IN THE INCOME TAX APPELLATE TRIBUNAL
RAJKOT BENCH, RAJKOT

Before Shri A.L. Gehlot (AM) and Shri D.T. Garasia (JM)

I.T.A. No. 552/Rjt/2008
(Assessment year 2005-06)

M/s Woodman Trading Co Pvt Ltd Plot No.573, Galpadar Road Gandhidham PAN : AAACW3815G	vs	the ITO (OSD) Gandhidham
(Appellant)		(Respondent)

Appellant by : Shri MP Sarda
Respondent by: Shri Avinash Kumar

O R D E R

A.L. Gehlot : This is an appeal filed by the assessee and is directed against the order of the CIT(A)-II, Rajkot dated 29-09-2008 for the assessment year 2005-06. The ground raised in the appeal is that the CIT(A) erred in sustaining disallowance of Rs.3,99,452 out of the interest expenses.

2. During the assessment proceedings, the assessing officer noticed that the assessee has given advance free loans of Rs. 3,84,000 to different parties for which he did not charge any interest whereas the assessee has claimed interest expenses u/s 36(1)(iii) of the Act. The assessing officer was of the view that interest to the extent of those parties from whom interest has not been charged is disallowable. He accordingly calculated by applying 12% of the interest rate at Rs.3,99,452 and the same was added to the total income.

3. The CIT(A) confirmed the order of the assessing officer as under:

> "3.2 I have considered the arguments of the A.O. as well as A.R. carefully. With due respect, I wish to differ from the decision of Ahmedabad ITAT in the case of Torrent Financers. In the appellant's case, ther A.O. tried to create direct link between interest-borne loans and interest-free advances. But, as per the

> appellant, it had sufficient interest-free funds, including adequate reserves to cover interest-free advances. Here, it is pertinent to draw the support from the Apex Court's decision in the case of S.A. Builders Ltd Vs. CIT(A)_(2007) 288 ITR 1. The Supreme Court clearly said that in order to decide whether interest on funds borrowed by the assessee given as an interest-free loan to be allowed as a deduction u/s 36(1)(iii) of the Act, one has to inquire whether the loan was given by the assessee as a measure of commercial expediency and also for the purpose of business. It further said that the authorities and courts should examine the purpose for which the assessee advanced the money and what the recipient did with the money. In this instant case, the appellant advanced interest-free loans to its relatives and friends and the appellant failed to prove that the advancement involved any logical grounds of commercial expediency. The A.R. also failed to elaborate how these friends and relatives utilized the said loan amounts purposefully. As the appellant failed to provide nexus between the expenditure and the purpose of business, I have no other go, except upholding the proportionate disallowance of interest is to be upheld."

4. The ld.AR submitted that it was contended before the assessing officer and CIT(A) by the assessee that the assessee was having sufficient own fund out of which the assessee has given the interest free advances. He submitted that the assessee before the CIT(A) assessee cited decision of ITAT, Ahmedabad Bench in the case of Torrent Financers 73 TTJ (Ahd) 624 and M/s Choice Impex vs ITO (unreported) and SA Builders vs CIT 288 ITR 1 (SC) which were not found favour with the CIT(A). The learned AR also relied upon order of the ITAT in the case of Dy.CIT vs. HP Shah & Co ITA No.3694/Mum/2006 order dated 15-01-2009. The ld.DR, on the other hand relied upon the order of the CIT(A).

5. We have heard the learned representatives of the parties, record perused. The CIT(A) while upholding the order of the assessing officer observed that he want to differ from the decision of Ahmedabad ITAT in the case of Torrent Financers (supra). At the cost of repetition the relevant observations of the CIT(A) reproduced below:

"With due respect, I wish to differ from the decision of Ahmedabad ITAT in the case of Torrent Financers."

The above observations made by the CIT (A) are not warranted in judicial discipline. Here we would like to mention that the principles of judicial discipline require that the orders of higher appellate authorities should be followed by the subordinate authorities otherwise; entire judicial system would lead to chaos. In this regard we would like to refer following observations of Hon'ble Delhi High Court in the case of Nokai Corporation V. Director of Income tax (International Taxation) [2007] 162 Taxman 369 (Delhi).

