. It is only in this background that the true effect and ambit of the provisions relating to

> allowance as deduction can be fully appreciated. These provisions are found very often to use the expression ' for the purpose of ' in connection with the expenditure related to the activity that produces or out of which income is produced. These words servers a sort of a bridge and requirement of nexus between the character of the expenditure and the character of the activity which produces or out of which income is produced. "

19. After elaborately referring to the basis underlying these statutory provisions, the Bench contrasted the scope of Section 10(2)(xv) of the Indian I.T. Act, 1922, corresponding to Section 37 of the I.T. Act, 1961, with that of Section 12(2) of the Act of 1922, and observed as follows (p. 8) :

> " From what we have stated, it follows that Section 12(2) is narrower in scope than Section 10(2)(xv) but the narrowness lies in this that whereas under the former provision the expenditure should be for the purpose of the business, profession or vocation, under the latter provision, an expenditure to qualify for deduction should be for the purpose of making or earning such income, profits or gains which is undoubtedly a narrower concept than ' business ', the scope of which would include the earning of income, profits or gains. For Section 12(2) to apply, the following requisites should, therefore, be satisfied. The expenditure should not be in the nature of a capital expenditure. That means, the expenditure is not intended or does not operate to create the source of income or add to it, but it should be of a revenue character as in the course of or for the purpose of maintenance of the source. The expenditure should have been actually incurred as indicated by the word 'incurred' in Section 12(2). The expenditure should also be solely for the purpose of making or earning such income ", [It is relevant to point out that Section 12(2) of the Indian Income-tax Act, 1922, used the expression 'solely', while Section 57(iii) of the Income-tax Act, 1961, uses the expression ' wholly and exclusively '] " that is to say, if the purpose of the expenditure is a mixed one, it will take it outside the scope of Section 12(2). The word ' solely ' has the same sense as the words ' wholly and exclusively' in Section 10(2)(xv). Further, by the use of the words ' for the purpose of, it is obvious that there must be a nexus between the character of the expenditure and earning of income, profits or gains. If the expenditure is not for that purpose, or is unrelated to or unconnected with the activity of earning such income, profits or gains, it will not be allowed as a deduction. These requisites are no doubt more easily stated than applied to particular circumstances."

20. The Gujarat High Court had occasion to consider the scope of Section 57(iii) of the I.T. Act, 1961, in Smt. Padmavati Jaykrishna v. CIT [1975] 101 ITR 153. In that case, the assessee borrowed monies for the purpose of discharging tax liabilities which included investment in annuity deposit and claimed to deduct the interest payable on the loan from the interest and dividends which she earned. The Gujarat High Court held that the asses-see was not entitled to the said deduction. The Bench very elaborately considered the scope of Section 57(iii) of the I.T. Act, 1961, and pointed out the significance of the word "purpose" occurring in the section and distinguished the same from the word " motive " and held that money was not borrowed and interest was not paid for the purpose of

earning income by way of dividend and interest on the annuity deposit.

21. The scope of Section 57(iii) of the I.T. Act, 1961, came to be considered by this court as well as the Supreme Court in another case. The decision of this court is K. Mahesh v. CIT [1968] 70 ITR 240. In that case the claim of the assessee to deduct the wealth-tax paid by him under Section 57(iii) of the Act came to be considered. This court held (p. 244) :

> " We find it difficult to hold that the wealth-tax was paid by each of the assessees in these cases as incidental to making or earning of income. In a sense it may be that in order to preserve the total net assets, the asses-see has to pay wealth-tax and that without such assets there can be no question of making or earning the income. But these facts do not establish the nexus required for the expenditure by way of wealth-tax to be a permissible deduction. The connection, if any, of the expenditure by way of wealth-tax with the assessee's making or earning the income appears to be too remote. The expenditure, in order to be a permissible deduction, should be directly connected with the purpose of making or earning of income, for, otherwise, it cannot be said that the expenditure is for the purpose of making or earning income."

