IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 18.04.2007

CORAM

THE HON'BLE MR.JUSTICE P.D.DINAKARAN
AND
THE HON'BLE MR.JUSTICE P.P.S.JANARTHANA RAJA

T.C.(A).Nos.368 to 372 of 2007

The Commissioner of Income Tax
Coimbatore. .. Appellant in T.C.368/07

The Commissioner of Income Tax
Salem. .. Appellant in T.Cs.369-372/07

Vs.

M/s.Sambandham Spinning Mills Ltd.,
Kamarajar Nagar Colony, .. Respondent in T.C.368/07

M/s.Mallur Siddheswara Spinnings
Mills Ltd., Attaiyampatti Road,
Athanur Post, Rasipuram Taluk,
Namakkal. .. Respondent in T.Cs.369-372/07

Appeals under Section 260A of the Income Tax Act, 1961 against the order of the Income Tax Appellate Tribunal, Madras 'D' Bench dated 25.8.2006 in ITA Nos.1559/Mds/2004, 754/Mds/2005, 1557/Mds/2004, 2479/Mds/2005 and 2541/Mds/2005 for the assessment years 2000-01, 2001-02, 2000-01, 2002-03 and 2002-03 respectively and against the order of the CIT (A) in ITA No.64-C/03-04 dated 15.3.2004 and against the order of the CIT (A) in ITA No.89-C/04-05 dated 29.10.2004 and against the order of the CIT (A) in ITA No. 71/05-06 dated 11.8.2005 and against the Assessment order for the Assessment year 2000 - 01 and against the Asst order for the Asst year 2001-02 and against the Asst order for the Asst., year 2002-03.

For Appellant : Mr.T.Ravikumar

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J U D G M E N T

(Delivered by P.D. DINAKARAN, J.)

The main issues that arise for our consideration in the above appeals under the following facts and circumstances of the case are:

(i) Whether the replacement of machinery is to be treated as revenue expenditure, but not as a capital expenditure ? and

(ii) whether the interest paid on the borrowed capital to the extent relatable to the sums advanced to the sister concern is allowable as deduction under Section 36(1)(iii) of the Income-tax Act, 1961 ?

2.1. The facts relating to the first issue, viz., whether the expenditure incurred on replacement of machinery is capital expenditure or revenue expenditure, are stated as hereunder:

The above appeals relate to the assessment years 2000-01, 2001-02 and 2002-03. The assessee claimed deferred revenue expenditure incurred for the replacement of parts of plant and machinery, which reflected in the books and the balance sheet. The expenditure was in the nature of routine maintenance of the machinery and therefore, the same was claimed as revenue expenditure under Section 31 of the Act in the year in which the expenses were incurred. These expenses were amortised over the estimated life of such expenditure in eight years in the books by debiting the Profit & Loss Account and crediting deferred revenue expenditure account.

2.2. According to the assessee, the expenditure incurred by him for the replacement of the machinery is a revenue expenditure under Section 31 of the Act. But, the assessing officer rejected the contention of the assessee on the ground that the expenditure was in the nature of capital expenditure on acquisition of plant and machinery, as the assessee himself admits the life of the machinery installed as eight years, as entered in his books of accounts and therefore, the assessee cannot ask for a different treatment to the capital expenditure on the plant and machinery and claim full cost of machinery as a deduction in one year, i.e., in the year in which the expenses were met. Holding so, the assessing officer disallowed the claim of deferred revenue expenditure and allowed depreciation at 25% on the cost of machinery installed. The Assessing Officer also observed that the disallowance was made not due to the fact that the assessee had capitalized the cost of machinery in its book but because of

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the fact that the nature of expenditure incurred and the cost of machinery itself is capital in nature.

2.3. Aggrieved by the order of the assessing officer, the assessee preferred appeals before the Commissioner of Income-tax (Appeals) for the respective assessment years and the Commissioner allowed the appeals by holding the issue in favour of the assessee, which was also confirmed by the Income-tax Appellate Tribunal, on appeals at the instance of the Revenue. Aggrieved by the same, the Revenue has filed the above appeals raising the following common substantial questions of law:-

> "(i). Whether on the facts and in the circumstances of the case, the Income Tax Tribunal is right in law in holding that the replacement of machinery was to be treated as a revenue expenditure and not capital ?
>
> (ii). Whether on the facts and in the circumstances of the case, the Income Tax Tribunal is right in holding that the cost of acquisition of new machinery to replace the old one was a revenue expenditure only ?

