

IN THE HIGH COURT OF KARNATAKA AT BANGALORE

Dated this the 25th day of January, 2011

PRESENT

THE HON'BLE MR. JUSTICE N KUMAR

AND

THE HON'BLE MR. JUSTICE RAVI MALIMATH

I.T.A. No. 3119 of 2005

BETWEEN:

- 1 The Commissioner of
Income Tax
C R Building
Queens Road
Bangalore
 - 2 The Income Tax Officer
Ward-6(6)
C R Building
Queens Road
Bangalore
- ...Appellants

(By Smt. Veena Jadhav, Advocate)

AND:

M/s. Rudra Industrial Commercial Corporation
No.4, 9th Cross

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Malleshwaram
Bangalore – 560 003

...Respondent

(By Sri A Shankar & Sri M. Lava, Advocates)

This ITA filed under Section 260-A of I.T. Act, 1961 arising out of order dated 24-05-2005 passed in ITA No.529/Bang/1997 for the Assessment year 1993-94, praying to i) formulate the substantial questions of law stated therein; (ii) allow the appeal and set aside the order passed by the ITAT, in ITA No.529/Bang/1997 dated 24-05-2005 confirming the order passed by the Appellate Commissioner and confirm the order passed by the Income Tax Officer, Ward-6(6), Bangalore.

This ITA coming on for hearing this day, **N. KUMAR J** delivered the following:

J U D G M E N T

This appeal is by the revenue challenging the order passed by the Appellate Tribunal holding that the money paid to the bank to save the mortgaged property from being sold in public auction, which was offered as a security by the surety amounts to business expenditure and not capital expenditure and also the finding that even though immovable property is converted into stock-in-trade it is only when the said property is sold, the index prevailing on the date of transfer is to be

taken into consideration for assessing the capital gains and not the index value ~~on~~ the date of conversion.

2. The assessee is a firm constituted by a Deed of Partnership dated 1.4.1992. One of the business activities of the firm is to carry on the business of acquisition, development and sale of immovable properties. The firm has various immovable properties including lands brought in by the partners towards their capital contribution. The firm entered into a development agreement with M/s. Unitech Limited on 16.3.1988 for development of its lands at Shivanahalli and construction of flats in that property. The firm has been converting the immovable properties, one by one, into stock-in-trade. Thus, the firm's business in development of properties was commenced by converting its own properties into stock-in-trade. The firm has a sister concern by name M/s. Rudra Industries. The assessee had given its properties as collateral security to the loan borrowed by M/s Rudra Industries from State Bank of Mysore in the year 1975 when M/s Rudra



Industries was constituted. The said industry became sick. They were unable to pay the loan borrowed from State Bank of Mysore. A suit came to be filed for recovery of the amount against the said firm. The assessee was also made a party to the said suit. It is on record that the assessee was also dealing in the products manufactured by M/s Rudra Industries and there was an on going relationship between the assessee and the said M/s Rudra Industries. It is because of that reason the assessee had considered expedient to provide collateral security to the loan borrowed from M/s Rudra Industries. In the partnership deed dated 10.11.1975 of the assessee, it is clearly mentioned that one of the objects of the assessee was to act as agents for sale and distribution of products manufactured by others. The balance sheet of M/s Rudra Industries for the years 31.3.1978 and 31.3.1980 shows the assessee as debtors in the books of accounts maintained by M/s Rudra Industries. When the assessee started developing the property at Shivanahalli with the help of M/s Unitech Corporation, under the terms of the agreement they were obliged to pass on a clear

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title to the purchasers of the flats free from all encumbrances. The said property had been mortgaged to State Bank of Mysore and the principal debtor was sick and was not paying the money, when the said property was likely to be brought to sale for recovering the money due from M/s Rudra Industries, they thought it commercial expedient to pay the said loan amount due by M/s Rudra Industries along with interest and take back the title deeds and thus they could convey a clear title to the purchasers of the flats. Therefore, they entered into a compromise with the State Bank of Mysore in the pending suit and paid a sum of Rs.37.25 Lakhs being the interest dues and, therefore, they claimed the said amount of Rs.37.25 Lakhs as business expenditure.

