

R. DALMIA

v.

C.I.T., DELHI, NEW DELHI

September 21, 1977

[P. N. BHAGWATI AND S. MURTAZA FAZAL ALI, JJ.]

*Income Tax Act 1922, s. 12(2)—Assessee borrowed money from a bank and bought shares—Agreement provided that dividend etc., on shares declared after a certain date shall be held by the bank for the benefit of the assessee—Shares not taken delivery of by the assessee by the stipulated date—Dividend declared, if accrued to the assessee.*

*Section 12(2), scope of—Interest paid on loan and damages paid—If permissible deduction.*

The assessee borrowed a large sum of money from a bank and purchased shares from it; but did not take delivery of the transfer forms and share certificates by making payment of the purchase price. Clause (3) of the agreement, however, stipulated that if the shares were not taken delivery of by a certain date, dividends, right, bonuses etc. which might be declared after that date would be held by the bank for the benefit of the assessee; and that the assessee would be liable to pay interest on the purchase price. Clause (4) provided that if the assessee did not take delivery of the shares by a certain date, the bank would be at liberty to sell the undelivered shares and to hold the assessee liable for the difference in the price fetched by the shares.

The assessee paid to the bank over two lacs of rupees by way of interest and more than a lac of rupees by way of damages for failure to take delivery of the shares. A sum of Rs. 95,000 odd was earned as dividend by the assessee on the shares.

The Income Tax Officer disallowed the claim of the assessee for deduction under s. 12(2) of the Indian Income Tax Act 1922 of the interest on the loan and damages paid by him to the bank but included the dividend earned on the shares in his total income. On appeal the Appellate Assistant Commissioner affirmed the view of the Income Tax Officer. The Tribunal, on the other hand, held that since there was no transfer of equitable title in the shares to the assessee, he was not entitled to any deduction of interest; disallowed the deduction of damages paid by the assessee but excluded the dividend from his total income on the ground that it was not dividend earned by him. On reference, the High Court affirmed the findings of the Tribunal.

Allowing the appeal in part,

**HELD :** (1) The High Court and the Tribunal were wrong in taking the view that the Income Tax Officer rightly disallowed the interest claimed by the assessee. This amount was a permissible deduction under s.12(2) of the Act and should have been allowed. There is a direct nexus between the amount paid by the assessee as interest and the earning of the dividend income. [546 A-B]

(2) In the *Bank of India v. J. A. H. Chinoy* A.I.R. 1950 P.C. 90 at 97, the Privy Council held that even though a transaction may not amount to an acquisition of equitable interest, yet as between the vendor and the purchaser a term regarding payment of the declared dividend would be fully effective because once the dividends are declared, they will be deemed to have accrued to the purchaser even though there may not have been any transfer of equitable title to the purchaser. Clause (3) of the agreement read in the light of this decision shows that even if there was no transfer of equitable title to the assessee, since the dividend declared would be an additional source of income to him, the assessee would be entitled to deduct the interest paid on the loan for acquiring the shares. [541 E & H]

A (3) An analysis of s.12(2) of the Indian Income Tax Act 1922 shows that before this provision could apply, the following conditions must be fulfilled: (i) the expenditure must have been incurred solely and exclusively for the purpose of earning income or making profit; (ii) the expenditure should not be in the nature of a capital expenditure; (iii) the amount in question should not be in the nature of personal expenses of the assessee; (iv) the expenditure should be incurred in the accounting year; and (v) there must be a clear nexus between the expenditure incurred and the income sought to be earned. [542 E-G]

B In the instant case (i) a genuine and *bona fide* contract had been entered into between the assessee and the bank for transfer of a large number of shares to the assessee; (ii) the assessee, in pursuance of this agreement raised the loan from the bank and paid interest for this purpose; and (iii) under cl.(3) of the agreement the dividends, rights and bonuses etc., were held by the bank for the benefit of the assessee after they were declared.

C *Eastern Investments Ltd. v. Commissioner of Income Tax, West Bengal* 20 I.T.R. 1 and *Bombay Steam Navigation Co. (1963) Private Ltd. v. Commissioner of Income-tax, Bombay* 56 I.T.R. 52, 59, followed.

