

A DEPUTY COMMISSIONER OF INCOME TAX, AHMEDABAD

V.

M/S. CORE HEALTH CARE LTD.
(Civil Appeal Nos. 3952-3955 of 2002)

FEBRUARY 8, 2008

B

(S.H. KAPADIA AND B. SUDERSHAN REDDY, JJ.)

Income Tax Act, 1961:

C s. 36(1)(iii) – *Computation of business income – Deduction towards interest paid in respect of capital borrowed for purpose of business – Assessee borrowed money in 1991-1992 for installation of new machinery – Claimed deduction towards interest paid on amount borrowed – A.O. disallowed deduction holding that production on new machinery had not started – ITAT and High Court allowed the claim – HELD: An assessee is entitled to claim deduction towards interest paid on borrowed capital used for business purpose irrespective of the result of using the capital borrowed – Once the test “for the purpose of business” is satisfied in respect of the capital*
D *borrowed, assessee would be entitled to deduction u/s 36(1)(iii) – The provision makes no distinction between money borrowed to acquire capital asset or revenue asset – What clause (iii) emphasizes is user of capital and not user of asset which comes into existence as a result of borrowed capital unlike*
E *s.37 which expressly excludes an expense of a capital nature – Proviso to clause (iii) inserted in s. 36(1) w.e.f. 1.4.2004 would not be applicable on facts of instant case.*
F

G s. 36(1)(iii), proviso and s.43(1), Explanation 8 – HELD: Proviso to s.36(1)(iii) inserted w.e.f. 1.4.2004, would operate prospectively – Explanation 8 to s.43(1) applies only to sections like ss. 32, 32A, 33 and 41 which deal with concepts like ‘depreciation’ – It has no relevancy to s.36(1)(iii) – Words ‘actual cost’ as defined in s.43(1), have no relevancy to s.36(1)(iii).
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Amendment Applications in Tax Appeals before High Court – Filed within time – Raising substantial questions of law – Summarily rejected by High Court without answering the questions of law – The questions remitted to High Court for its consideration in accordance with law – Practice and Procedure.

The assessee-respondent in the instant appeals was engaged in the business of manufacturing and sale of intravenous solutions. For the assessment year under consideration it claimed deduction of Rs.1,56,76000/- paid as interest on borrowings made for installation of new machinery during the year 1991-1992. The A.O., relying on Challapalli Sugars Ltd. case*, disallowed the deduction claimed holding that during the assessment year under consideration production on the new machinery had not started. The A.O. and the CTT(A) added the said amount of Rs.1,56,76,000/- to the income of the assessee. However, the Tribunal held that the A.O. was not justified in making the disallowance. The assessee filed Tax Appeals before the High Court. Subsequently, the assessee filed Civil Applications 53 and 54 of 2001 in the Tax Appeal Nos.449 and 450 of 2000 before the High Court raising additional grounds involving substantial questions of law. The High Court dismissed the appeals filed by the Revenue and confirmed the order of the Tribunal. It also rejected Civil Applications 53 and 54 of 2001 summarily, without considering the additional grounds and the substantial questions of law on merits.

The question for consideration before the Court was: whether interest paid in respect of borrowings on capital assets *not put to use* in the financial year concerned can be permitted as allowable deduction under Section 36(1)(iii) of the Income-tax Act, 1961?

Answering the question in favour of the assessee and partly allowing the appeals, the Court

A HELD: 1.1 Interest on moneys borrowed for the
purposes of business is a necessary item of expenditure
in a business. For allowance of a claim for deduction of
interest under Section 36 of the Income Tax Act, 1961, all
that is necessary is that – firstly, the money, i.e. capital,
B must have been borrowed by the assessee; secondly, it
must have been borrowed for the purpose of business;
and, thirdly, the assessee must have paid interest on the
borrowed amount. All that is germane is : whether the
borrowing was, or was not, for the purpose of business.
C Section 36(1)(iii) of the 1961 Act has to be read on its own
terms. It is a Code by itself. Section 36(1)(iii) is attracted
when the assessee borrows the capital for the purpose
of his business. [para 8 and 13] [670-C, D, E; 673-G]

D *Challapalli Sugars Ltd. & Anr. Vs. Commissioner of
Income-tax, A.P. and Anr.* [1975] 98 ITR 167 – held
inapplicable.

*Calico Dyeing & Printing Works v. Commr. of Income-
tax, Bombay City-II* (1958) 34 ITR 265 – approved.