3. The assessing authority while assessing the returns filed by the assessee held that, the aforesaid amount of Rs.37.25 Lakhs cannot be treated as business expenditure, on the contrary he assessed it as business profit. Secondly, he

took the index value on the date of conversion of the immovable property into stock-in-trade, i.e., 16.3.1988 for the purpose of calculating the capital gains instead of the date of transfer and passed the assessment orders. Aggrieved by the same, the assessee preferred an appeal to the Commissioner of Income Tax (Appeals).

4. The Appellate Authority on re-appreciation of the entire material on record held that the actual payment of the amount due to the bank by the assessee was to maintain and protect its business interest with its clients and consequently to further its business prospects. Considering the earlier business connections and the commercial expediency at a later stage, the amount paid to the bank should be allowed as a business expenditure and, therefore, the entire sum of Rs.37.25 Lakhs claimed by the assessee was allowed as a revenue expenditure. In assessing the capital gains he held that the index value to be adopted is on the date of sale is 223 and not 161 which was prevailing on the date of conversion of

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immovable property into stock-in-trade and, therefore, he granted the relief to the assessee.

5. Aggrieved by the aforesaid order, the revenue preferred an appeal to the Tribunal. The Tribunal upheld the order passed by the Commissioner of Income Tax (Appeals) and dismissed the appeal. Aggrieved by the same, the revenue is in appeal.

6. Learned counsel for the revenue assailing the impugned order contended that in the first place, when the loan was not borrowed by the assessee and he had only offered his property as a security to M/s Rudra Industries to enable them to raise a loan, when a suit is filed for non-payment of the amount by the State Bank of Mysore, the amount paid by the assessee under a compromise in respect of interest, by no stretch of imagination can be said to be a business expenditure. Therefore, both the Appellate Authority and the Tribunal committed a serious error in treating it as a business

expenditure and not as business profit as held by the assessing officer, consequently as a non-allowable expenditure. Secondly she contended that, when once the property is converted into stock-in-trade and possession of the same is handed over to the developer for the purpose of construction, transfer takes place and, therefore, the index value to be taken into consideration is the date of handing over of possession of the stock-in-trade and not the date on which registered sale deeds are executed in favour of the flat owners conveying undivided interest in the immovable property. Therefore, the authorities again committed a serious error in holding that, only the date of sale deed is crucial in deciding the capital gains payable.

7. Per contra, the learned counsel appearing for the assessee supported the impugned orders.

8. This appeal was admitted on 10.10.2006 to consider the following substantial questions of law: -

- i) Whether, the appellate authorities are correct in adopting for the purpose of computation of income from capital gains, the cost of inflation index for the financial year 1992-93 instead of index for the financial year 1987-88 in view of the provisions of Section 48 read with Section 45(2) of the Act?
- ii) Whether the assessing officer had correctly worked out the capital gains of the property on the cost of land sold by the assessee as per the index relevant to financial year 1998-99 as this asset had been converted into stock in trade on 16-3-1998 which was not considered by the appellate authorities in the proper prospective and consequently recorded a perverse finding?
- iii) Whether the appellate authorities are correct in allowing deduction claimed by the assessee as revenue expenditure in respect of the payment made to State Bank of Mysore as a guarantor in the face of the fact that the borrower, namely M/s. Rudra Industrial Sister concern of the assessee, had assets to pay the liability which were offered as security by the borrower and the payment was

promoted by extraneous considerations and not necessitated by commercial expediency?

9. **Regarding question Nos. 1 and 2:-** The material on record discloses that the appellant-a partnership firm, which owned immovable property, converted the same into stock-in-trade in the year 1987-88. They entered into an agreement dated 16.3.1988 with M/s. Unitech Limited under which the said Company was expected to develop the property, construct flats and give to the assessee their share in the constructed building. The assessee is assessed to income tax regularly. In the year 1988-89 when this agreement was entered into, the revenue did not treat it as a transfer and called upon the assessee to pay tax. However, the claim for capital gains is made only when the assessee executed registered sale deeds in favour of the purchaser of the flats in the financial year 1992-93. At that stage, for the purpose of calculating capital gains instead of taking the cost inflation index, they took the index as prevailing in 1988, the date on which the immovable property

was converted into stock-in-trade and consequently entered into contract for development of the property. In this regard, the question that arises for consideration is, which is the relevant date to be taken into consideration for the purpose of assessing the capital gains.

10. Section 45(2) which is relevant reads as under:-

"45. Capital gains.

