
(1991) 04 MAD CK 0040

In the Madras High Court

Case No : Tax Cases No"s. 734 to 739 of 1979 (References No"s. 415 to 420 of 1979)

Vijayakumar Mills Ltd.

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 24-04-1991

Acts Referred:

Income Tax Act, 1961 — Section 36, 36(1), 43, 57

Citation : (1992) 194 ITR 197

Hon'ble Judges : V. Ratnam, J;K.A. Thanikkachalam, J

Bench : Division Bench

Advocate : S.A. Balasubramanian, for the Appellant; C.V. Rajan, for the Respondent

Judgement

Thanikkachalam, J.—At the instance of the assessee, as well as the Department, the Tribunal referred the following question of law for our

opinion under sec 256(1) of the Income Tax Act, 1961.

2. Question of the law referred at the instance of the assessee :

1. Whether, on the facts and in the circumstances of the case, the addition of Rs. 34,692, Rs. 31,826 and Rs 11, 693 for the assessment year

1958-59, 1961-62, 1962-63, respectively, on account of inflation of cotton purchase price was justified ?

2. Whether, on the facts and in the circumstances of the case, the addition of Rs. 43,420, Rs. 67,518, Rs. 1,22,346, Rs. 61,745, and Rs. 30,989

on account of interest on borrowings of the assessment years 1958-59, 1959-60, 1961-62, 1962-63 and 1963-64, respectively, was justified ?

3. Whether, on the facts and in the circumstances of the case, the addition of Rs. 4,40,000 to the total income in the assessment for the year

assessment year 1961-62 was justified ?

3. Question of the law referred at the instance for the department :

1. Whether, on the facts and in the circumstances of the case, the sum of Rs. 10,000 and Rs. 5,600 for the assessment years 1965-66 and 1966-

67 respectively, could be allowed as deduction for the total income of the assessee ?

4. In so far as question No. 1 referred at the instance of the assessee is concerned, it relates to inflation of the cotton purchase price in the

assessment year 1958-59, 1961-62 and 1962-63 the assessee is a limited company carrying on a business in manufacturing of yarn, etc. The

assessee-company was managed by a managing agency firm called R. S. Guruswamy Naidu and Company consisting of Mr. G. Krishnan was

controlling both the assessee-company as a director and the managing agency firm as a partner.

5. The Income Tax Officer made additions of Rs. 34,692, Rs. 31,826 and Rs. 11,693 for the assessment years 1958-59, 1961-62 and 1962-63

respectively, on account of inflation of cotton purchase price. The Income Tax Officer found that the price of cotton supplied to the mill by certain

Bombay parties were contracted at certain rates which were very much higher than the rate originally quoted by the Bombay sellers. The difference

was distributed between Shri G. Krishnan, and one Mr. Sippy the broker, who arranged the transactions for the assessee-mills. The Income Tax

Officer examine the profit and loss account of the assessee-mills and also traced these amounts from the Bank accounts of various parties.

Therefore, the Income Tax Officer held that the manufacturing and profit and loss account of assessee-mills has been debited with price of cotton

purchased and purchase of waste at highly inflated figures. For the assessment years 1958-59, 1961-62 and 1962-63, the Income Tax Officer

determine such inflation at Rs. 34,692, Rs. 31,826 and Rs. 11,693 respectively.

6. On the appeal for the assessment years 1958-59 and 1962-63, the Appellate Assistant Commissioner deleted the addition of Rs. 34,692 and

Rs. 11,693 respectively. The Appellate Assistant Commissioner for such deletion relied on a decision of this Court in the case of Sri Ramalinga

Choodambikai Mills Ltd. Vs. Commissioner of Income Tax, Madras, and earlier inflated amount went to the above said two persons and the

assessee benefited by these transactions.

7. For the assessment year 1961-62, another Appellate Assistant Commissioner who dealt with this appeal held that there was an artificial inflation

in the purchase price of cotton and the benefit went to Mr. G. Krishnan who was one of the directors of the assessee-company. The Appellate

Assistant Commissioner further pointed out that the excessive rebate was made by the company with the full knowledge and connivance of the

directors accordingly, the Appellate Assistant Commissioner upheld the addition made by the Income Tax Officer.

8. Aggrieved, the department filed appeals before the Tribunal for the assessment years 1958-59 and 1962-63 and the assessee filed an appeal

for the assessment year 1961-62.

9. The Tribunal, on considering the facts and the circumstances arising in this case, in the light of the decision in the case of Sri Ramalinga

Choodambikai Mills Ltd. Vs. Commissioner of Income Tax, Madras, , in the case of SREE MEENAKSHI MILLS LIMITED Vs.

COMMISSIONER OF Income Tax, MADRAS., , in the case of Ramdas Dossa and Co. Vs. Commissioner of Income Tax, Bombay City,

Bombay, , the case of Commissioner of Income Tax, Bombay City-I Vs. India United Mills Ltd., and in the case of Commissioner of Income Tax

Vs. Vijayalakshmi Mills Ltd., , held that there is inflation of cotton purchase price in the assessment year 1958-59, 1961-62 and 1962-63 and,

accordingly upheld addition made by Income Tax Officer for all these assessment years under consideration.