3.1. The law on the point, viz., whether the expenditure incurred on replacement of machinery is to be treated as revenue expenditure or capital expenditure, is well settled by the decision of this Court in COMMISSIONER OF INCOME-TAX v. JANAKIRAM MILLS LTD., [2005] 275 ITR 403, whereunder it has been held that all plant and machinery put together amounts to a complete spinning mill which is capable of manufacturing yarn and hence, each replaced machine could not be considered as an independent one and no intermediate marketable product was produced.

3.2. In view of the ratio laid down by this Court in the decision cited supra, we hold that the expenditure on replacement of machinery is revenue expenditure and therefore, the Tribunal was right in allowing the claim of the assessee.

4.1. With regard to the second issue, viz., whether the interest paid on the borrowed capital to the extent relatable to the sums advanced to the sister concern is allowable as deduction under Section 36(1)(iii) of the Act, during the respective assessment years, the brief facts are that the assessee claimed the interest on borrowed money as expenditure in the Profit & Loss Account, which was disallowed by the assessing officer on the ground that the assessee diverted the funds borrowed from the financial institutions and banks to its sister concerns and therefore, the interest paid on such funds borrowed for purchase of machinery on working capital finance, which was subsequently

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diverted to the sister concerns, is not entitled to be allowed as deduction under Section 36(1)(iii) of the Act. Aggrieved by the order of assessment made by the assessing officer, the assessee preferred appeals before the Commissioner of Income-tax (Appeals), who rendered a finding that the amounts paid by the assessee to its sister concerns are not out of the funds borrowed from the financial institutions and banks, the interest paid on which is sought to be allowed, but out of the profits earned during the relevant assessment years, as it is not in dispute that the assessee had earned profits during the relevant assessment years and consequently, the Commissioner, based on the facts, held that the advances were made by the assessee to the sister concerns out of the profits earned during the relevant assessment years and the borrowings of the assessee company were fully utilised for acquisition of fixed/capital assets and therefore, the assessee had not diverted the borrowed funds to the sister concerns during the relevant assessment years.

4.2. On further appeals by the Revenue, the Tribunal by its common order dated 25.8.2006, concurred with the factual findings rendered by the Commissioner that the advances were given out of the profits earned by the assessee during the relevant assessment years and the borrowings were utilised for acquisition of fixed/capital assets as envisaged in the respective expansion projects and hence, there is no diversion of funds borrowed and as a result, the question of disallowing interest paid by the assessee on the funds borrowed on the ground that the assessee diverted the funds to its sister concerns, does not arise.

5. Aggrieved by the said order of the Tribunal, the Revenue has raised the following common substantial questions of law:-

> "(i) Whether on the facts and circumstances of the case, the Income Tax Tribunal is right in law in holding that the interest on the capital borrowed for the funds diverted to the trust/ hospital was to be allowed in spite of Sec.36(1)(iii) of the Income Tax Act ?
>
> (ii) Whether on the facts and in the circumstances of the case, the Income Tax Tribunal is right in not following the judgment of the Madras High Court in the case of K.Somasundaram and Brothers Vs. CIT reported in 238 ITR 939 wherein it was held that the capital borrowed should not only invested in the business but the capital borrowed should continue to remain in the business ?

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(iii) Whether on the facts and in the circumstances of the case, the Income Tax Tribunal is right in not following the judgment of the Kerala High Court in the case of CIT Vs. V.I.Baby & Co. reported in 254 ITR page 248 wherein it was held that if the assessee with liquidity diverts funds interest-free and borrows, then such borrowings cannot be considered for business purposes, but for supplementing the case diverted without any benefit to it ?"

6. Mr.T.Ravikumar, learned standing counsel for the Revenue, reiterated the submissions made before the authorities below placing reliance on the decision of this Court in K.SOMASUNDARAM AND BROTHERS vs. COMMISSIONER OF INCOME-TAX [(1999) 238 I.T.R. 939] and on the decision of the Kerala High Court in COMMISSIONER OF INCOME-TAX vs. V.I.BABY AND CO. [(2002) 254 I.T.R. 248].