E 1.2 The expression “for the purpose of business”
occurring in Section 36(1)(iii) indicates that once the test
of “for the purpose of business” is satisfied in respect of
the capital borrowed, the assessee would be entitled to
deduction under Section 36(1)(iii) of the 1961 Act. This
F provision makes no distinction between money borrowed
to acquire a capital asset or a revenue asset. All that the
section requires is that the assessee must borrow capital
and the purpose of the borrowing must be for business
which is carried on by the assessee in the year of account.
G What sub-section (iii) emphasizes is the user of the capital
and not the user of the asset which comes into existence
as a result of the borrowed capital unlike Section 37 which
expressly excludes an expense of a capital nature. The
legislature has, therefore, made no distinction in Section
H 36(1)(iii) between “capital borrowed for a revenue

purpose” and “capital borrowed for a capital purpose”. A
The transaction of borrowing is not the same as the
transaction of investment. The transaction of borrowing
attracts the provisions of Section 36(1)(iii). An assessee
is entitled to claim interest paid on borrowed capital B
provided that capital is used for business purpose
irrespective of what may be the result of using the capital
which the assessee has borrowed. [para 8 and 13]
[670-E, F, G, H; 671-A; 674-B, C]

India Cements Ltd. v. Commissioner of Income-tax, Madras (1966) 60 ITR 52; Commissioner of Income Tax vs. Associated Fibre and Rubber Industries (P) Ltd. [1999] 236 ITR 471 – relied on. C

1.3 In the instant case, A.O. was not justified in making disallowance of Rs.1,56,76,000/- in respect of borrowings utilized for purchase of machines. Before the High Court it was not the case of the Department that a new business was set up or commenced during the assessment year under consideration. It was undisputed before the High Court that three additional machines were installed by the assessee during the assessment year under consideration for the production of intravenous injectibles. It was not in dispute that the assessee had borrowed moneys during the accounting year commencing from 1.4.91 to 31.3.92. [para 6 and 14] [668-F, G; 674-E] D E F

2. The instant appeals pertain to the assessment years 1992-93, 1993-94, 1995-96 and 1997-98. The proviso inserted in Section 36(1)(iii) of the 1961 Act w.e.f. 1.4.2004 will not apply to the facts of the case. The said proviso would operate prospectively w.e.f. 1.4.04. [para 11] [672-F] G

3. Explanation 8 applies only to those Sections like Sections 32, 32A, 33 and 41 which deal with concepts like Depreciation. The concept of Depreciation is not there in Section 36(1)(iii). That is why the legislature has used the H

A words “unless the context otherwise requires”. Hence, Explanation 8 has no relevancy to Section 36(1)(iii) and, therefore, it has no application to the facts of the instant case. Similarly, the words “actual cost” do not find place in Section 36(1)(iii) of the 1961 Act which otherwise find place in Sections 32, 32A etc of the 1961 Act. “Actual cost” of an asset has no relevancy in relation to Section 36(1)(iii) of the 1961 Act. [para 8,10] [671-A, 672-B, D, E]

C 4. Although the Department had moved Civil Application Nos.53 and 54 of 2001 during the pendency of Tax Appeal Nos.449 and 450 of 2000 well within limitation, the High Court without answering the three questions raised therein, summarily rejected the said applications. The High Court erred in dismissing the two civil applications for amendment of the Memo of Appeal in the said Tax Appeals. The three questions mentioned in the judgment are substantial questions of law and, therefore, the High Court ought to have decided those questions. Accordingly, the said three questions are remitted to the High Court for fresh consideration by it in accordance with law. [para 16-17] [675-C, D, E]

CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 3952-3955 of 2002.

F From the Judgment and Order dated 25.04.2001 of the High Court of Judicature of Gujarat at Ahmedabad in Tax Appeal Nos. 449 & 450 of 2000 and civil Applications Nos. 53 and 54 of 2001.

WITH

G Civil Appeal Nos. 8509-10 of 2002.

P. Vishwanatha Shetty, T. Srinivasa Murthy, Gaurav Agrawal and B.V. Balaram Das for the Appellant.

H S. Ganesh, Amar Dave and Rustom B. Hathikhanawala for the Respondent.

The Judgment of the Court was delivered by

KAPADIA, J. 1. For the sake of convenience we state the facts occurring in Civil Appeal Nos.3952-55 of 2002 – Dy. Commr. of Income Tax, Ahmedabad v. M/s. Core Health Care Ltd.

2. These civil appeals are directed against judgment and order dated 25.4.01 delivered by Gujarat High Court in Tax Appeal Nos.449 and 450 of 2000 and in Civil Application Nos.53 and 54 of 2001 whereby the Department's appeals, under Section 260A of the Income-tax Act, 1961, stood dismissed.