10. Before us, learned counsel, Mr. S. A. Balasubramanian, appearing for the assessee, submitted as under : The assessee-company is not

responsible for the mischief committed by he director in collusion with a broker. So far as the assessee-company is concerned, it has paid the full

price quoted by the sellers as per the contract and hence the money went out of its coffers. There was no evidence to show that the money paid

came back to the assessee-company either directly or indirectly. It is a case where a director of the company defrauded the company, whether this

was known to the company or not. In working out the profit and loss account of a business, the assessee has to take into account the actual price

paid for the purchase of the raw materials and the company as a legal entity

cannot take into account for the misbehaviour of any of its directors or employees. Further, it is also not relevant in a matter like this to ascertain whether, by exercising a little more vigilance, the company could have paid a lower price than it has paid. The assessee did not get any benefit out of these transaction. Hence, it is submitted that the Tribunal was not correct in confirming the additions made by the Income Tax Officer under this head in all these assessment years under consideration. In order to support his contentions, learned counsel for the assessee relied upon the following decision : in the case of Sri Ramalinga Choodambikai Mills Ltd.

Vs. Commissioner of Income Tax, Madras, , in the case of Commissioner of Income Tax, Bombay City-I Vs. India United Mills Ltd., , in the case of SREE MEENAKSHI MILLS LIMITED Vs. COMMISSIONER OF Income Tax, MADRAS., , in the case of A.D. Jayaveerapandia Nadar and Co. and Others Vs. Income Tax Officer, .

11. On the other hand, learned standing counsel for the Department submitted as under. As a matter of fact, there was an artificial inflation in the purchase price of cotton. Mr. G. Krishnan was the director of the assessee-company under the relevant assessment years and he was controlling both the assessee-company as a director and the managing agency firm as a partner. A company can act only through its directors and, therefore, it cannot be said that, without a knowledge of the directors of the company, inflated amounts were paid to the sellers. There was collusion between the director, G. Krishnan, and the broker, the company's income was diverted by these persons in order to reduce the tax effect for their own benefit. Hence the assessee-company and the managing agency firm are all closely related. Therefore, it was submitted that, by inflating the price of the cotton purchased, the real income attributable to the assessee-company was suppressed. Thus learned standing counsel supported the additions made by the Tribunal under this head. In order to support his contentions, learned standing counsel relied upon the decision in the case of Sri Ramalinga Choodambikai Mills Ltd. Vs. Commissioner of Income Tax, Madras, , in the case of ASIAN TOOL AND PLASTIC CO. Vs. COMMISSIONER OF Income Tax, CALCUTTA., .

12. We have heard the rival submissions.

13. For the assessment years 1958-59, 1961-62 and 1962-63, The Income tax

Officer made additions of Rs. 34,692, Rs. 31,826 and Rs.

11,693 respectively, on account of inflation of the cotton purchased price for the purpose of working out the profit and the loss account of a

business, it is necessary to take into account the actual expenses incurred. If such expenses are inflated deliberately to the knowledge of the

assessee, then, the Income Tax Officer is entitled to disallow the inflated expenditure. If the account of the assessee-company reflect such

irregularities committed by the directors, than the account of the assessee cannot be set to be a true account. In such a case, the Income Tax

Officer is entitled to reject the entire books of accounts and work out the correct profit from the materials gathered by him. A company is a legal

entity and it can act through its directors. The company can act only through the resolutions passed by the directors. The assessee has not

contraverted the facts mentioned in the assessment orders for all the three assessment years under consideration. The quantum of inflation is also

not disputed. According to the assessee, in working out the profit and loss of the business, the assessee has to take into account the proper price

paid for the raw materials. The assessee pointed out that, whether it could have saved some money if the company was a little more alert, is

immaterial in this context. In the instant case, the assessee pointed out that the money has gone out of its coffers, since the correct price quoted by

the seller was paid and on part of it was returned to the assessee-company. Therefore, according to the assessee, even if there was any inflation,

that cannot be added to the income of the assessee in the assessment years under consideration. In the present case, the facts reveal that Mr. G.

Krishnan was not only a director of the assessee-company, but also a partner in the firm which was managing the assessee-company and the

partner of the managing agency firm are all closely related to each other. In fact, Mr. G. Krishnan was controlling both these entities.

14. Admittedly, the company paid an inflated price for purchasing the raw materials. As already pointed out while ascertaining the real income of

an assessee, it is open to the department to find out whether a particular item of expenditure was incurred for the purpose of the business. A part

of the sale price paid by a company went into the pocket of Mr. G. Krishnan. This would amount to siphoning off the assessee-company's income

deliberately to reduce the taxable income of the assessee. Further, if the company is defrauded by its director, it is always open to the company to recover the amount defrauded from the director who is responsible for the same. A similar situation arose in a case reported in Sri Ramalinga

Choodambikai Mills Ltd. Vs. Commissioner of Income Tax, Madras, . The facts in that case are as under (headnote) :

The account book of the assessee, a limited company, showed that some of its goods were sold, in its managing agency firm, to one of its director

and to a firm in which one of its director was a partner, at prices much lower than the market rates, and the Income Tax authorities, finding that the

sales to these persons at lower prices were not bona fide sales and were effected to benefit the purchasers at the expense of the company,

included the difference between the price for which these goods were sold and their market price at the date on which the goods were sold, as

profits of the company in its assessment.