> ***"12.*** *The Supreme Court stated, many years ago, in Union of India v. Kamlakshi Finance Corpn. Ltd. [1991] (55) ELT 433 as follows :*
>
> *"...The principles of judicial discipline require that the orders of the higher appellate authorities should be followed unreservedly by the subordinate authorities...." (p. 436)*
>
> *It was further observed by the Supreme Court that if the order of an appellate authority is the subject-matter of further appeal, that cannot furnish any ground for not following it, unless its operation has been suspended by a competent Court. The Supreme Court went on to say that if this healthy rule is not followed; the result will not only be undue harassment to assessees but chaos in the administration of tax laws.*
>
> ***13.*** *In CIT v.Ralson Industries Ltd. [2007] 2 SCC 326, the Supreme Court held :—*
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> *"9. When an order is passed by a higher authority, the lower authority is bound thereby keeping in view the principles of judicial discipline...." (p. 330)*
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> *The Supreme Court drew support from Bhopal Sugar Industries Ltd. v. ITO [1960] 40 ITR 618 wherein it was held :*
>
> > *"If a subordinate Tribunal refuses to carry out directions given to it by a Superior Tribunal in the exercise of its appellate powers the result will be chaos in the administration of justice...." (p. 622)*
>
> *It was further observed in Bhopal Sugar Industries Ltd.'s case (supra) :*
>
> *"...The Judicial Commissioner was not sitting in appeal over the Tribunal and we do not think that, in the circumstances of this case, it was open to him to say that the order of the Tribunal was wrong and, therefore, there was no injustice in disregarding that*

order. As we have said earlier, such a view is destructive of one of the basic principles of the administration of justice." (p. 623)

14. *Similarly, in Triveni Chemicals Ltd. v. Union of India [2007] 2 SCC 503, the Supreme Court reiterated the principle that adjudicating authorities are bound by the doctrine of judicial discipline."*.

5.1. On merit, we find that the issue is squarely covered by the detailed order of the ITAT in the case of Dy.CIT vs HP Shah & Co ITA No.3694/Mum/2006 order dated 15-01-2009 wherein various relevant judgments of the Apex Court, High Courts and ITAT are considered. The relevant finding is reproduced below:

"4. We have heard the learned representatives of the parties and perused record. The crux of the matter to be considered by us is in respect of allowability of interest expenditure under section 36(1)(iii) of the Act where interest bearing borrowed funds and own capital has lost it's separate identity as both are mixed. Section 36 of the Act occurs in Chapter IV which deals with the computation of total income and it is a provision which relates to the computation of income earned under the head "Profits and gains of business or profession". The deduction contemplated by the section is in relation to the expenditure which could properly be regarded as necessary for the purpose of the business or profession. Expenditure incurred on account of commercial expediency for the purpose of business would be allowable under this provision. The expenditure to be allowed must have a nexus with the business of the Assessee. If the expenditure incurred is ostensibly incurred for the business, but if in reality is not for the purpose of business then such expenditure is not allowable.

4.1 Section 36(1) (iii) of the Act refers to "the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession". The capital borrowed should be for the purposes of the

business or profession. It is implicit in this provision that the capital so borrowed should not only be invested in the business, but that the amount borrowed should continue to remain in the business. So long as the amount borrowed is used in the business, the interest paid on such borrowing is an expenditure which is required to be deducted in the computation of the income from the business. The interest payable on the capital borrowed is a liability which continues till such time as the amount borrowed is repaid. Such interest is allowable under the provision only for the reason that the amount on which interest is paid continues to be used in the business and the payment of such interest is, therefore, necessary for the purpose of running the business.

4.2 The object of the provision is not to enable an assessee to make a large borrowing and create a liability for payment of interest thereon not only in the year in which the borrowing was made, but the subsequent years as well, keep the loan outstanding and thereafter, divert the amount borrowed by taking it out of the business by giving it interest-free to others like sister concerns and relatives or for personal use., but continue to pay interest out of the income of the business and claim the amount of interest paid as a business expenditure. The payment of interest on the amount not used in the business cannot be regarded as a business expenditure as the business does not derive any benefit by the outgoing by way of interest on an amount which is no longer in the business, but had been diverted from the business. This provision, therefore, cannot be construed as enabling an assessee to burden the business with interest even while taking the amount initially borrowed for the business, but subsequently taken out of the business by diverting it as interest-free loans to sister concerns and relatives or for personal use.