3. On 31.12.92 assessee filed its return of income for A.Y. 1992-93 declaring "nil" income. Later on the assessee filed a revised return on 6.8.93 declaring a loss of Rs.1,11,68,543/-. Assessee-company is engaged in the business of manufacturing and sale of intravenous solutions. For the assessment year under consideration assessee claimed deduction towards expenses aggregating to Rs.2,12,05,459/- which included interest on borrowings of Rs.1,56,76,000/-. During the assessment year under consideration assessee had installed new machinery. The A.O. vide assessment order dated 30.3.95 disallowed the amount of Rs.1,56,76,000/- placing reliance on the judgment of this Court in **Challapalli Sugars Ltd. & Anr. v. Commissioner of Income-tax, A.P. and Anr.** – (1975) 98 ITR 167, *inter alia*, on the ground that during the assessment year under consideration assessee had installed new machinery on which production had not started. On appeal, vide order dated 15.11.96, CIT (A) confirmed the addition of interest amount on borrowings of Rs.1,56,76,000. Therefore, both the authorities, namely, the A.O. and CIT (A) added the said amount of Rs.1,56,76,000/- to the income of the assessee. The matter was carried in appeal by the assessee. Vide order dated 6.6.2000 the Tribunal held that the Department was not justified in adding Rs.1,56,76,000/- to the income of the assessee. In other words, the Tribunal held that the A.O. was not justified in making disallowance of Rs.1,56,76,000/- in

A respect of borrowings utilized for purchase of machinery. This decision was confirmed by the High Court, hence these civil appeals are filed by the Department.

4. The following question of law has been placed before us for determination:

B "Whether interest paid in respect of borrowings on capital assets *not put to use* in the concerned financial year can be permitted as allowable deduction under Section 36(1)(iii) of the Income-tax Act, 1961?"

C 5. According to the Department, the assessee was not entitled to treat the interest on borrowings as revenue expenditure. According to the Department, in view of Explanation 8 to Section 43(1) of the Income-tax Act, 1961 (for short, "1961 Act") the assessee was not entitled to claim
D deduction for interest on borrowings, particularly, when the machines were not put to use during the assessment year under consideration. According to the Department, provisions of Section 36(1)(iii) of the 1961 Act were required to be harmoniously construed along with the provisions of Explanation
E 8 to Section 43(1) regarding actual cost. According to the Department provisions of Section 36(1)(iii) being general in nature had to give way to the special provisions contained in Explanation 8 of Section 43(1) of the 1961 Act.

F 6. At the outset, we may clarify that before the High Court it was not the case of the Department that a new business was set up or commenced during the assessment year under consideration. It was undisputed before the High Court that three additional machines were installed by the assessee during the assessment year under consideration for the production of
G intravenous injectibles. It was not in dispute that the assessee had borrowed moneys during the accounting year commencing from 1.4.91 to 31.3.92.

H 7. We quote hereinbelow Section 36(1)(iii) and Explanation 8 to Section 43(1) of the 1961 Act which read as

follow:

A

“OTHER DEDUCTIONS

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

B

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

Provided that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalised 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.

C

D

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

E

“Definitions of certain terms relevant to income from profits and gains of business or profession.

43. In sections 28 to 41 and in this section, unless the context otherwise requires –

F

(1) “actual cost” means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority:

G

Provided that where the actual cost of an asset, being a motor car which is acquired by the assessee after the 31st day of March, 1967, but before the 1st day of March, 1975, and is used otherwise than in a business of running it on hire for tourists, exceeds twenty-five thousand rupees,

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A the excess of the actual cost over such amount shall be
ignored, and the actual cost thereof shall be taken to be
twenty-five thousand rupees.

B **Explanation 8:** For the removal of doubts, it is hereby
declared that where any amount is paid or is payable as
interest in connection with the acquisition of an asset, so
much of such amount as is relatable to any period after
such asset is first put to use shall not be included, and
shall be deemed never to have been included, in the actual
cost of such asset.”