15. On appeal, both the Appellate Assistant Commissioner and the Tribunal decided against the assessee. On a reference, since the books of the

three purchasers were not examined, the matter was remitted to the Tribunal for reconsideration. In that decision, this court felt that it is not for the

Revenue to fix the price and assess the assessee on that amount.

16. But, according to the facts appearing in the instant case, higher prices were paid to the sellers than the market rate and the difference was

pocketed by the director so as to reduce the profit of the assessee-company. Hence, the present case has go to be decided on the facts available

on records. Thus, on the facts, the Tribunal came to the conclusion that expenditure on cotton purchased was inflated deliberately for the personal

benefit of the managing director.

17. The Calcutta High Court had occasion to consider a question of similar nature in the case of ASIAN TOOL AND PLASTIC CO. Vs.

COMMISSIONER OF Income Tax, CALCUTTA., . In the said decision, the Calcutta High Court pointed out that the Income Tax Authorities

can substitute their own standard of reasonableness of expenditure for that of the assessee when the following conditions prevail (headnote) :

Where (a) the transaction is not a genuine or a straightforward one or is either colourable or illusory or fraudulent, (b) there are considerations

other than the purpose of the business, (c) on grounds of commercial expediency the expenditure is not justified, or (d) the expenditure is incurred

for fostering the business of another only or is made by way of distribution of profits or is wholly gratuitous or for some improper or oblique

purpose outside the course of business, the tax authorities are entitled to disallow the deduction claimed. They have also the same power when the

reality of the payment is questioned or challenged or is in dispute.

18. In the case of SREE MEENAKSHI MILLS LIMITED Vs. COMMISSIONER OF Income Tax, MADRAS., , The Supreme Court, in

similar circumstances, held as under :

The profits made by a company even though not reflected in the balance-sheet and the account books, the profit is taxable; what applies to

income applies with equal force to the expenditure claimed. Where expenditure is inflated to the extent of the inflation it can be disallowed.

19. Similarly in the case of Ramdas Dossa and Co. Vs. Commissioner of Income Tax, Bombay City, Bombay, :

The payment made by to 56 persons who are not in existence, the amount entered in the books as paid to them would be considered to be paid

to the assessee himself and constituted the income of the assessee. The mere fact that the amounts were shown as having gone out of the books

was not considered sufficient for deduction.

20. Learned counsel for the assessee relied upon a decision reported in the case Commissioner of Income Tax, Bombay City-I Vs. India United

Mills Ltd., , according to the facts appearing in that case, the assessee-company consisted of a group of textile mills. A firm was managing as the

agent of the company. The Income Tax Officer discovered that several contracts entered into by the managing agent on behalf of the assessee

were not genuine. He, therefore, did not accept the income as disclose by the assessee-company and applying the proviso to section 13 of the

Indian Income Tax Act, 1922, made an addition. However, the Tribunal found that though the contracts were not genuine, the assessee was not

responsible for that and the Tribunal further pointed out that the managing agency firm had, in fact, no regard for the welfare of the assessee-

company and had taken advantage of their position to enrich themselves. Considering all these aspects, the Tribunal came to the conclusion that, as

far as the assessee-company was concerned, it could not be said that the alleged income either accrued to, or was received in fact by, the assessee-company. On a reference, the High Court agreed with the Tribunal. But the facts appearing in the present case are entirely different as pointed out earlier. In the present case, the Tribunal, on considering the facts appearing in this case, came to the conclusion that the inflated price was paid deliberately only for the purposes of siphoning off the income of the assessee-company in order to reduce the profit of the company. Further, the director who is responsible for this was controlling both the assessee-company and the managing agency firm. The partners of the managing agency firm and the directors of the assessee-company are closely related. Therefore, in the present case, it cannot be said that the assessee-company did not benefit out of the inflation in the price paid to the sellers. Therefore, the above said decision will not be applicable to the facts of this case.

21. Another decision relied upon by learned counsel for the assessee was that reported in the case of A.D. Jayaveerapandia Nadar and Co. and

Others Vs. Income Tax Officer, . In this decision, this court, while considering the provisions of the Income Tax Act, 1961, and section 4 of the

Indian Partnership Act, 1932, held as under (headnote, p. 391) :

The acts of the organs of the corporation are to be attributed to the corporation and treated for legal purpose as though they were acts of the

corporation itself. However, when an act or mental state will be imputed to a company as its own is a question that has to be considered by a court

upon the facts and circumstances of each case. A company can commit crimes and it is a question in each case whether the act of the agent

including his state of mind, intention, knowledge or belief can be imputed to the corporation. It depends upon the nature of the charge, the position

of the officer or agent relative to the corporation and other relevant facts and circumstances of the case.