*J. K. Commercial Corporation Ltd. v. Commissioner of Income-tax, U.P.* 72. I.T.R. 296 and *Commissioner of Income-tax, Bombay City I v. H. H. Maharani Vijaykuverba Saheb of Morvi* 100 I.T.R. 67, approved.

D *Ormerods (India) Private Ltd. v. Commissioner of Income-tax, Bombay City* 36 I.T.R. 329 and *Smt. Nirmala M. Doshi v. Commissioner of Income-tax, Bombay City II* 82 I.T.R. 648, referred to.

(4) Since the assessee's main business was not dealing in shares, damages were paid by him due to his own default. The damages paid would, therefore, be capital expenditure. [546 C]

(5) The dividend earned by the assessee should be included in his total income. [546 F]

E CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1519 of 1971.

Appeal by Special Leave from the Judgment and Order dated 22-1-1971 of the Delhi High Court in I. T. Reference No. 25 of 1966.

*Bishamber Lal* for the Appellant.

F *V. P. Raman*, Addl. Sol. Genl. and *J. Ramamurthi* for the Respondent.

The Judgment of the Court was delivered by

G FAZAL ALI, J. In this appeal by special leave, the assessee who is an individual had purchased a large number of shares from the Bharat Bank Ltd. for Rs. 44,14,990/- by borrowing this amount from the Bharat Bank and he paid interest of Rs. 2,04,744/- on the said amount. In fact four years back i.e. in 1944-45 the joint family of which the assessee was a member had sold these very shares along with other shares to the Bharat Bank Ltd. The agreement by which the assessee purchased these shares is dated February 5, 1948 and is to be found at Annexure A on p. 19 of the Paper Book. In spite of the fact that the assessee had agreed to buy the shares from the Bharat Bank Ltd. he did not take delivery of the transfer forms and the share certificates by making payment of the purchase price. Under the agree-

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ment dated February 5, 1948 it was agreed that the shares would be taken delivery of on or before March 31, 1948. It was further agreed that if the shares were not taken delivery of by this date, the dividends, rights, bonuses etc. which may be declared after that date, namely, March 31, 1948 will be held by the Bank for the benefit of the assessee and the assessee would be liable to pay interest at the rate of 6% p.a. on the purchase price from April 1, 1948 till actual delivery of the shares. Clause (4) of the agreement provided that if for any reason the shares were not taken delivery of by March 31, 1951, the Bank will be at liberty to sell the then undelivered shares and to hold the assessee liable for the difference in the price fetched by the shares. The assessee did not take delivery of some of the shares until March 31, 1951 and paid a sum of Rs. 1,05,000/- as damages for his failure to take delivery as stipulated in the agreement between the parties. It is also the admitted case of the parties that the assessee earned a dividend income of Rs. 95,664/-. The assessment year in the instant case is 1953-54 i.e. the previous year ending September 30, 1952. The assessee claimed that he was entitled to deduct the interest paid for acquiring the shares worth Rs. 44,14,990/- and, therefore, a sum of Rs. 2,04,744/- was deductible under s. 12(2) of the Income-tax Act, 1922—hereinafter referred to as 'the Act'. It was further alleged by the assessee that even the damages amounting to Rs. 1,05,000/- which he had paid to the Bharat Bank for not taking delivery of the shares were also deductible because this was a business expenditure. Finally, the assessee also claimed that the sum of Rs. 95,664/- being the dividend income was not to be included in the total income of the assessee. The Income-tax Officer rejected all the pleas taken by the assessee and disallowed the deductions claimed by the assessee as mentioned above. The Income-tax Officer also included the sum of Rs. 95,664/- in the total income of the assessee.

The assessee filed an appeal before the Appellate Assistant Commissioner who affirmed the order of the Income-tax Officer, though on slightly different grounds with which we are not concerned here. Thereafter the assessee filed an appeal before the Tribunal which gave a finding that under the facts and circumstances of the present case there was no transfer of equitable title in the shares to the assessee and, therefore, he was not entitled to any deduction of the interest paid by him on the capital amount which constituted the purchase money of the shares. The Tribunal further held that the interest paid was of a capital nature and did not fall within the ambit of s. 12(2) of the Act. As regards the assessee's claim to the dividend income of Rs. 95,664/-, the Tribunal held that as the said income had been credited to the account of the assessee in terms of cl. (3) of the agreement dated February 5, 1948 it had not been actually earned by the assessee and the receipt of the dividend by the Bank was only taken into account for finalisation of the price. The Tribunal accordingly directed deletion of this amount from the total income of the assessee. As regards the third point, namely, the sum of Rs. 1,05,000/- which the assessee paid as damages to the Bank, the Tribunal held that as the assessee was not doing business exclusively in shares he was not entitled to set off the interest paid by him as revenue loss.