(1)

(2) *Notwithstanding anything contained in sub-section (1), the profits or gains arising from the transfer by way of conversion by the owner of a capital asset into, or its treatment by him as stock-in-trade of a business carried on by him shall be chargeable to income-tax as his income of the previous year in which such stock-in-trade is sold or otherwise transferred by him and, for the purposes of section 48, the fair market value of the asset on the date of such conversion or treatment shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset."*

11. Explanation (iii) to Section 48 defines indexed cost of acquisition which means an amount which bears to the cost of acquisition the same proportion as Cost Inflation Index for the year in which the asset is transferred bears to the Cost Inflation Index for the first year in which the asset was held by the assessee or for the year beginning on the 1st day of April, 1981, whichever is later.

12. A harmonious interpretation of these two provisions makes it clear as to how the capital gains is to be taken into consideration. First we have to find out what is the fair market value of the asset on the date of conversion, then to find out what is the market value of the property on the date of transfer. So, in order to compute the capital gains payable, it is the market value on the date of transfer that is relevant and in arriving at that market value the index cost of acquisition as prescribed on the date of transfer is to be taken into consideration and not the date of conversion. In the instant

case, the index cost of acquisition was 223 on the date of transfer in the year ending 1993 and the index cost of acquisition on the date of conversion is 161. Therefore, the assessing officer committed a serious error in taking 161 as the index. The Appellate Authorities have rightly interfered with the said assessment and have taken 223 as correct index cost of acquisition. Therefore, when the impugned order passed by the Appellate Authorities is in accordance with the aforesaid statutory provisions, the said substantial questions of law have to be answered in favour of the assessee and against the revenue.

13. **Regarding question No.3:-** The material on record discloses that the immovable property at Shivanahalli belongs to the assessee. The said property was offered as a security to State Bank of Mysore for the loan borrowed by sister concern M/s Rudra Industries. The assessee was dealing with the products of the said sister concern. The businesses of these two firms are connected with each other as is clear from the

balance sheet of M/s Rudra Industries where they have shown the amounts due by the assessee to them which fact is not in dispute. The said sister concern became a sick industry. They were unable to discharge the loan. Therefore, the bank filed a suit for recovery of the amount against the principal debtor and the assessee who is the surety. It was likely that a decree could have been passed and to recover the said decretal amount, the Bank would have brought the property at Shivanahalli belonging to the assessee for sale in public auction. In respect of the very same property, the assessee has entered into an agreement of development with M/s Unitech Corporation and had undertaken in the agreement to convey a clear and marketable title to the intending purchasers of the flats to be constructed thereon. If the property had been brought to sale, sold in public auction, the agreement entered into between the assessee and M/s Unitech Corporation would have been in jeopardy. They would have committed breach of the terms of the contract in as much as a failure to make out a marketable tile. Therefore the assessee paid Rs.37.25 lakhs as



interest claimed by the Bank, got back the property and thus made good the marketable title in favour of the purchasers of the flats, in terms of the agreement entered into between them and M/s Unitech Corporation. It is in this context it is to be seen whether the assessee is entitled to the said payment of interest as business expenses under Section 37(1) of the Act.

14. The Apex Court in the case of **COMMISSIONER OF INCOME TAX Vs. CHANDULAL KESHAVLAL & CO.**, reported in **38 ITR 601, 610 (SC)**, held as under:

“Another fact that emerges from these cases is that if the expense is incurred for fostering the business of another only or was made by way of distribution of profits or was wholly gratuitous or for some improper or oblique purpose outside the course of business then the expense is not deductible. In deciding whether a payment of money is a deductible expenditure one has to take into consideration questions of commercial expediency and the principles of ordinary commercial trading. If the payment of expenditure

is incurred for the purpose of the trade of the assessee it does not matter that the payment may inure to the benefit of a third party. Another test is whether the transaction is properly entered into as a part of the assessee's legitimate commercial undertaking in order to facilitate the carrying on of its business; and it is immaterial that a third party also benefits thereby. But in every case it is a question of fact whether the expenditure was expended wholly and exclusively for the purpose of trade or business of the assessee."