22. In fact, in the present case, considering the above-said principles, the Tribunal upheld the additions.

23. Thus, a careful consideration of the facts appearing in the present case clearly establish that the assessee-company with the connivance of the

said Mr. G. Krishnan, who is one of the directors of the assessee-company and a

partner of the managing agency firm, deliberately inflated the expenditure which cannot be considered as business expenditure. Therefore, on facts, we consider that the Tribunal was correct in upholding the additions made by the Income Tax Officer towards the inflation of the cotton purchase price in the assessment years under consideration.

Accordingly, we find that there is no infirmity in the order passed by the Tribunal in all the assessment years under consideration. In that view of the matter, question No. 1 referred to us by the Tribunal at the instance of the assessee is answered affirmatively and against the assessee.

24. In so far as the second question is concerned, it relates to the disallowance of interest on amounts allegedly diverted for non-business

purposes. For the assessment years 1958-59 to 1963-64, the Income Tax Officer disallowed amounts of Rs. 43,420, Rs. 67,518, Rs. 1,22,346,

Rs. 61,745 and Rs. 30,989, respectively, on account of interest on borrowings. The Income Tax Officer pointed out that even though there was a

huge cash balance in the assessee's cash book to the extent of Rs. 6 lakhs, the assessee's company borrowed huge amounts. The Income Tax

Officer doubted from the manner in which the amounts have been advanced to cotton suppliers that the cash balance was not really so high and the

extra cash must have been used in some manner other than for the assessee's business. Two of the managing agents accepted the withdrawal of

money to the extent of Rs. 4,50,000 for personal purposes. The entries in the accounts books showed that the amounts were taken and brought

back again. The Income Tax Officer pointed out that if the assessee had its own money and had not to resort to borrowings, a huge cash balance

would have been justified. The assessee was borrowing large amounts from its bankers. The Income Tax Officer found that the assessee had

advanced amounts to various parties allegedly for the purpose of cotton, but these amounts were not specifically utilised for that purpose. The

borrowed amounts were actually diverted for the benefits of the managing director and his men. The assessee contended that there is no nexus

between the diversion of the money and the borrowings from banks and outsiders. The Income Tax Officer pointed out that the director, after

collecting the outstanding, diverted the same to their personal benefits. From the above position, the Income Tax Officer came to the conclusion

that the account books did not reflect the reality. The Income Tax Officer, therefore, disallow the above-said amounts on an estimated basis in the

original assessment for the assessment year 1961-62 to 1963-64 and in the reopened assessment for the assessment years 1958-59 and 1959-60.

25. On appeal, the Appellate Assistant Commissioner, who dealt with the appeals relating to the assessment years 1958-59, 1959-60 and 1962-

63, held that the transaction of the assessee-company were all genuine transactions and the money borrowed by the company had been advanced

only for the purpose of purchasing cotton, kapas, etc. He further pointed out that, unless the funds borrowed themselves had a connection with the

funds advanced by the company for interest, the interest paid on the funds borrowed would not be disallowed. Accordingly for the assessment

years 1958-59, 1959-60 and 1962-63, the Appellate Assistant Commissioner deleted the additions of Rs. 43,420, Rs. 54,793 and Rs. 16,745,

respectively.

26. However, another Appellate Assistant Commissioner, who dealt with appeals relating to the assessment years 1961-62 and 1963-64

sustained the disallowance of interest made by the Income Tax Officer. According to this Appellate Assistant Commissioner, the assessee had not

produced the evidence to show that the borrowed funds had been utilized only for business purposes. With regard to the advance of money to the

other parties, the Appellate Assistant Commissioner held that the facts clearly established that the advance had nothing to do with the purchase of

cotton alleged to have been by the assessee. The Appellate Assistant Commissioner refused to accept the contention of the assessee that the

company and the directors are separate legal entities. Thus, the Appellate Assistant Commissioner upheld the disallowance of interest of Rs.

1,22,346 for the assessment year 1961-62 and Rs. 30,989 for the assessment year 1963-64 by the Income Tax Officer.

27. Aggrieved, both the assessee and the Department went in appeal before the Tribunal. The Tribunal, on considering the facts in circumstance of

the case and placing reliance on the decisions in Commissioner of Income Tax Bombay City-II Vs. Bombay Samachar Ltd., Bombay, , BIRLA

GWALIOR PRIVATE LTD. Vs. COMMISSIONER OF Income Tax, M.P., , Commissioner of Income Tax, Madras Vs. Coimbatore Salem

Transport (Private) Limited., , upheld the disallowance made by the Income Tax Officer in all assessment years under consideration.

28. Before this court, learned counsel for the assessee submitted as under : The cash balance in the books of the assessee-company was

maintained to the extent reflected in the accounts and that there was nothing to show that there was depletion. When amount had to be taken out,

they were taken out and promptly returned. The entries for the same can be seen from the account books. The amounts that were withdrawn were

only for the purpose of the business of the company there was no evidence on the site of the department to show that the huge cash balance was in

existence on a particular day and the same was withdrawn for the personal benefit of the managing director or the partners of the managing agency

from. So far as advance made to the persons like Pannalal Ramkumar, c. Jairam and Co., etc., are concerned, it cannot be said that these persons

had no business transactions with the assessee. The raw material had been purchased from them and utilized by the assessee for its business. It is

well known in this line of business that sellers of commodities have to paid in advance since they themselves were not in a position to finance the