A Thereafter the appellant moved the Tribunal for making a reference to the High Court and after hearing counsel for the parties the Tribunal referred the following questions for the opinion of the High Court :

“(1) Whether on the facts and in the circumstances of case the tribunal rightly rejected the assessee’s claim for deduction of the interest payment of Rs. 2,04,744/- ?

B (2) Whether on the facts and in the circumstances of the case the tribunal rightly held that the revenue was not estopped from disallowing the claim for the deduction of the interest amount in view of the allowance of such claim in the past ?

C (3) Whether on the facts and in the circumstances of the case the tribunal rightly disallowed the loss of Rs. 1,05,000/- in respect of 7500 preference shares of the Dalmia Investment Company Ltd. ?

(4) Whether on the facts and in the circumstances of the case the tribunal rightly held that the dividend amount of Rs. 95,664/- did not constitute the income of the assessee ?”

D Out of these questions, Question No. (2) has not been pressed by the appellant because it is well settled that there is no question of *estoppel* or *res judicata* in relation to the assessment of different years. Thus the only questions that were to be determined by the High Court were Questions Nos. (1), (3) and (4). The High Court agreed with the Tribunal that in the facts and circumstances of the case there was no transfer of equitable title of the shares to the assessee and, therefore, he was not entitled to claim deduction of Rs. 2,04,744/-. The finding of the Tribunal on Question No. (3) was also upheld and the High Court agreed that the loss of Rs. 1,05,000/- was rightly disallowed. On Question No. (4) the High Court, also agreed with the view of the Tribunal and held that this amount could not be included in the total income of the assessee. The assessee has come up to this Court, after obtaining special leave from this Court.

G Both the Tribunal and the High Court have gone into the question of transfer of equitable title at very great length, but in the facts and circumstances of this case after hearing the parties and going through the record we feel that the question of transfer of equitable title is a vexed question of law and is not free from difficulty. Having regard to the peculiar facts of this case, it is not necessary for the Court to decide the question of equitable transfer in order to give relief to the appellant on Question No. (1). In other words, we are of the opinion that the question as to whether or not the appellant is entitled to a deduction of Rs. 2,04,744/- can be decided without touching or affecting the question of transfer of equitable title to the assessee. This can be done by examining the scope and ambit of s. 12(2) of the Act in order to find out if the assessee’s case for payment of interest can come within the four corners of that section. In these circumstances we do not propose to go into the question of transfer of equitable title which had occupied a greater part of the judgments of the High Court and

the Tribunal. We would, however, like to make it clear that we should not be taken to have affirmed the decision of the High Court on this point, but we refrain from expressing any opinion thereon in the view that we take in the present case.

In *Bank of India v. J.A.H. Chinoy*,<sup>(1)</sup>, Lord MacDermott pointing out the extent of the doctrine of transfer of equitable title to a purchaser observed as follows :

"Their Lordships do not desire to cast doubt on the proposition that in India a purchaser of shares (which under the Indian Sale of Goods Act come within the definition of "goods") does not acquire an equitable interest by virtue of the contract of sale. But they cannot agree with the application of this proposition which commended itself to the Appellate Court. No doubt as between a company and a purchaser of shares therein the date of completion is all important. But as between vendor and purchaser, where the contract does not otherwise provide, the term to be implied as to dividends is not confined to dividends still to be declared in respect of a period or periods prior to the contract. It includes such dividends but that is not because the period in which they were earned is crucial; what is crucial is the date or dates of declaration."

