HIGH COURT OF ALLAHABAD

Commissioner of Income-tax-I, Lucknow

v.

Sahu Enterprise (P.) Ltd.*

DEVI PRASAD SINGH AND DR. SATISH CHANDRA, JJ.
IT APPEAL NOS. 43 OF 2006 AND 55 & 112 OF 2005†
FEBRUARY 20, 2013

JUDGMENT

Dr. Satish Chandra, J. - All the appeals have been preferred by the department under Section 260-A of the Income Tax Act against the judgment and orders dated 10.11.2004; 28.02.2005; and 27.05.2005 passed by the Income Tax Appellate Tribunal, Lucknow Bench, Lucknow in ITA Nos 1446/All./1998 (A.Y. 1995-96); 258/All./2000 (A.Y. 1995-960); and ITA No.176/Luc./2001 (A.Y. 1997-98).

2. Income Tax Appeal No.55 of 2005 was admitted by this Court vide its order dated 04.07.2005 on the following substantial questions of law framed at Sl. No. 1 to 4:

1. Whether on the facts and in the circumstances of the cases, the leaned Income Tax Appellate Tribunal was justified in deleting the disallowance of equivalent of interest on borrowed capital which was debit balances existing in the names of directors and their family members, on the ground that no such disallowance was made by the assessing officer in the assessment years 1991-92 & 1992-93 while ignoring that the omission on the part of the assessing officer to add back the same in the preceding year will not preclude the assessing officer to add back the same on the basis material available on record.
2. Whether the learned Income Tax Appellate Tribunal was justified in deleting the disallowance of interest on borrowed capital by the assessing officer on the basis of material available on record merely because the same was not added back to the income of the assessee by the assessing officer in the preceding years.
3. Whether on the facts and in the circumstances of the cases, the ITAT was justified in confirming the order of the CIT (A) in allowing the interest of Rs. 8,11,335/- claimed by the assessee on the borrowed funds even though there is strong evidence of linking these funds with withdrawals for non-business purposes.
4. Whether on the facts and in the circumstances of the cases, the ITAT was justified in holding that the heavy personal withdrawals made by the lineal ascendent of the directors in the past will not be construed as adverse evidence for the purposes of disallowance of proportionate interest on borrowed funds merely because the erstwhile proprietorship of such lineal ascendant has since been converted to a private limited company and the said debit balance of such lineal ascendants have got split in the names of various legal heirs.

3. Income Tax Appeal No. 112 of 2005 has been admitted vide order dated 28.09.2005 on the following substantial questions of law:

1. Whether on the facts and in the circumstances of the case, the leaned Income Tax Appellate Tribunal was justified in confirming the order of the CIT (Appeals) in allowing the interest payments totalling Rs. 12,67,462/- claimed by the assessee on the borrowed funds even though there is evidence of linking funds with withdrawals for non-business purposes.
2. Whether on the facts and in the circumstances of the case, the leaned Income Tax Appellate Tribunal was justified in deleting the disallowance of equivalent of interest on borrowed capital to the debit balances existing in the names of directors on the ground that no disallowance was made in the assessment year 1991-92 & 1992-93 ignoring the fact that omission on the part of the assessing officer in particular years will alone not become ground for relief in a case where Assessing Officer has given concrete material to make the disallowance.
3. Whether on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal was justified in holding that the heavy personal withdrawals made by the lineal ascendent of the directors in the past will not be construed as adverse evidence for the purposes of disallowance of proportionate interest on borrowed funds merely because the erstwhile proprietorship of such lineal ascendant has since been converted to a private limited company and the said debit balance of such lineal ascendants have got split in the names of various legal heirs.

4. Similarly, the Income Tax Appeal No. 43 of 2006 was admitted by this Court vide order dated 05.02.2008 on the following substantial questions of law.