local purchases from several persons and use to keep the advance till payments were made by the company. The amounts advance to the seller of

cotton, kapas, etc., were made in normal course of business and could not have been avoided by any prudent businessmen. If the assessee had

charged interest from these persons it would have been impossible to get supply of goods. The supply of raw materials would suffer if moneys

were not given to these sellers in advance. In a matter like this, it is not proper on the part of the Income Tax Officer disallow the interest on the

ground that these amounts had been advanced for non-business purpose. In fact, these amounts were utilized from time to time for financing

purchases and other working expenses of the company's business. There was no nexus between the amount advanced to the suppliers even if

these are treated as not for business purpose and the amount borrowed from outside persons. Therefore, it is not correct to state that the

borrowed amounts were not utilized for business purposes. As regards interest disallowed on loans from Multani Bankers, learned counsel relied

on the order passed by the Appellate Assistant Commissioner. According to the learned counsel, even if, in the alternative, these loans were not

treated as genuine, the net result would be that purchased of cotton represented by these loans were not made. It was, therefore, submitted that

the disallowance of interest is improper. In order to support this contention, learned counsel for the assessee relied upon decisions in *Amna Bai*

Hajee Issa Vs. Commissioner of Income Tax, Madras., , *COMMISSIONER OF Income Tax, ANDHRA PRADESH Vs. GOPIKRISHNA*

MURALIDHAR., , *Commissioner of Income Tax Bombay City-II Vs. Bombay Samachar Ltd., Bombay*, , *Commissioner of Income Tax,*

Madras Vs. Coimbatore Salem Transport (Private) Limited., .

29. On the other hand, learned standing counsel of the department submitted as under : The assessee had substantial cash balance on hand to the

extent of Rs. 6 Lakhs as per its accounts books and even then the assessee continued borrowings. The assessee had also advanced huge amounts

to the suppliers of cotton in many cases. The amount advanced were much more than the supplies made. In some cases, supplies were not made at

all. There was also evidence on record to show that the amount advanced were diverted by these supplies to the managing director and his

partners. It is a deliberate attempt on the part of the assessee to divert the amounts from the business to personal benefits of the managing director

and his partners. Therefore, the amounts borrowed were not utilized for the purpose of business in its entirety. The interest on the amounts diverted

for non-business purpose should be disallowed. In the present case, it is not correct that the company and the managing agency firm are two

different entities. The mere facts that the monies borrowed found their way into account books of the company would not be sufficient to show that

they were borrowed for business purpose. As regards interest on loans from Multani Bankers, the interest should be necessarily disallowed in

order to support his contention, learned standing counsel for the department also relied upon the decision in the case of *Commissioner of Income*

Tax Vs. Sujani Textiles (P) Ltd., .

30. We have heard the rival submissions.

31. The facts remain that there was a huge cash balance in the assessee's cash book as high as Rs. 6 Lakhs. Even then the assessee-company

borrowed huge amounts. On perusal of the accounts, The Department doubted that these adjustments would have been made to accommodate

the extra cash which was used in the assessee's business in some other manner.

32. A scrutiny of cash on August 1, 1960 showed a cash balance of only Rs. 885. Two of the partners of the managing agents accepted the

withdrawal of money from the cash balance for personal purposes and in fact agreed to return the cash of Rs. 4,50,000. the cash balance itself

started with a small amount which goes up to about Rs. 6 lakhs at the end of the year. On the leaving a small amount of cash balance. It remains to

be seen that if the assessee had its join money and had not to resort to borrowals, a huge cash balance would have been justified. On the other

hand, the assessee was borrowing large amounts from the bankers. The above position of the books did not reflect the reality. In fact, considering

all these aspects, the authorities below pointed out that the managing director is surreptitiously diverting the funds belonging to the assessee-

company for his personal benefit. Under the above said circumstances, it is also not possible for the assessee to contend that there is no nexus

between the diversion of money and the borrowings from banks and outsiders. Thus, the Tribunal, on a detailed analysis of the facts, clearly

demonstrated that the addition could be justified not merely on the ground of disallowance of interest but also is significant to note that, in the case

of Commissioner of Income Tax Bombay City-II Vs. Bombay Samachar Ltd., Bombay, , the Bombay High Court, while considering a similar

question arising u/s 10(2) (iii) of the Indian Income Tax Act, 1992, expressed the following view (headnote) :

The view that if the assessee had collected the outstanding which were due to it from others, it would have been able to reduce its indebtedness

and thus save a part of the interest which it had to pay on its own standings to remain without charging any interest thereon while it was paying

interest on the amounts borrowed by it, and that the extent to which it would have been in a position to collect interest on the outstanding due to it

from other, it could not be permitted to claim as an allowance interest paid by it, is not correct.