4.3 The amount borrowed for the business remains a liability for the business till its discharge. The fact that the amount borrowed may have been invested in the purchase of machinery or utilised as working capital or used in any other way does not in any way affect the liability for repayment of the amount borrowed. So long as the money borrowed is used in the business, interest paid on such borrowing is a proper charge on the business and is allowable as expenditure. Under section 36(1)(iii) of the Act, amounts diverted not being used for the purposes of the business, interest relating to the amount diverted out of the business cannot be treated as a permissible deduction in the computation of income. On many occasions the assessee take stand that once the amount borrowed is found to have been used for some time in the business, then subsequent diversion is of no consequence, but such stand of the assessee cannot be accepted. The legislative language of sec. 36(1)(iii) of the Act is very as clear expression "borrowed for the purpose of the business" is used. The amount borrowed must continue to be used for the purposes of the business and the fact that it was used for some point of time, but later diverted would not entitle the assessee to claim the interest paid on the borrowing as a deduction under sec.36(1)(iii) even after such diversion. In cases where diversion occurs immediately after the borrowing and the borrowed amounts are not invested in the business at all, but diverted for other purposes, then there should not be any cloud of doubt that interest paid on such borrowed amounts is not allowable deduction. The factum of deferment, in cases where such diversion of funds from the business is clearly established from the facts on record, does not entitle the assessee to claim the benefit of deduction in respect of interest paid on the amounts borrowed but not presently used in its business. The time at which the diversion takes place is not the only relevant criterion but it is the fact of the diversion which is material and once it has been shown that there has been diversion of

interest on the amount borrowed, but subsequently diverted would not qualify for deduction. Any view to the contrary would not in the least sub serve the object of the legislative provision, but it would only open the gates for the assessees to borrow merrily and after ostensibly using it in the business for a short period and at a subsequent point of time divert the funds in whole or part, for non-business purposes and continue to claim the interest on the borrowing as a deductible item of expenditure. The objects of the section would not in any way be advanced by the adoption of such a view. If a business for which the interest paid is claimed as a deduction has not benefited during the year from the capital borrowed by such borrowed amount being used in the business, such interest cannot be regarded as expenditure for the purposes of the business. The assessee may not even while using borrowed funds for its personal purposes and not business purposes claim deduction of the interest paid on the borrowing. In any case if the assessee takes stand that it is business expediency then, heavy burden lies on the assessee to prove such contention and said contention is to be examined by applying deferent criteria.

4.4 A real problem arises in cases where funds are pumped out of business which are comprise of both type of funds, borrowed as well as own funds for non-business purposes. In all such cases where mixed funds are used for both business and other than business purposes, there is no presumption that moneys used for other purposes came out of borrowed funds. It can be said that interest free funds given are out of own funds to the extent of capital and reserves, and this proposition is supported by the decision of Hon'ble Andhra Pradesh High Court in the case of CIT Vs. Gopikrishna Murlidhar, 47 ITR 469 (AP) and in the said case their Lordships accepted the contention that the assessee is entitled to withdraw from capital. The Facts of that case are that the assessee is a Hindu undivided family carrying on business on an

extensive scale with a capital of nearly Rs. 20,00,000 (twenty lakhs). During the year ended 9th November, 1950, the assessee made large borrowings for purposes of his business and paid interest amounting to Rs. 93,611 on said borrowings. During the course of that year, the assessee withdrew from the business from time to time amount of Rs. 1,77,984 for his personal expenses. The Income-tax Officer disallowed a sum of Rs. 13,500 on prorata, representing the interest element relating to Rs. 1,77,984, since he was of view that amount of Rs. 1,77,984 withdrew was made in the name of the business but used for his personal purposes. According to him, money was withdrawn from the books of account to meet the personal expenditure of the assessee and, as this sum of money was not actually used for the business, the interest paid thereon could not be allowed as permissible deduction.