1. Whether on the facts and in the circumstances of the case, the leaned ITAT was justified in deleting the disallowance of equivalent of interest on borrowed capital to the debit balances existing in the name of Directors on the ground that no disallowance was made in the assessment year 19AFR91-92 & 1992-93 while placing reliance on its decision in the case of the assessee for the Assessment Years 1995-96 and 1996-97, ignoring the facts that the omission on the part of the Assessing Officer in particular years will alone not become ground for relief in a case where Assessing Officer has given concrete material to make the disallowance?.
2. Whether on the facts and in the circumstances of the case, the leaned ITAT was justified in confirming the order of CIT (Appeals) in allowing the interest of Rs.10,09,000/- claimed by the assessee on the borrowed funds even though there is evidence of linking; these funds with withdrawals for non-business purposes ?

5. In all the Appeals, the facts and circumstances are identical. Hence, all these appeals are decided by this common judgment for the sake of convenience.

6. In all the questions admitted by this Hon'ble Court, the issue is only one i.e. pertaining to interest free advances given to the family members and Director of the assessee company.

7. Sri D. D. Chopra assisted by Sri Ghanshyam Chaudhary learned counsel for the appellant-department submits that in all the assessment years under consideration, the assessee has shown the following loss in its return:

Appeal Number	*A.Y*	*Loss Amount*
1. 55/2005	1995-96	Rs.2,03,560/-

2.	112/2005	1996-97	Rs.3,74,870/-
3.	43/2006	1997-98	Rs.6,19.750/-

Learned counsel further submits that in the assessment year 1995-96, the assessee has shown interest free advance on amount of Rs.40,56,770/- to its family members and a few of them are the Directors in the assessee company. As per the details given in paragraph 14 for the assessment order for the year 1995-96, interest free advances were given. The recovery of the above mentioned amount was not doubtful. In other words, the loan is not a bed debt.

8. He further submits that with the advances in question, a few Directors have constructed the residential houses, which were never used by the Company. No commercial exploitation of the said building was made out. The other Directors have also used funds for their personal purposes, which has no connection with the business activity of the Company.

9. Learned counsel further submits that if the interest free advances had not been given to the Directors and relatives, then certainly proportionately borrowing was not required or the interest paid on the borrowing could have been saved. During the assessment years under consideration, loss might have not been incurred or it might have been reduced. So, he submits that the additions made by the A.O. are justifiable. For this purpose, he relied on the ratio laid down in the cases of *Indian Savings Product Ltd.* v. *CIT* [2004] 265 ITR 250/[2003] 133 Taxman 75 (Raj.), Rajasthan where it was observed that when the assessee did not have its own funds sufficient even to run its business and was running in huge losses and had borrowed huge amounts on interest and gave advances to its subsidiaries free of interest for the purpose of shares, dis-allowance of interest paid by it to financial institution on borrowed money was justified.

10. Learned counsel also relied on the ratio laid down in the case of *CIT* v. *Narendra Mohan Paliwal* [2004] 271 ITR 347/140 Taxman 94 (Raj.) where it was observed that if the assessee was paying interest on borrowing and had advances loan to his wife at nominal rate of interest, the dis-allowance out of interest paid as justified even when no fresh loan had been raised for making such advances. Lastly, he made a request to set aside the order passed by the Tribunal.

11. On the other hand, Sri Ashish Bansal holding brief of Sri S.K. Garg, learned counsel for the assessee submits that the amount shown in the debit balance of the Directors and their relatives is an old amount and the issue had been examined by the authorities below for the earlier assessment year 1991-92 and 1992-93.