22. By the time the matter was taken up to the Supreme Court, whose decision is T. S, Krishna v. CIT [1973] 87 ITR 429, the Act itself had been amended by expressly providing for the non-deductibility of wealth-tax in the computation of income under the head " other sources ". However the Supreme Court observed (p. 436) :

> " Even apart from the amendment disallowing the deduction, the very nature of the income from the dividends in respect of which deduction of wealth-tax is claimed does not, as pointed out by the High Court, bear any relationship direct or incidental to the earning of that income and cannot therefore be said to be laid out or expended exclusively for the purpose of making or earning such income within the meaning of Sub-clause (iii) of Section 57 of the Act or under the corresponding provisions of Section 10(2)(xv) of the Indian Income-tax Act, 1922."

23. However, Mr. Uttam Reddi, learned counsel for the assessee, relied on a decision of the Bombay High Court in Kevalckand Nemchand Mehta v. CIT [1968] 67 ITR 804. In that case Kevalchand withdrew from his account with a firm Kapurchand and Company a sum of Rs. 3,75,000 on 16th December, 1955, and on the same date he deposited the said amount with M/s. Kapurchand Ltd. in the name of his minor son to whom he gifted the said amount. With reference to the interest received in respect of the said deposit, Kevalchand claimed to deduct the interest payable by him on the amount of Rs. 3,75,000 borrowed for the purpose of making the gift to his minor son. The Tribunal rejected the claim, but when the matter was taken up to the High Court, the High Court allowed the claim. The Tribunal had stated in that case (p. 807) :

> " In our opinion, in deciding this point, we have only to look to the purpose of the borrowing by the assessee at the time when the borrowings were made. That purpose was simply to make the gift to his minor child. The fact that the minor child

> subsequently invested the amount with another concern and earned income thereon, which interest in turn was included in the income of the assessee, is in our opinion, too remote to be taken into consideration. We would, therefore, hold that as the amount in question was borrowed or withdrawn for the purpose of making a gift and as the gift was actually made and the assessee ceased to be the owner of the amount in question, he was not entitled to a deduction of the interest paid by him on the borrowing of the amount against the amount of interest which was included in his total income by virtue of the provisions of Section 16(3). This contention of the assessee, therefore fails.".

24. From the above passage, it is clear that the Tribunal decided two questions. One was, the assessee not being the owner of the income, whether he was entitled to claim the interest paid by him as a deduction and the second was, whether, in any event, Section 57(iii) of the I.T. Act, 1961, applied to the claim for deduction made by him. We are here concerned only with the latter question and while considering that question the Bombay High Court elaborately referred to the significance of the word " purpose " occurring in Section 12(2) of the Indian I.T. Act, 1922, and pointed out that the Tribunal failed to bear in mind the distinction between "purpose" and " motive ". Having said so, the court held (p. 817) :

> " We hold that, upon all the facts and circumstances of the present case, the assessee deposited the amount Rs. 3,75,000 with Kapurchand Ltd., solely for the purpose of earning an income from such deposit. His motive may have been to help his son or to provide an income for his son but the purpose was to earn the income from the amount. In that view, the necessary condition for the grant of the allowance contemplated in Section 12(2) was fulfilled and the assessee would be entitled to set off the interest paid to the firm, Kapurchand & Co., against the interest earned from Kapurchand Limited."

24. We are of the opinion that the above decision is not of any assistance to support the case of the assessee in the present case. With great respect to the learned judges, we have to point out that notwithstanding the elaborate discussion and references to the consideration of the relevant statutory provision in other decisions, the learned judges had failed to consider the very question which they were seeking to consider. From the extract from the judgment which we have given above, it is clear that the learned judges were connecting the deposit made by Kevalchand with the income received from such deposit. However, for the purpose of the applicability of Section 12(2) of the Indian I.T. Act, 1922, or Section 57(iii) of the I.T. Act, 1961, what has to be correlated or connected is not the deposit with the income received from such deposit but the earlier borrowing and the payment of interest thereon with the subsequent earning of interest from the deposit. That question the learned judges had not considered in the conclusion which they had recorded in the passage which we have extracted. In view of this, the above decision cannot be said to be of any assistance to the assessee to sustain its claim in the present case.

25. Under these circumstances, we answer the question referred to this court in T.C. No. 392 of 1974 in the negative and against the assessee.

26. The department will be entitled to its costs of these references. Counsel's fee Rs. 500 (Rupees five hundred only), one set.