It would appear from the observations of the Privy Council that even though the transaction may not amount to acquisition of equitable interest, yet between the vendor and the purchaser the term regarding payment of the declared dividend would be fully effective because once the dividends are declared they will be deemed to have accrued to the purchaser even though there may not have been any transfer of equitable title to the purchaser. In the instant case, cl. (3) of the agreement by which the assessee purported to acquire shares from the Bank runs thus :

"That if the shares are not taken delivery of by 31-3-48 the dividends, rights, bonuses, etc., that may be declared after that date, will be for your benefit, but you will be liable to pay interest at 6% from 1-4-1948 till the date of actual delivery on the price of the shares calculated at the rates above mentioned."

A perusal of the statement made in this paragraph manifestly reveals that even if the shares are not taken delivery of by the assessee, the dividends, rights, bonuses etc. which may be declared after that date were to be held by the Bank for the benefit of the purchaser. Thus the principle which is deducible from the decision of the Privy Council in *J.A.H. Chinoy's case* (supra) fully applies to the facts of the present case. It follows, as a logical corollary, therefore, that even if there was no transfer of equitable title to the assessee, since a Company declared the dividend etc. which would be an additional source

(1) A.I.R.1950 P.C 90., 97.

A of income to the assessee, would he not be entitled to deduct a sum of Rs. 2,04,744/- being the interest paid on the loan for acquiring the shares? The position will become clear if we extract s. 12(2) of the Act as it stood at the relevant time :

B “(2) Such income, profits and gains shall be computed after making allowance for any expenditure incurred solely for the purpose of making or earning such income, profits or gains provided that no allowance shall be made on account of—

(a) any personal expenses of the assessee, or

C (b) any interest chargeable under this Act which is payable without the taxable territories, not being interest on a loan issued for public subscription before the 1st day of April, 1938, or not being interest on which tax has been paid or from which tax has been deducted under section 18, or

D (c) any payment which is chargeable under the head “Salaries” if it is payable without the taxable territories and tax has not been paid thereon nor deducted therefrom under section 18.”

E An analysis of this sub-section would show that in computing the income under this head the assessee is entitled to deduction in respect of the expenditure incurred solely for the purpose of earning such income, provided the expenditure is not of a capital nature and does not include any personal expenses incurred by the assessee. In other words, before this provision could apply the following conditions must be fulfilled :

(i) the expenditure must have been incurred solely and exclusively for the purpose of earning income or making profit;

F (ii) the expenditure should not be in the nature of a capital expenditure;

(iii) the amount in question should not be in the nature of personal expenses of the assessee;

(iv) that the expenditure should be incurred in the accounting year; and

G (v) there must be a clear nexus between the expenditure incurred and the income sought to be earned.

H In *Eastern Investments Ltd. v. Commissioner of Income-tax, West Bengal*<sup>(1)</sup> the facts were that the assessee which was an Investment Company was formed for acquiring, holding and dealing in shares and Government securities belonging to C. C died and S was appointed Administrator of his estate and in that capacity he sold 50,000 ordinary shares. Money was required by the Executor of C and he entered into an agreement with the assessee Company by which the assessee

agreed to reduce its share capital by Rs. 50 lakhs by taking over from the Administrator 50,000 shares at Rs. 100/- per share and to receive instead debentures of the face value of Rs. 50 lakhs carrying interest at 5% per annum. The agreement was sanctioned by the High Court and was ultimately carried out. The transaction was held to be genuine. The Appellate Tribunal and the Calcutta High Court took the view that in computing the income of the assessee the interest paid on the debentures could not be deducted under s. 12(2) of the Act as this was not an expenditure for the purpose of earning the income. This Court, while reversing the judgment of the Calcutta High Court, held that once the transaction was held to be a genuine one it clearly fell within the purview of s. 12(2) of the Act and the interest paid by the assessee was a permissible deduction under s. 12(2) of the Act. In this connection, this Court observed as follows :—

“On a full review of the facts it is clear that this transaction was voluntarily entered into in order indirectly to facilitate the carrying on of the business of the company and was made on the ground of commercial expediency. It therefore falls within the purview of Section 12(2) of the Income-tax Act, 1922, before its amendment.

This being an investment company, if it borrowed money and utilised the same for its investments on which it earned income, the interest paid by it on the loans will clearly be a permissible deduction under Section 12(2) of the Income tax Act.”