C 8. Interest on moneys borrowed for the purposes of
business is a necessary item of expenditure in a business. For
allowance of a claim for deduction of interest under the said
section, all that is necessary is that – firstly, the money, i.e. capital,
D must have been borrowed by the assessee; secondly, it must
have been borrowed for the purpose of business; and, thirdly,
the assessee must have paid interest on the borrowed amount
[See: **Calico Dyeing & Printing Works v. Commr. of Income-
tax, Bombay City-II –(1958) 34 ITR 265**]. All that is germane
E is : whether the borrowing was, or was not, for the purpose of
business. The expression “for the purpose of business” occurring
in Section 36(1)(iii) indicates that once the test of “for the
purpose of business” is satisfied in respect of the capital
borrowed, the assessee would be entitled to deduction under
F Section 36(1)(iii) of the 1961 Act. This provision makes no
distinction between money borrowed to acquire a capital asset
or a revenue asset. All that the section requires is that the
assessee must borrow capital and the purpose of the borrowing
must be for business which is carried on by the assessee in the
G year of account. **What sub-section (iii) emphasizes is the
user of the capital and not the user of the asset which
comes into existence as a result of the borrowed capital
unlike Section 37 which expressly excludes an expense
of a capital nature.** The legislature has, therefore, made no
distinction in Section 36(1)(iii) between “capital borrowed for a
H revenue purpose” and “capital borrowed for a capital purpose”.

An assessee is entitled to claim interest paid on borrowed capital provided that capital is used for business purpose irrespective of what may be the result of using the capital which the assessee has borrowed. Further, the words "actual cost" do not find place in Section 36(1)(iii) of the 1961 Act which otherwise find place in Sections 32, 32A etc of the 1961 Act. The expression "actual cost" is defined in Section 43(1) of the 1961 Act which is essentially a definition section which is subject to the context to the contrary.

9. In the case of **Commissioner of Income-tax v. Associated Fibre and Rubber Industries (P) Ltd. – (1999) 236 ITR 471**, the Division Bench of this Court held as follows:

"Even though the machinery has not been actually used in the business at the time when the assessment was made, the same has to be treated as a business asset as it was purchased only for business purposes. In the circumstances, the interest paid on the amount borrowed for purpose of such machinery is certainly a deductible amount."

10. As stated above, the Department contended before us that the judgments of this Court, prior to insertion of Explanation 8 in Section 43(1) of the 1961 Act, has no application to the present case. According to the Department, Section 36(1)(iii) of the 1961 Act being general in nature has to give way to special provisions contained in Explanation 8 to Section 43(1) of the 1961 Act. According to the Department, in none of the earlier judgments this Court has considered the true scope of Explanation 8 to Section 43(1) vis-à-vis Section 36(1)(iii) of the 1961 Act. We find no merit in this contention. Section 43 groups together all provisions in the nature of definitions or interpretations relevant to the computation of income under the head "Profits and Gains of Business". Section 43(1) defines "actual cost". The definition of "actual cost" has been amplified by excluding such portion of the cost as is met directly or indirectly by any other person or authority. Explanation

A 8 has been inserted in Section 43(1) by Finance Act, 1986 (23
of 1986), with retrospective effect from 1.4.74. It is important to
note that the word "actual cost" would mean the whole cost and
not the estimate of cost. "Actual cost" means nothing more than
the cost accurately ascertained. The determination of actual cost
B in Section 43(1) has relevancy in relation to Section
32(depreciation allowance), Section 32A(investment
allowance), Section 33(development rebate allowance), and
Section 41(balancing charge). "Actual cost" of an asset has no
relevancy in relation to Section 36(1)(iii) of the 1961 Act. This
C reasoning flows from a bare reading of Section 43(1). Section
43 defines certain terms relevant to income from profits and
gains of business and, therefore, the said section commences
with the words "In Sections 28 to 41 and unless the context
otherwise requires" "actual cost" shall mean the actual cost of
D the assets to the assessee, reducing by that portion of the cost
thereof, if any, as has been met directly or indirectly by any other
person or authority. In other words, Explanation 8 applies only
to those Sections like Sections 32, 32A, 33 and 41 which deal
with concepts like Depreciation. The concept of Depreciation
is not there in Section 36(1)(iii). That is why the legislature has
E used the words "unless the context otherwise requires". Hence,
Explanation 8 has no relevancy to Section 36(1)(iii). It has
relevancy to the aforementioned enumerated sections.
Therefore, in our view Explanation 8 has no application to the
facts of the present case.

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11. Before concluding on this point we may state that in
this batch of civil appeals we are concerned with the assessment
years 1992-93, 1993-94, 1995-96 and 1997-98. A proviso has
since been inserted in Section 36(1)(iii) of the 1961 Act. That
G proviso has been inserted by Finance Act, 2003 w.e.f. 1.4.2004.
Hence, the said proviso will not apply to the facts of the present
case. Further, in our view the said proviso would operate
prospectively. In this connection it may be noted that by the same
Finance Act, 2003 insertions have been made by way of proviso
in Section 36(1)(vii) by the same Finance Act which is also

made with effect from 1.4.2004. Same is the position with regard to insertion of a sub-section after Section 90(2) and before the Explanation. This insertion also operates w.e.f. 1.4.04. In short, the above amendments have been made by Finance Act, 2003 and all the said amendments have been made operational w.e.f. 1.4.04. Therefore, the proviso inserted in Section 36(1)(iii) has to be read as prospectively and w.e.f. 1.4.04. In this case, we are concerned with the law as it existed prior to 1.4.2004. As stated above, we are not concerned with the interpretation or applicability of the said proviso to Section 36(1)(iii) w.e.f. 1.4.04 in the present case.