33. Similarly, while considering the provisions of section 36(1)(iii) and section 57(iii) of the Income Tax Act, 1961, this court, in the case of

Commissioner of Income Tax Vs. Sujani Textiles (P) Ltd., , held as under (head note) :

That in view of the finding of the Tribunal that the amounts borrowed by the company had been utilised for non-business purposes, viz, for investment in shares, the interest paid on the capital borrowed could not be allowed as a deduction u/s (36) (iii). In view of the question of allowance u/s 57(iii) not having been argued before the tribunal, m even though there was a passing observation that the interest may be allowed under the head "Other sources" the question of considering the allowability of the interest u/s 57(iii) could not be said to be comprehended in the question refereed to the High Court. Even assuming that the question of allowability of interest u/s 57(iii) could be considered to be one facet of the question referred to the High Court, the assessee could not have the benefit of the said section because, for an application of that section, there must possibility of income coming from the investment, though factually no such income need have arisen in the year in question and, in the instant case, in view of the resolution of the board of directors waiving interest on the advances and amounts due from the estate, there was no question of any receipt of income from that source against which the interest on the borrowed funds could be set off. Consequently, the interest paid by the company on its borrowed funds could not be allowed as a deduction either u/s 36(1)(iii) or u/s 57(iii).

34. Learned counsel for the assessee relied upon a decision of this court in the case of Commissioner of Income Tax, Madras Vs. Coimbatore

Salem Transport (Private) Limited., . According to the facts appearing in that case, moneys were borrowed by a company on interest and the

revenue authorities disallowed a portion of the interest paid by the assessee on the moneys borrowed by it in proportion to what it could have

charged from the directors on moneys advanced to them. The Tribunal, however, granted full deduction on the ground that it was a matter of

business prudence and, in the absence of positive materials that the moneys borrowed had been utilised for non-business purposes, the department

was not justified in disallowing any portion of the interest paid. In these facts, the High Court on a reference, held as under (headnote) :

That the Tribunal had not misplaced the onus of proof or failed to realise that the burden of proving that the moneys borrowed had not been

utilised for non-business purposes was on the assessee. The finding if the Tribunal, which was a factual one, was justified on the materials on

record, and its decision that there was no justification for disallowing any portion of the interest was right.

35. Therefore, this decision was rendered on the facts and circumstances available in that case. On the other hand, the facts and circumstances of

the present case are entirely different. The Tribunal, on a critical analysis of the facts, held that there was positive evidence to show that the

assessee company's funds were diverted for the personal benefit of the managing director and his men. In view of the categorical findings given by

the Tribunal that the amounts borrowed were utilised for non-business purposes, we consider that the above-cited decisions will not render any

help to the assessee to succeed in this case.

36. Another decision relied on by learned counsel for the assessee was that in the case of *Amna Bai Hajee Issa Vs. Commissioner of Income Tax,*

Madras, . According to the facts appearing in this case, on April, 1956, the assessee had an overdraft of Rs. 96,625 in a firm which acted as her

bankers. On March 31, 1957, she received a sum of Rs. 1,01,000 and paid it to this firm. She also borrowed Rs. 90,000 and other withdrawals

made by her, the debit balance remained at Rs. 53,182 on March 31, 1957. In the accounting year ended March 31, 1959, she had allowance

from her profits from the firm in which she had invested Rs. 90,000. This claim was disallowed by the Tribunal on the ground that the Rs. 90,000

could not be treated as borrowed capital as it could have come out of Rs. 1,01,000 she had received on March 31, 1957, and that reference, this

court held as under (headnote) :

That, as the assessee's directions to the bank showed that this particular sum of Rs. 90,000 was debited against her for the purpose of being that

the assessee had, according to the accounts, some funds at her disposal which she could have utilised for investment as capital was irrelevant.

37. This decision was also rendered on the facts and circumstances arising in that case, The question that arises for consideration in this case is

whether the assessee established the identity of the borrowed funds utilised for business purposes. On the other hand, in the present case, the

Tribunal clearly pointed out that the borrowed funds were not utilised for business purposes but the same was diverted as in the case of

COMMISSIONER OF Income Tax, ANDHRA PRADESH Vs. GOPIKRISHNA

MURALIDHAR., , where in the Andhra Pradesh High

Court, while considering the claim of deduction of interest on borrowed capital, held as under (headnote) :

.....as the amounts were borrowed for the purposes of the business of the family and as no particular sum purporting to be borrowed on behalf

of the business was spent for house hold expanses and the family was entitled to withdraw from the capital supplied by it thereby depleting the

capital, the fact that part of the amounts borrowed was later on used for personal expanses did not deprive the assessee of the benefit of deduction

the entire interest paid on borrowed capital u/s 10(2)(3) of the Indian Income Tax Act, 1992, and a part of the interest could not, therefore, be

disallowed.

38. In this decision, the Andhra Pradesh High Court pointed out that, on the facts, no particular sum purported to be borrowed for business

purposes was utilised for household expenses and the family is entitled to withdraw from the capital supplied by it and, therefore, it came to the

conclusion that no part of the interest can be disallowed. On the other hand, the facts arising in the present case are entirely different appointed our

earlier. Therefore, this decision also will render no help to the assessee herein.