12. Learned counsel further submits that up to 14.04.1983, the business was run by late Sri S. N. Sahu in his propriety set up in the name of "Sahu Theater". During his life time, there was heavy loss, so late Sri S. N. Sahu made the withdrawals from his business and on his death, debit balance in his capital amount was distributed amongst his legal heirs. After the death of late Sri S. N. Sahu, the business was taken over by partnership firm namely "Ms/ Sahu Enterprises" and the said debit balances were reflected in the name of legal heirs and family members in the balance sheet. In the year 1991-92, the business was taken over by the respondent company with all the assets and liabilities. Hence, these debit balances appeared in the balance sheet of the respondent-company. He further submits that the A.O. has made the wrong addition for the assessment year 1995-96 of Rs. 8,11,355/- on the total interest free advance of Rs. 40,56,770/-. But, the CIT (A) has deleted the said amount. The Tribunal also upholds the order of the First Appellate Authority.

13. Learned counsel further submits that it is undisputed that the respondent company had not given or used the borrowed money for non-business purposes. These debit balances were coming from last several years, which were on account of losses and withdrawals incurred by Late Sri S. N. Sahu, who was running the business as his proprietorship. After the said business was taken over by the partnership firm M/s Sahu Theater, these debit balances continued to appear in the account of the legal heirs and

relatives. The respondent company has taken over the business from the partnership firm along with all the assets and liabilities. So these debit balances continued to appear in the balance sheet. Thus, no borrowed funds were given to the Directors and relatives. It is a well settled law that any amount of interest paid in respect of the capital borrowed for the purposes of the business or profession, the same is to be allowed as deduction while computing the business income. He relied on Section 36 (1)(iii) of the Income Tax Act. The same reads as under:

> "36(1). The deduction provided for in the following clause shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28-"
>
> (*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 or 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].

14. It is settled principle of law that resjudicata does not apply to Income Tax proceedings as each assessment year is the diffident unit of assessment and what is decided in one year may not apply in the following years, but where a fundamental aspects and facts are permeating through different assessment years and has been found to be correct, then the same cannot be changed in subsequent years. In recent decision this Hon'ble Jurisdictional High Court in the case of *CIT* v. *Goel Builders* [2010] 192 Taxman 28 (All.) after considering the various judgments available on this subject, has summarized the rule of consistency in the following manner. :

> "Law merges after considering various pronouncements of Hon'ble Supreme Court and other High Courts is that the principle of consistency is a rule in general but for cogent reasons or on justifiable ground, the revenue has got right to depart from its earlier practice and take a different view which shall be determined upon the facts and circumstances of each case. While departing from earlier practice, the revenue cannot act mechanically without applying its mind to earlier facts and circumstances under which a view was taken by the taxman and the facts and circumstances of the assessment year in question calling to depart from earlier view.
>
> Where there is a fundamental aspect permeating through different assessment years allowed by the authorities to sustain, it would not be appropriate to change the view in subsequent year except on justifiable ground like change of circumstances or non-consideration of relevant material or statutory provisions, or failure on the part of assessing or appellate authority to exercise jurisdiction for extraneous reason or small amount of revenue involved or other justifiable ground depending on facts of each case."

15. Thus, the aforesaid principle of 'Rule of Consistency' is squarely applicable as there is no change of circumstances or new material on record to show that dis-allowance of interest on debit balance coming from earlier years should be made out of interest paid during the year on the borrowed funds utilized for business purpose. Lastly, he made a request to dismiss the present appeals.

16. We have heard both the parties at length and gone through the material available on record.

17. It is undisputed that the interest free advances were given to the Directors and relatives who have used the said amount for their personal purposes. A few Directors have constructed the house(s), which was never used for the purpose of the Company. The said house and advances were used exclusively for personal purpose. On the other hand, the Company has borrowed the funds from the market @20% interest.

18. From the record, it appears that interest free borrower i.e. Directors and relatives have not made any attempt to repay the loan to the company, but the fact remains that the loan was never treated/shown as bed debt.

19. It may be mentioned that in the case of *Indian Savings Product Ltd.* (*supra*), Hon'ble Rajasthan High Court has held that when the interest free loan to its subsidiaries was not for the purpose of business, then there was no justification to pay the huge amount of interest on the borrowing and advance to loan to its subsidiaries free of interest.