12. In the case of **Challapalli Sugars Ltd. (supra)** this Court observed that interest paid on the borrowing utilized to bring into existence a fixed asset which has not gone into production, goes to add to the cost of installation of that asset. It was further observed that if the said borrowing was not "for the purpose of business" inasmuch as no business had come into existence, it must follow that it was made for the purpose of acquiring an asset which could be put to use for doing business, and hence interest paid on such borrowing would go to add to the cost of the assets so acquired.

13. In our view the above observations have to be confined to the facts in the case of **Challapalli Sugars Ltd. (supra)**. It was a case where the company had not yet started production when it borrowed the amount in question. The more appropriate decision applicable to the present case would be the judgment of this court in the case of **India Cements Ltd. v. Commissioner of Income-tax, Madras – (1966) 60 ITR 52** in which it has been observed that, for considering whether payment of interest on borrowing is revenue expenditure or not, the purpose for which the borrowing is made is irrelevant. In our view, Section 36(1)(iii) of the 1961 Act has to be read on its own terms. It is a Code by itself. Section 36(1)(iii) is attracted when the assessee borrows the capital for the purpose of his business. It does not matter whether the capital is borrowed in order to acquire a revenue asset or a capital asset, because of

A that the section requires is that the assessee must borrow the
capital for the purpose of his business. This dichotomy between
the borrowing of a loan and actual application thereof in the
purchase of a capital asset, seems to proceed on the basis
B any new asset of enduring nature into existence, and that it is
the transaction of investment of the borrowed capital in the
purchase of a new asset which brings that asset into existence.
The transaction of borrowing is not the same as the transaction
of investment. If this dichotomy is kept in mind it becomes clear
C that the transaction of borrowing attracts the provisions of
Section 36(1)(iii). Thus, the decision of the Bombay High Court
in **Calico Dyeing & Printing Works (supra)** and the judgment
of the Supreme Court **India Cements Ltd. (supra)** have been
given with reference to the borrowings made for the purposes
D of a running business, while the decision of the Supreme Court
in **Challapalli Sugars Ltd. (supra)** was given with reference
to the borrowings which could not be treated as made for the
purposes of business as no business had commenced in that
case. Therefore, there is no inconsistency between the above
decisions.

E

CONCLUSIONS

14. For the above reasons, we hold that A.O. was not
justified in making disallowance of Rs. 1,56,76,000/- in respect
of borrowings utilized for purchase of machines. Accordingly,
F the above question is answered in favour of the assessee and
against the Department.

15. Apart from the above question under Section 36(1)(iii),
the present civil appeals are filed by the Department against
the decision of the High Court whereby the High Court has
G dismissed Civil Application Nos. 53 and 54 of 2001 filed by the
Department. It may be noted that during the pendency of Tax
Appeal Nos. 449 and 450 of 2000, the Department had moved
the above two civil applications for amendment of its Memo of
H Appeal raising substantial questions of law, namely –

- (a) whether advertisement expenses incurred by the assessee to create a brand image with enduring benefit are allowable as revenue expenditure; A
- (b) whether the Tribunal had erred in granting deduction under Section 35D regarding short-term loan, in view of Explanation to Section 35D(3) which refers only to long-term borrowings; B
- (c) whether the Tribunal had erred in directing deduction under Section 80-HH and 80-I on the miscellaneous income of Rs.26,64,113 being income on sale of empty containers? C

16. Although the Department had moved the said Civil Application Nos.53 and 54 of 2001 during the pendency of Tax Appeal Nos.449 and 450 of 2000 well within limitation the High Court without answering the above three questions summarily rejected Civil Application Nos.53 and 54 of 2001. We are of the view that the High Court had erred in dismissing the above two civil applications for amendment of the Memo of Appeal in Tax Appeal Nos.449 and 450 of 2000. In our view the above three questions are substantial questions of law and, therefore, the High Court ought to have decided those questions. D E

17. Accordingly, we remit the above three questions to the High Court for fresh consideration by it in accordance with law. Accordingly, Civil Appeal Nos.3952-55 of 2002 and Civil Appeal Nos.8509-8510 of 2002 filed by the Department are partly allowed with no order as to costs. F

R.P.

Appeals partly allowed.