39. Thus, in short, in order to claim deduction if interest on borrowed capital, the assessee had got to satisfy that (1) the money was borrowed (2)

it must have been borrowed for the purpose of business; and (3) the pointed out, in the present case, the Tribunal, after delving very deep into the

facts in detail came to the conclusion that the accounts books did not reveal the reality, the managing director was diverting the funds belonging to

the assessee-company for his own personal benefit, the extra amount was not brought into the accounts and there was nexus between the amounts

diverted and the borrowings from banks and outsiders. Therefore, the Tribunal came to the conclusion that the borrowed fund was not utilised for

business purposes of the assessee-company. Hence, the addition is sustainable not only on the ground of disallowance but also on the ground of

extra income not brought in the account books in all the assessment years under consideration.

40. In that view of the matter, we answer the second question referred to us at the instance of the assessee, in the affirmative and against the

assessee.

41. The third question referred to us at the instance of the assessee related to the addition of Rs. 4,40,000 for the assessment year 1961-62. While

completing the assessment for the assessment year 1961-62, the Income Tax officer found the percentage of waste and the invisible loss excessive.

The wastage seems to have occurred only at the blow room stage. Therefore, the Income Tax officer came to the conclusion that the assessee had

not issued cotton for manufacture but only showed it as having been issued in several cases. The Income Tax officer pointed out that the actual

extent of cotton consumed was far less than what was entered in the books. Hence, the Income Tax officer worked out the excess consumption of

cotton and, estimating the average price, determined the inflated expenses at Rs. 4,40,000. The Income Tax officer pointed out that this inflation is

also due to the fact that, as against the issue of cotton by Vijaykumar Cotton Press weighing 400 pounds, each bale was found to contain as a

matter of fact only 260 to 270 pounds. Hence, he made an addition of Rs. 4,40,000. On appeal, the Appellate Assistant Commissioner confirmed

the addition. On further appeal, the Tribunal, considering the facts on this aspects, upheld the addition.

42. Before us, learned counsel for the assessee submitted that, inasmuch as the entire amounts have been spent for the purchase of kapas, it should

be allowed as an expenditure. According to learned counsel, merely because the company has been defrauded by one of the suppliers by giving

short weight of cotton, an additional burden of tax on Rs. 4,40,000 should not be imposed on the assessee. On the other hand, learned standing

counsel for the Department pointed out that the inflation was shown deliberately with the connivance of the managing director. It was pointed out

berately with the connivance of the managing director. It was pointed out that Sri G. Krishnan was, in fact, running both the assessee-company and

Vijaykumar Cotton Press was not disputed. Learned standing counsel further pointed out that the cotton consumed was debited to the

manufacturing account of the company and purchases as such were not debited to the accounts. It was, therefore, pleaded that the Tribunal was

correct in sustaining the addition.

43. We have heard the rival submissions.

44. The production and manufacturing details of the assessee's business show wastage at 29 per cent. and an invisible loss at 13 per cent.

Amounting to Rs. 3,61,580. There is no evidence to show that the waste produced was utilised as alleged. If, really, the waste produced was

utilised as alleged, the invisible loss would have been reduced to a great extent. The wastage was found to have taken place at blow room stage.

The irresistible conclusion was that in fact the assessee had not issued cotton for manufacture but only showed it as having been issued in several

cases. It remains to be seen that the actual extent of cotton consumed was far less than what was entered in the books. Vijaykumar Cotton Press

supplied the cotton. It supplied cotton bales each weighing 400 Pounds but actually each bale weighed only 260 to 270 pounds. It was conceded

that 40,000 Pounds of cotton found deficient was not a wastage as claimed at the blow room stage but it represented shortage in the over all

quantity of cotton put into manufacture. It was shown that the managing director, Mr. G. Krishnan, of the assessee-company was defrauded. The

company being a party to the entire transaction, it cannot plead that the suppliers of cotton defrauded the assessee-company. In fact, the quantity

of cotton said to have been purchased was not actually put into use. Therefore, it is not proper on the part of the assessee-company to charge its

trading accounts with the cost of 40,000 Pounds of cotton not supplied. In such circumstances, the authorities below worked out the excess

consumption of cotton and estimating the average price of cotton prevalent at that time, made the above-said additions. Therefore, on considering

the facts, the Tribunal sustained the addition. Accordingly, we consider that there is no infirmity in the order passed by the Tribunal on this aspect.

In that view of the matter, we answer the question referred to us at the instance of the assessee in the affirmative and against the assessee.

45. As the instance of the Department also, the Tribunal referred question relating to the deduction of a sum of Rs. 10,000 in the assessment year

1965-66 and another sum of Rs. 5,600 in the assessment year 1966-67. For the assessment years 1965-66 and 1966-67, the assessee entered

into a contract with one Bhajrajamal Gobiram for purchase of cotton bales. The contract could not be executed and hence it was settled by a lump

sum payment of Rs. 10,000 being the compensation. The Income Tax officer treated the same as a speculative transaction and disallowed the

claim. So also, in the assessment year 1966-67, the Income Tax officer disallowed a sum of Rs. 5,000 claimed under those heads. On appeal, the Appellate Assistant Commissioner sustained the additions made by the Income Tax officer in both the assessment years, placing reliance on the ratio laid down in the case of HOOSEN KASAM DADA (INDIA) LTD. Vs. COMMISSIONER OF Income Tax, CALCUTTA., and in the case of RUGHUNARAYAN RICE MILLS Vs. COMMISSIONER OF Income Tax, BIHAR AND ORISSA., . On further appeal, considering the facts and circumstances of the case, the Tribunal held that the damages were incurred in the regular course of a continuing business and, accordingly, allowed the claim made by the assessee in both the years.