15. Following the said judgment, the Apex Court in the case of **SASSOON J DAVID AND CO.P.LTD., Vs. COMMISSIONER OF INCOME-TAX, BOMBAY** reported in **261 ITR Vol 118 (SC)** held as under:

"The case of the company that many of the employees were old and superfluous and the business could be carried on with a smaller number and the only way in which they could reduce the number was to terminate the services of all the employees by paying them compensation

and thereafter re-employing some of them only. If the company felt that, that was a method which would inure to its benefit, it cannot be said that the payment of compensation was made with an oblique motive and without regard to commercial considerations or expediency."

16. The Apex Court in the case of **S.A. BUILDERS Vs. COMMISSIONER OF INCOME-TAX** reported in **(2007) 288 ITR 1 (SC)**, after reviewing the case law on the point held as under:

"What is relevant is whether the assessee advanced such amount to its sister concern as a measure of commercial expediency."

"The correct view in our opinion was whether the amount advanced to the subsidiary or associated company or any other party was advanced as a measure of commercial expediency."

"Once it is established that there was nexus between the expenditure and the purpose of the business (which need not necessarily be the

business of the assessee itself), the Revenue cannot justifiably claim to put itself in the arm-chair of the businessman or in the position of the board of directors and assume the role to decide how much is reasonable expenditure having regard to the circumstances of the case. No businessman can be compelled to maximize his profit. The income-tax authorities must put themselves in the shoes of the assessee and see how a prudent businessman would act. The authorities must not look at the matter from their own view point but that of a prudent businessman. As already stated above, we have to see the transfer of the borrowed funds to a sister concern from the point of view of commercial expediency and not from the point of view whether the amount was advanced for earning profits."

"The expression "commercial expediency" is an expression of wide import and includes such expenditure as a prudent businessman incurs for the purpose of business. The expenditure may not have been incurred under any legal obligation, but yet it is allowable as a business expenditure if it

was incurred on grounds of commercial expediency."

17. Therefore from the aforesaid decisions what emerges is first, in order to claim the benefit of deduction under the head of business expenditure, the assessee has to show that the money is actually expended. Then he has to show the nexus between the expenditure and purpose of the business. In demonstrating this nexus, it is necessary that the said expenditure incurred should necessarily be the expenditure incurred in connection with the business of the assessee. By such expenditure there should be a direct and minimum benefit to the assessee. It must be on account of necessity. In other words, commercial expediency is to be demonstrated. By such expenditure, merely because a third party is also benefited, it cannot be disallowed.

18. In this background if we look at the facts of this case, the assessee has stood as surety for one of its sister

concerns. Business of these two firms were intimately connected with each other. Because of non-payment of loans, the Bank had filed a suit for recovery of money both against the sister concern as well as the assessee. Both of them had no valid defence to put forth. It was a matter of time that a decree would have been passed and the property mortgaged belonging to the assessee would have been brought to sale to recover the said amount. The very same property was the subject matter of an agreement between the assessee and the Developer. Under the terms of the Development Agreement, the assessee had undertaken to convey a marketable title to the purchasers of the flats to be built on the said property. If the property had been sold jeopardizing the assessee, he would have committed a breach of the terms of the contract. It would have a cascading effect having regard to the value of the property, the amount of loan, the interest payable thereon and the value of the property which the assessee was to get in the development agreement and to see that the assessee is not accused of a breach of contract. If the assessee thought it fit to

discharge the loan to the Bank and get the property which is mortgaged, released, thus making good the title in terms of the development agreement and in the process if he had to pay Rs.37.25 lakhs towards interest, it is an expenditure which is incurred by the assessee in the course of the business. He was under a legal obligation to discharge the debt due to the Bank. It is in pursuance of the legal obligation, without giving room for a decree being passed and the property being brought to sale in public auction, he fulfilled the said claim by way of a compromise, paid the money and got the property released. Therefore as a prudent businessman he incurred this expenditure to discharge a debt borrowed by the sister concern and thus saved the property which he had offered as security and in turn was able to make out a marketable title in terms of the development agreement. It cannot be said that the payment of the said amount does not constitute business expenditure. Both the appellate authorities on appreciation of the aforesaid material rightly held that the assessee is entitled to a deduction under the head of business expenditure and

have rightly set aside the order of the Assessing Officer disallowing the said deduction. In that view of the matter, the third substantial question of law is answered in favour of the assessee and against the Revenue. Hence there is no merit in this appeal. **Accordingly it is dismissed.**

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JUDGE

Sd/-
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