7. We have given our anxious consideration to the submissions of the learned standing counsel for the Revenue and also perused the entire materials placed before us.

8. All the above three questions revolve on the issue as to whether the interest paid on the borrowed capital to the extent relatable to the sums advanced to the sister concern is allowable as deduction under Section 36(1)(iii) of the Act.

9.1. In K.SOMASUNDARAM AND BROTHERS vs. COMMISSIONER OF INCOME-TAX [(1999) 238 I.T.R. 939], cited supra, a Division Bench of this Court observed that it is not in dispute that the amount of interest paid in respect of capital borrowed for the purposes of the business or profession as referred to in Section 36(1)(iii) of the Act, implies that the capital amount so borrowed should not only be invested in the business, but that the amount borrowed should continue to remain in the business and 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 income from the business. In the said case, the assessee-firm was engaged in the business of construction and it borrowed certain amounts for the purpose of its business and also claimed deduction for the interest amounts paid on such borrowings. The assessing officer found that the assessee had been advancing monies to close relatives of the partners without charging any interest. The assessee therein claimed that the amounts so lent had not been lent out of the borrowed funds, but only at a time when the firm had sufficient funds at its disposal. According to the assessee therein, the advance was made when it received substantial contract receipts. But, the assessing officer, holding that there was diversion of

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borrowed funds, disallowed the claim of interest paid to the extent relatable to the amount diverted. On appeal, the Appellate Commissioner reduced the extent of disallowance, but upheld the finding of the assessing officer that there had been a diversion, which was confirmed by the Tribunal on further appeal. Under the said facts and circumstances of the case, this Court, on a reference, held as follows:-

> ".. the amount lent, according to the assessee, came out of the contract earnings. The amount borrowed, according to the assessee, was invested in the execution of the contracts. It was clear, therefore, that the assessee had invested the borrowed funds in the execution of the contracts, had recouped the money so invested presumably with profits as well on executing the contract. The amount realised on the execution thus included the amount which the assessee had borrowed and invested. When the assessee decided to lend a substantial part of those funds interest-free to the relatives of the partners, it was clearly not a business purpose. The assessee clearly diverted the funds which had been borrowed. After such diversion, the interest paid on the capital borrowing to the extent of the amounts diverted could no longer be an item of expenditure which could be claimed for deduction as an item of business expenditure."

9.2. Similarly, reliance was also placed on the decision of the Kerala High Court in COMMISSIONER OF INCOME-TAX vs. V.I.BABY AND CO. [(2002) 254 I.T.R. 248], wherein the assessee, a firm dealing in piecegoods, paid interest on borrowings from banks and since the assessee had transferred amounts to the personal accounts of its partners and also advanced amounts to the relatives of the partners and sister concerns without charging interest, the assessing officer disallowed proportionate interest payments in respect of the amounts so advanced by the assessee in computing its profits. But, the appellate Tribunal held that the disallowance was not proper because the partners and their relatives had utilised the amounts for business purposes, such as construction of a shop building. A Division Bench of the Kerala High Court, on a reference, reversed the decision of the appellate Tribunal by holding that the disallowance of proportionate interest was proper, since so long as the assessee was not the beneficiary of the investments made by the partners and their relatives, the nature of the investments or the utilisation of such advances had no relevance and that the cash balances available for the advances to the partners, their relatives and the sister concerns were also of no effect. It was further held that so long as the assessee was not the beneficiary

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of the investments made by their relatives and the sister concerns and so long as the advances made were interest-free, the Assessing Officer was justified in disallowing interest in proportion to the advances made.