20. The Hon'ble Apex Court in the case of *S.A. Builders Ltd.* v. *CIT* [2007] 288 ITR 1/158 Taxman 74(SC) observed that

> "in order to decide whether interest on funds borrowed by the assessee to give an interest free loan to a sister concern (e.g., a subsidiary of the assessee) should be allowed as a deduction under section 36(1)(iii) of the Income-Tax Act, 1961, one has to inquire whether the loan was given by the assessee as a measure of commercial expediency. The expression "commercial expediency" is one 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 business expenditure if it was incurred on grounds of commercial expediency.
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> Decisions relating to section 3 will also be applicable to section 36 (1) (iii) because in Section 37 also the expression used is "for the purpose of the business". "For the purpose of business" includes expenditure voluntarily incurred for commercial expediency, and it is immaterial if the third party also benefits thereby.
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> Atherton (*H.M. Inspector of Taxes*) v. *British Insulated And Helsby Cables Ltd.* [1925] 10 Tc 155 (HL), *Eastern Investments Ltd.* v. *CIT* [1951] 20 ITR 1 (SC); [1951] 21 Comp Cas 194 (SC) and *CIT* v. *Chandulal Keshavlal & Co.* [1960] 38 ITR 601 (Sc) Followed:
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> The Expression "for the purpose of business" is wider in scope than the expression "for the purpose of earning profits".

In the case of *CIT* v. *Malayalam Plantations Ltd.* [1964] 53 ITR 140 (SC) and *CIT* v. *Birla Cotton Spg. & Wvg. Mills Ltd.* [1971] 82 ITR 166 (SC) it was observed that :

> "To consider whether one should allow deduction under section 36(1)(iii) of interest paid by the assessee on amounts borrowed by it for advancing to a sister concern, the authorities and the courts should examine the purpose for which the assessee advanced the money and what the sister concern did with the money. That the borrowed amount is not utilized by the assessee in its own business but had been advanced as interest free loan to its sister concern is not relevant. What is relevant is whether the amount was advanced as a measure of commercial expediency and not from the point of view whether the amount was advanced for earning profits.
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> Once it is established that there was nexus between the expenditure and 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 his profits."

21. Needless to mention that Section 36 (1) (iii) of the Income Tax Act provides for deduction of interest of loan raised for business purposes. Once the assessee claimed any such deduction in the books of account, the onus will be on the assessee to satisfy the Assessing Officer that whatever loans were raised by the assessee were used for business purposes. If in the process of examination of genuineness of such

a deduction, it transpires that the assessee had advanced certain funds to sister concerns or any other person like relatives, directors without any interest, there would be a very heavy onus on the assessee to discharge before the Assessing Officer to the effect that in spite of pending term loans and working capital loans on which the assessee is incurring liability to pay interest, there was justification to advance loans to sister concerns for non-business purposes.

22. In the instant case, the assessee company was not having its own capital. It has borrowed the funds from the market on interest @ 20%. Thus, the assessee has paid heavy interest and the returns were filed by showing loss.

23. On the other hand, the Directors (Brain of the Company) made no attempt to repay the loan. Had they paid the interest free loan, proportionately, borrowing liability might have been reduced. The Company has not acted as a prudential businessman as per the ratio laid down in the cases of *Voltamp Transformers (P) Ltd.* v. *CIT* [1981] 129 ITR 105/5 Taxman 253 (Guj.); and *CIT* v. *Walchand & Co. (P.) Ltd.* [1967] 65 ITR 381 (SC) where it was observed that yardstick will have to be taken from the businessman point of view but the businessman must be a prudent businessman.