46. Before us, learned standing counsel for the department submitted that the Tribunal was not correct in holding that the transaction is not a speculative one. According to learned standing counsel, the assessee ought not to have entered into a contract with a third party to purchase foreign goods without a licence to lift the same. On the other hand, learned counsel for the assessee submitted that the assessee entered into a contract with a third party and the contract could not be honoured since the assessee has no licence to lift the goods. The third party filed a suit and the same was compromised by paying a lump sum amount of Rs. 10,000 in the assessment year 1965-66 and Rs. 5,600 in the assessment year 1966-67. Therefore, it was not a speculative transaction but the expenditure was incurred in the ordinary course of a continuing business in order to maintain good relationship with the customer. Therefore, it was submitted that the Tribunal was correct in allowing the claim.

47. We have heard the rival submissions.

48. In the assessment year 1965-66, there was an agreement for supply of cotton. The assessee could not obtain the necessary licence. The cotton, therefore, could not be lifted. The third party filed a suit O. S N.. 35 of 1963 and the suit was compromised on payment of a lump sum amount of Rs. 10,000 in the assessment year 1965-66 and a sum of Rs. 5,600 in the assessment year 1966-67.

49. The assessee was interested in importing cotton for manufacturing and sale of yarn. In the absence of a licence, the assessee could not avail of the import of goods. The damages for the non-fulfillment of the contract and also

for continuing the business with a customer. The loss in speculative business cannot be allowed. But the damages for non-fulfillment of a contract for business cannot be disallowed if it is incurred in the interest of the continuing business. In this context, it is pertinent to note that the Supreme Court in the case of Commissioner of Income Tax, Bombay City-III Vs. Shantilal P. Ltd., , while considering the provisions of Explanation 2 to section 73 of the Indian Contract Act, 1872, held as under (at pp. 60, 61)

Is a contract for the purchase or sale of any commodity settled when no actual delivery or transfer of the commodity is effected, and instead, compensation is awarded under an arbitration award as damages for a breach of the contract? A contract can be said to be settled if, instead of effecting the delivery or transfer of the commodity envisaged by the contract, the promisee, in terms of section 63 of the Contract Act, accepts, instead of it, any satisfaction which he thinks fit. It is quite another matter where, instead of such acceptance, the parties raise a dispute and no agreement can be reached for discharge of the contract. There is a breach of the contract and, by virtue of section 73 of the Contract Act, the party suffering by such breach becomes entitled to receive the loss caused to him thereby. There is no reason why the sense conveyed by the law relating to contracts should not be imported into the definition of "speculative transaction" The award of damages for the breach of a contract is not the same thing as a party to the contract accepting satisfaction of the contract otherwise than in a general sense, the layman would understand that the contract must be regarded as settled when damages are paid by way of compensation for its breach. What is really settled by the award of such damages and their acceptance by the aggrieved party is the dispute between the parties. The law, however, speaks of a settlement of the contract, and a contract is settled when it is either performed or the promisee dispenses with or remits, wholly or in part, the performance of the promise made to him or accepts instead of it any satisfaction which he thinks fit. We are concerned with the sense of law, and it is that sense which must prevail in sub-section (5) of section 43. Accordingly, we hold that a transaction cannot be described as a "speculative transaction" within the meaning of sub-section (5) of section 43 of the Income Tax Act, 1961, where

there is a breach of the contract and, on a dispute between the parties, damages are awarded as compensation by an arbitration award.

50. However, learned standing counsel for the Department relied on a decision of the Orissa High Court in the case of RUGHUNARAYAN

RICE MILLS Vs. COMMISSIONER OF Income Tax, BIHAR AND ORISSA., . According to the facts appearing in that case, there was no

breach of contract. By frustration, the contract became unenforceable. It was open to the assessee to resile from the contract and take a stand that

the residual contractual obligation was incapable of performance. Without doing so and without doing so and without any pressure from the

Calcutta constituents, the assessee, to save its business reputation, honoured the contract which amounts to settlement of the contract within the

meaning of speculative contract under Explanation 2. Hence, the Orissa High Court held on the facts that the transaction in that cases a speculative

one and, therefore, the claim made by the assessee could not be allowed. But the facts arising in the present case are entirely different. According

to the facts in this case, a suit was filed to recover the amount. The suit was compromised on mediation, compelling the assessee to pay the above

said lump sums. Therefore, applying the ratio laid down by the Supreme Court in the decisions cited supra, we consider that the transaction in the

present case is not a speculative one and hence there is no infirmity in the order passed by the Tribunal in allowing the Claim made by the assessee

in the above-said two assessment years under consideration. In that view of the matter, we answer the question referred to us at the instance of the

Department in the affirmative and against the Department.

51. In the result, the questions referred at the instance of the assessee are answered in the affirmative and against the assessee and the question

referred at the instance of the Department is also answered in the affirmative but against the Department.

52. Parties are directed to bear their own costs.