10. But, in the instant case, both the Commissioner and the appellate Tribunal concurrently found, on the basis of the materials available on record, that the amounts paid by the assessee to the sister concern, viz., SPMM Hospital/Trust are from the profits earned by the assessee during the relevant assessment years and not by diverting the funds borrowed from the financial institutions and banks. It is not in dispute that the assessee had profits during the relevant years and hence, we find it difficult to hold that the amounts paid by the assessee to the sister concern, be that be a trust or a hospital, are diverted from the funds borrowed from the financial institutions and banks, since both the Commissioner and the appellate Tribunal have rendered a specific finding that the assessee paid the amounts to the sister concerns, whether trust or hospital, only out of the profits earned during the relevant assessment years. Hence, the refusal to allow the interest paid by the assessee from and out of the funds borrowed from the financial institutions and banks would be contrary to the spirit and substance of Section 36(1)(iii) of the Act. We are, therefore, convinced that the ratios laid down in K.SOMASUNDARAM AND BROTHERS vs. COMMISSIONER OF INCOME-TAX [(1999) 238 I.T.R. 939] and COMMISSIONER OF INCOME-TAX vs. V.I.BABY AND CO. [(2002) 254 I.T.R. 248], do not fit into the facts and circumstances of the case on hand, as dealt with above.

11. On the other hand, the Apex Court in a recent decision in S.A.BUILDERS LTD. vs. COMMISSIONER OF INCOME-TAX (APPEALS), [(2007) 288 I.T.R. 1], had an occasion to consider the issue, viz., whether the interest on borrowed capital from the bank can be disallowed merely on the ground that the assessee lent some amount to its sister concern without charging interest out of their bank account, in which there was sufficient credit balance. Even in the said case, the assessee therein had received payments from its clients and deposited the same in its accounts, out of which advances were subsequently made to the sister concern. In the said decision, the Apex Court, agreeing with the view taken by the Delhi High Court in COMMISSIONER OF INCOME-TAX v. DALMIA CEMENT (B.) LTD. [(2002) 254 I.T.R. 377], held 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

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circumstances of the case. It is further held that no businessman can be compelled to maximize his profit and the income-tax authorities must put themselves in the shoes of the assessee and see how a prudent businessman would act and they must not look at the matter from their own point but that of a prudent businessman.

12. In the instant case, the assessing officer refused to allow the interest paid by the assessee on the amounts borrowed from the financial institutions and banks on the ground that the assessee advanced certain amounts to SPMM hospital, run by S.Palaniandi Mudaliar Charitable Trust, out of the funds borrowed by the assessee. But, both the Commissioner and the appellate Tribunal factually found that the assessee had made advances to the hospital/trust not out of the amounts borrowed, but out of the profits made during the relevant assessment years.

13. That apart, the case of the assessee was that the advances were given primarily for the reason that the employees of the assessee company and their family members are being given concessional treatment at SPMM hospital and the said arrangement is a permanent one and all the employees of the assessee company are benefited by the same. If that be so, it cannot be disputed that the amounts advanced by the assessee are nothing but a measure of commercial expediency.

14. In view of the ratio laid down by the Delhi High Court in COMMISSIONER OF INCOME-TAX v. DALMIA CEMENT (B.) LTD. [(2002) 254 I.T.R. 377], which is affirmed by the Apex Court in S.A.BUILDERS LTD. v. COMMISSIONER OF INCOME-TAX [(2007) 288 I.T.R. 1], referred supra, 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 and the Revenue should not look at the matter from their own point of view but that of a prudent businessman, once it is established that there was nexus between the expenditure and the purpose of business.

15. In the instant case, there are sufficient materials to reach a conclusion that the amounts advanced to the sister concerns, viz., SPMM Hospital/Trust, are for the commercial expediency and therefore, it may not be proper for the Revenue to deny the benefit conferred under Section 36(1)(iii) of the Act allowing deduction for the interest paid by the assessee on the borrowed amounts.

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In that view of the matter, finding no question of law much less a substantial question of law that arises for consideration, the tax case appeals are dismissed. Consequently, connected miscellaneous petitions are also dismissed.

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Sd/
Asst.Registrar

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Sub Asst.Registrar

To

1. The Asst Registrar,
Income Tax Appellate Tribunal,
Rajaji Bhavan, Besant Nagar,
Chennai 90.

2. The Assistant Registrar,
Income Tax Appellate Tribunal
Bench "D", Chennai.

3. The Secretary, Central Board
of Direct Taxes, New Delhi.

4.The Commissioner of Income Tax
(Appeals), Coimbatore.

5.The Assistant Commissioner
of Income-tax, Central Circle-I,
Coimbatore.

6. The Deuty Commissioner of Income Tax,
Company Circle, Salem 636 007.

+ 5 ccs to MR. N. Muralikumaran, Senior Standing Counsel for IT,
SR Nos.25686 to 25690.

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