24. It may also be mentioned that corporate veil could be lifted to ascertain the true utilization of the borrowed funds as per the ratio laid down in the case of *CIT* v. *Indian Express Newspapers (P.) Ltd.;* [1999] 238 ITR 70/104 Taxman 575 (Mad.). In the case of *CIT* v. *Motor General Finance Ltd.* [2002] 254 ITR 449/122 Taxman 447 (Delhi), it was observed that a finance company would not grant any interest free loan. Similarly, in the case of *Saraya Sugar Mills (P.) Ltd.* v. *CIT* [2000] 246 ITR 509/[2002] 120 Taxman 411 (All.), Hon'ble Allahabad High Court observed that part of interest paid to the Bank could be disallowed to the extent to which money had not been utilized for the purpose of business. The disallowance should be paid by calculating the amount of interest at the same rate at which interest was paid by the Company on the loans borrowed.

25. In the case of *CIT* v. *Sujanni Textiles (P.) Ltd.* [1997] 225 ITR 560 (Mad.), the Madras High Court observed that interest paid by an assessee on borrowed funds, which were used for non business purposes, cannot be allowed under section 36 (1)(iii) of the Income Tax Act, 1961.

26. Thus, it appears that nothing is available from the record that advances/loan without interest were ever given for business purposes. It was for the personal use of Director or family members and after obtaining the loan/advances, the borrower never made any effort to repay the loan amount nor did the assessee company made any effort to recover the said loan from the borrower. In fact assessee company allowed its Director and family members to use its funds for their personal benefits. This cannot be intention of the statute which allowing the payment interest on borrowed funds for business purpose under section 36 (1)(iii) of the Act. Therefore, the interest on borrowed funds can not allowed for a longer period even the funds are not being used for the business purpose.

27. In view of above discussion and by considering the totality of the peculiar facts and circumstances of the case, it is established that the borrowed funds on interest will have to be utilized only for the purposes of business. But in the case in hand, it was not done so. Had the Directors or relatives have repaid the loan to the Company, certainly proportionate borrowing liability might have been reduced. It makes no difference that the loan was borrowed in the earlier assessment years. The principle of *res judicata* is applicable as per the ratio laid down in the following cases:

1. *CIT* v. *Brij Lal Lohiya* [1972] 84 ITR 273 (SC)
2. *M.K. Mohd*. v. *CIT* [1973] 92 ITR 341 (Ker.)
3. *J. K. Oil Mills Ltd.* v. *CIT* [1976] 105 ITR 53 (All.)

28. Further, in the case of *Radha Swami Satsang* v. *CIT* [1992] 193 ITR 321/60 Taxman 248 (SC), the

Hon'ble Supreme observed that where a fundamental aspect permitting through the different assessment years had been found as a fact, one way or the other and parties have allowed that decision to be sustained by not challenging the order, it would not be at all to appropriate to allow the decision to be changed in the subsequent orders, but in the instant case, it is evident that borrowers i.e. Director and relatives have made no attempt to repay the amount. They utilized the interest free advances for their personal purposes, which has no connection with the business activity of the Company. In other words, the funds were utilized for the purpose of non-business purposes. At the same time, a huge amount has been borrowed @ 20% interest. No attempt was made to reduce the said borrowing.

29. The Commercial expediency would include such purpose as is expected by the assessee to advance its business interest and may include measures taken for preservation, protection or advancement of its business interests. The business interest of the assessee has to be distinguished from the personal interest of its directors or partners, as the case may be. In other words, there has to be a nexus between the advancing of funds and business interest of the assessee. The appropriate test in such a case would be as to whether a reasonable person stepping into the shoes of the directors/partners of the assessee and working solely in the interest of the assessee, would have extended such interest free advances. Some business objective should be sought to have been achieved by extending such interest-free advance when the assessee itself is borrowing funds for running its business. It may not be relevant as to whether the advances have been extended out of the borrowed funds or out of the mixed funds, which included borrowed funds. The test to be applied in such cases is not the source of the funds but the purpose for which the advances were extended.

30. In the light of above discussion, we set aside impugned order passed by the Tribunal and restored the order passed by the assessing officer in this regard for the assessment years mentioned above.

31. In the result, all the appeals filed by the department are allowed.