4.5 The relevant finding of the Court is reproduced below:-

> *"We do not think that we can give effect to this argument. Indisputably, these amounts were borrowed only for the purpose of business of the family. The assessee drew out from time to time various sums of money aggregating to Rs. 1,77,984/- from the business. It is not a case where any particular sum purporting to be borrowed on behalf of the business was spent for household expenses. This is a case where the loans were taken for carrying on the business but the family used to withdraw some amounts from the business whenever occasions arose. The family was surely entitled to withdraw from the capital supplied by it with the result of the capital being depleted. There is, therefore, no substance in the submission that the fact that part of the amount borrowed was later on used for personal expenses, would deprive the assessee of the benefits."*

4.6 From the above judgment of Hon'ble Andhra Pradesh High Court we find that the assessee has right to replace his own capital with borrowed funds which were already used for the purpose of business in acquiring assets and other. With the help of this ratio of the judgment such problem can be resolved by examination and analyses of financial statements prepared on the basis of books of account maintained by

the assessee. It is well accepted proposition that for the purpose of ascertaining profit and gains, the normal principles of commercial accounting should be applied, so long as they do not conflict with any express statutory provisions as held by the Hon'ble Supreme Court in CIT Vs. U.P. State Industrial Development Corporation, 225 ITR 703(SC). Thus such problem can be resolved by analyzing statement of accounts and in particular balance-sheet. Where details of own capital, borrowed funds and interest free funds given or utilized for other purposes are available. There is no much difficulties in examination of right to replace own capital to borrow funds in case of individual and partnership firm. But in the case of company, capital is fund of public/ share holders which is managed by the Board of Directors. In the case of company there are certain restrictions under the Companies Act in use of capital/fund for personal benefits. Such replacement is required to be authorized by proper resolution and must be in conformity with the provisions of Companies Act and rules and regulations of regulatory bodies. Same are required to reflect in the financial statements prepared on the basis of audited books of account. The Auditor is also required to point out such replacement/utilization of funds. If funds are diverted in contravention of statutory provisions, then same may be subject to legal and penal consequences under the Companies Act and others. The onus is on the assessee to furnish the relevant material regarding replacement of borrowed funds by own capital and interest free funds available with the assessee.

4.7 On the basis of above discussion a proposition / Formula can be laid down that if an assessee having sufficient interest free funds, in the form of capital reserves and other funds without interest bearing from relatives and friends not related to business, to cover funds given interest free or utilized other than for business purposes, no disallowance is warranted. If the own funds are not sufficient to cover

interest free advances, a proportionate disallowance is warranted. While examining interest free funds available with assessee and interest free funds given a care is required to be taken that these funds were not related to business of the assessee. Capital and Reserves are certainly assessee's own interest funds. This proportion is fortified by the decision of ITAT in the case of Torrent Financers V. ACIT, 73 TTJ 624 (Ahd.), judgment of Allahabad High Court in the case of CIT V. Prem Heavy Engineering Works P. Ltd., 285 ITR 554 (All.), and the judgment of Hon'ble Supreme Court in the case of Munjal Sales Corporation V. CIT, 298 ITR 298 (SC).It is to note that decisions of the Hon'ble Punjab and Haryana High Court in Munjal Sales Corporation V CIT (208) 298 ITR 288 and CIT V Munjal Sales Corporation(2008) 298 ITR 294 wherein the Hon'ble Punjab and Haryana High Court followed CIT Abhishek Industries Ltd (2006) 286 ITR 1(P&H) have been reversed by the Hon'ble Supreme Court. Thus the decision of the Punjab and Haryana High Court in the case of CIT Abhishek Industries Ltd (2006) 286 ITR 1(P&H) has been impliedly reversed on the issue.

6 If we apply the formula laid down in the case of ACIT vs HP Shah & Co (supra) we find that the assessing officer himself noted the following balance-sheet from which it is clearly established that the assessee was having its share capital of Rs. 1,45,16,533 against which the loans and advances were Rs.38,40,000:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Holders Fund	1,45,16,533	Fixed assets	44,08,048
Loan fund & Borrowings	1,05,36,997	Loans & Advances	38,40,000
Current Liabilities & Provisions	2,91,19,625	Other Current Assets & Cash, Bank balance & Misc. Exp.	4,59,25,107
Total	5,41,73,155	Total	5,41,73,155

We are, therefore, of the considered view that no addition is warranted. Therefore, the addition of Rs. 3,99,452 is deleted.

7. In the result, the appeal filed by the assessee is allowed.

Order pronounced in the open court on 31-12-2010.

Sd/- *sd/-*

(D.T. Garasia) (A.L. Gehlot)
JUDICIAL MEMBER ACCOUNTANT MEMBER
Rajkot, Dt : 31st December, 2010
Pk/-
copy to:
1. the appellant
2. the respondent
3. the CIT(A)-II, Rajkot
4. the CIT-I, Rajkot
5. the DR

(True copy) By order

Asstt.Registrar, ITAT, Rajkot