The aforesaid case appears to be on all fours with the facts in the present case. In the instant case also it is not disputed before us that the agreement entered into between the parties was a genuine one. In fact the Tribunal had also held that the agreement was actually acted upon. Once this was so, then the interest which the assessee paid on the loan of Rs. 44,14,990/- which came to Rs. 2,04,744/- was really paid for the purpose of earning income, namely, the dividends, bonuses etc. which were held by the Bank for the benefit of the assessee. The interest of Rs. 2,04,744/- paid by the appellant could not be said to be of a capital nature, nor could it be deemed to be personal expenses incurred by the assessee. In these circumstances, therefore, the essential ingredients of s. 12(2) are fully satisfied in this case and on the authority of this Court in *Eastern Investments Ltd.'s case* (supra) the appellant's case squarely falls within the four corners of s. 12(2) as a result of which the amount of interest of Rs. 2,04,744/- was a permissible deduction under s. 12(2) of the Act.

In *Bombay Steam Navigation Co. (1953) Private Ltd. v. Commissioner of Income-tax Bombay*<sup>(1)</sup>, in somewhat similar circumstances, this Court allowed the expenditure as a deduction under s. 10(2)(xv) and observed as follows :

“But in our judgment interest paid by the assessee-company is a permissible deduction under Section 10(2)(xv)

(1) 56 I.T.R. 52, 59.

A which permits "any expenditure not being an allowance of the nature described in any of the clauses (i) to (xiv) 'inclusive and not being in the nature of capital expenditure or personal expenses of the assessee laid out or expended wholly and exclusively for the purpose of such business, profession or vocation' as a permissible allowance in the computation of profits or gains of the business carried on in the year of account. . . . . The expenditure was incurred after the commencement of the business. The expenditure is not for any private or domestic purposes of the assessee-company. It is in the capacity of a person carrying on business that this interest is paid."

C This Court further observed :

D "Whether a particular expenditure is revenue expenditure incurred for the purpose of business must be determined on a consideration of all the facts and circumstances, and by the application of principles of commercial trading. The question must be viewed in the larger context of business necessity or expediency. If the outgoing or expenditure is so related to the carrying on or conduct of the business, that it may be regarded as an integral part of the profit-earning process and not for acquisition of an asset or a right of a permanent character, the possession of which is a condition of the carrying on of the business, the expenditure may be regarded as revenue expenditure."

E Apart from these decisions of this Court, a number of decisions of the High Courts have also taken the same view. In *Ormerods (India) Private Ltd. v. Commissioner of Income-tax, Bombay City*<sup>(1)</sup>, the Bombay High Court allowed certain sums of money paid as interest on borrowed capital for the purchase of shares and held that the word "purpose" in the expression "expenditure incurred solely for the purpose of making or earning such income, profits or gains" did not mean motive for the transaction, much less can it mean ulterior motive or ulterior object. The Court held that as the investments were made for the purpose of earning income, the interest paid thereon would be deductible under s. 12(2) of the Act.

G A similar view was taken by the Allahabad High Court in *J. K. Commercial Corporation Ltd. v. Commissioner of Income-tax, U.P.*<sup>(2)</sup> where it was held that any expenditure incurred for preservation or protection of a capital asset was revenue in nature. The Court held that legal and travelling expenses incurred by the assessee for protecting dividend income and to ensure the prospective dividend earning capacity were clearly allowable under s. 12(2) of the Act. We find ourselves in complete agreement with the view taken by the Allahabad High Court in that case.

(1) 36 I.T.R. 329.

(2) 72 I.T.R. 296.

In *Smt. Nirmala K. Doshi v. Commissioner of Income-tax, Bombay City II*<sup>(1)</sup>, the Bombay High Court held that payment of interest for earning dividend income was deductible under s. 12(2) of the Act.

In *Commissioner of Income-tax, Bombay City I v. H. H. Maharani Vijaykuverba Saheb of Morvi*<sup>(2)</sup>, a Division Bench of the Bombay High Court held that the deduction which is permissible under sub-s. (2) of s. 12 is an expenditure incurred solely for the purpose of making or earning the income which has been subjected to tax and the dominant purpose of the expenditure incurred must be to earn income. It was further held that the connection between the expenditure and the earning of income need not be direct, and even an indirect connection could prove the nexus between the expenditure incurred and the income. We fully agree with the view taken by the Bombay High Court.

In view of the direct decision of this Court in *Eastern Investments Ltd.'s case* (supra), it is not necessary for us to multiply authorities. Summarising, therefore, the facts of the present case, the position which emerges is as follows :—

- (1) that a genuine and *bona fide* contract had been entered into between the assessee and the Bank for transfer of large number of shares to the assessee;
- (2) that the assessee in pursuance of this agreement had raised a loan of Rs. 44,14,990/- from the Bank in order to acquire the shares and had paid interest of Rs. 2,04,744/- for this purpose; and
- (3) as a result of the aforesaid acquisition, under cl. (3) of the agreement the dividends, rights, bonuses etc. held by the Bank were held for the benefit of the assessee after they were declared. It is obvious that if the assessee would not have paid the interest on the loan raised by him he would not have been able to get the dividend income.

In these circumstances, therefore, there was a direct nexus between the expenditure of Rs. 2,04,744/- incurred by the assessee as interest and the earning of the dividend income. The assessee has clearly established that the expenditure aforesaid was incurred solely and wholly for the purpose of earning the bonuses and dividend income. As the shares were not the stock-in-trade of the appellant it could not be said that the interest paid by the assessee to the Bank was an expenditure of a capital nature, nor was there any material to show that the expenditure incurred by the assessee amounted to his personal expenses. In these circumstances, we are satisfied that the case of the appellant in paying the interest amounting to Rs. 2,04,744/- falls clearly within s. 12(2) of the Act and the conditions of the aforesaid provision being fulfilled the assessee was in law entitled to deduction of the amount of

(1) 82 I.T.R. 648.

(2) 100 I.T.R. 67.

- A** Rs. 2,04,744/- under s. 12(2) of the Act. We are, therefore, of the opinion that the High Court and the Tribunal were wrong in taking the view that the Income-tax authorities rightly disallowed the amount of Rs. 2,04,744/- as claimed by the assessee. We are clearly of the opinion that this amount was a permissible deduction under s. 12(2) of the Act and should have been allowed by the Income-tax authorities. In these circumstances, therefore, we hold on question No. (1) that
- B** both the Tribunal and the High Court should have held that the assessee's claim for deduction of interest amounting to Rs. 2,04,744/- was wrongly rejected by the Income-tax authorities.

- So far as Question No. 3 relating to damages of Rs. 1,05,000/- paid to the Bank by the assessee for non-delivery of the shares is concerned, we are unable to agree with counsel for the appellant that this
- C** was a deductible expenditure. We have already pointed out that the assessee's main business was not dealing in shares and, therefore, the damages paid were due to his own default and would, therefore, be a capital expenditure rather than a revenue one. The High Court and the Tribunal were right in disallowing this amount.

- As regards question No. (4) the position is somewhat obscure.
- D** While the Tribunal had deleted the amount of Rs. 95,664/- from the total income of the assessee, the High Court also agreed with the Tribunal and answered this question in the affirmative against the Revenue. Learned counsel for the Revenue has, however, submitted that if we are of the opinion that the appellant should be entitled to the deduction of Rs. 2,04,744/- under s. 12(2) of the Act, then it automatically follows that he cannot claim exemption in respect of the dividend
- E** income. In our opinion the argument of Mr. V. P. Raman, learned counsel for the Revenue is well founded and must prevail. Even Mr. Bishamber Lal appearing for the assessee/appellant was fair enough to concede that if we hold that the interest of Rs. 2,04,744/- was a permissible deduction under s. 12(2) of the Act then he would not press his claim before the Income-tax authorities for deletion of the dividend
- F** income of Rs. 95,664/- and he would have no objection if this Court sets aside this deletion. In this view of the matter we set aside the order of the High Court as also that of the Tribunal deleting the amount of Rs. 95,664/- which will be included in the total income of the assessee.

- The result is that the appeal is allowed in part and our finding on Question No. (1) is that the High Court and the Tribunal were wrong in disallowing the deduction of Rs. 2,04,744/- as claimed by the
- G** assessee. The assessee is, therefore, entitled to a deduction of this amount from his total income. We affirm the judgment of the High Court in disallowing the claim of Rs. 1,05,000/- which forms the basis of Question No. (3). As the appeal has partially succeeded and partially failed, we leave the parties to bear their own costs in this Court.