Bombay High Court
The Commissioner Of Income Tax-7 vs M/S.Reliance Communications ... on 28 March, 2012
Bench: Dr. D.Y. Chandrachud, M.S. Sanklecha

VBC 1/15 itxa3155.09-28.3

IN THE HIGH COURT OF JUDICATURE AT BOMBAY
O. O. C. J.

INCOME TAX APPEAL NO.3155 OF 2009

The Commissioner of Income Tax-7. ...Appellant.
Vs.

M/s.Reliance Communications Infrastructure Ltd. ...Respondent.
....
Mr.Abhay Ahuja for the Appellant.
Mr.Soli Dastur, Senior Advocate with Mr.Niraj Sheth, Mr.Rajesh Shah and Mr.B.G.Yewle i/b. Rajesh Shah & Co. for the Respondent.
.....

CORAM : DR.D.Y.CHANDRACHUD AND
M.S.SANKLECHA, JJ.

March 28, 2012.

ORAL JUDGMENT (PER DR.D.Y.CHANDRACHUD, J.) :

This appeal by the Revenue under Section 260A of the Income Tax Act, 1961, arises from a decision of the Income Tax Appellate Tribunal, dated 12 January 2009. The Assessment Year to which the appeal relates is 2003-04. We have permitted Counsel appearing on behalf of the Revenue, on his request, to reframe the questions of law as originally framed and allow the Revenue to amend the

questions of law as follows :

> "(A) Whether in the facts and the circumstances of the case and in law, the Tribunal was justified in holding that interest free funds available with the Assessee are much more than the amount invested in Reliance VBC 2/15 itxa3155.09-28.3 Infocomm Limited (subsidiary of Assessee) and advances given to Reliance Industries Limited, even though the sources of funds without considering secured loans are not sufficient for the application of funds as can be seen from the working based on the funds received during the year and its application and even though the Annual Accounts of Reliance Industries Limited discloses only an amount of Rs.455.26 crores as having received from the Assessee towards guarantee whereas the Assesee's was showing advances of Rs.476 crores to Reliance Industries Limited, clearly indicating that the Assessee does not have its own funds for making investment in the subsidiary or for advances to Reliance Industries Limited and therefore borrowed funds have been utilized and interest on a pro rata basis has been rightly disallowed by the Assessing Officer;
>
> (B) Whether in the facts and the circumstances of the case and in law, the Tribunal was justified in relying on S.A.Builders v. Commissioner of Income Tax (Appeals) [(2007) 288 ITR 1 (SC)] and holding that if the business purpose is there while advancing money to the sister concern the disallowance of interest cannot be sustained without appreciating that the said case is clearly distinguishable from the present case where interest bearing funds have inter alia been used for investment in equity shares of Reliance Infocomm Limited (subsidiary company)."

2. The appeal is admitted on the aforesaid two questions of law and is taken up for hearing and final disposal, by consent at this stage.

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3. Since the questions are rather prolix, it would be appropriate for this Court to indicate briefly the background in which the dispute arises.

4. In the course of the order of assessment under Section 143(3) of the Income Tax Act, 1961, which the Assessing Officer passed on 20 March 2006, a disallowance on a pro rata basis was made of Rs.15.76 crores, out of a total amount of Rs.34.32 crores claimed by way of a deduction under Section 36(1)(iii). The assessee had debited the above amount of Rs.34.32 crores as interest charges on secured loans raised. The Assessing Officer relied on the following figures appearing in the balance sheet of the assessee:

> "I. Sources of funds available to the assessee
>
> i) Share capital and reserve and Rs.46,82,26,21,552/-

surplus.

ii) Secured loan Rs.24,00,00,00,000/-

II. Application of funds

i) Fixed assets and capital work in-progress. Rs.34,22,50,95,364/-
ii) Investments Rs.20,22,39,08,966/-
iii) Loans and advances Rs.25,92,94,96,582/-"

> According to the Assessing Officer, the difference between the share capital and reserve and surplus (I(i) above : Rs.4,682 crores) and the application of funds in fixed assets and capital work-in-process and investments (II(i) and (ii) above : Rs.5,444 crores) works out to Rs.762 crores. If this amount of Rs.762 crores is reduced from the secured loan of Rs.2,400 crores (I (ii) above), the balance available for application of funds would be Rs.1638 crores.

According to the Assessing Officer, this balance of Rs.1638 crores had been advanced by the assessee to a subsidiary company and the assessee had made other advances and deposits without charging interest. The Assessing Officer held that the explanation submitted by the assessee does not establish that the assessee had made investments, loans and advances out of its non-interest bearing funds. Since according to the Assessing Officer, the assessee had not proved that interest bearing funds had not been diverted for non-interest yielding investments, he was of the view that the assessee had not satisfactorily explained that the investments made and the loans and advances were for the purpose of business. The Assessing Officer relied upon a judgment of a VBC 5/15 itxa3155.09-28.3 Division Bench of this Court in Phalton Sugar Works Ltd. vs. CWT1. Accordingly, an interest disallowance of Rs.15.76 crores was made pro rata, as not being eligible for deduction under Section 36(1)(iii).

5. In appeal, the CIT(A) came to the conclusion that no disallowance under Section 36(1)(iii) could be made. According to the CIT(A), the assessee had sufficient interest free funds and the investments which were made in Reliance Infocomm Ltd. and the advances to the Reliance Industries Ltd. were out of interest free funds. The Assessing Officer relied upon a chart showing the incremental increase or, as the case may be, decrease in the sources of funds and the application of

funds in arriving at this conclusion.

Moreover, the CIT(A) held that the investments in Reliance Infocomm Ltd. were for the purpose of business as it ensured the utilization of the infrastructure of the assessee and in furtherance of the business prospects of the assessee in the area of telecommunication services. The advance furnished to Reliance Industries Ltd. was noted to be in consideration of a guarantee 1 208 ITR 989 VBC 6/15 itxa3155.09-28.3 given by the said Company on behalf of the assessee and this was, therefore, for the purposes of business. Hence, the CIT(A) held that on both counts no disallowance under Section 36(1)(iii) would be called for.

6. In appeal, the Tribunal has affirmed the finding of the CIT(A) on two counts. Firstly, the Tribunal has noted that the Assessing Officer in holding that the assessee had utilized interest bearing funds for investments in the shares of its subsidiary and for an advance to Reliance Industries Ltd. had not considered the debenture application money of Rs.1104 crores refunded/adjusted against fresh investments by way of investment in Reliance Infocomm Ltd. during the year under consideration. The Tribunal affirmed the finding of the CIT(A) that the interest free funds available to assessee were more than the amount invested in Reliance Infocomm Ltd. and advances given to Reliance Industries Ltd. The Tribunal further observed that the departmental representative had failed to point out any infirmity in the working which was extracted in the order passed by the CIT(A). Secondly, the Tribunal held that the investment in Reliance Infocomm Ltd.

VBC 7/15 itxa3155.09-28.3 was for the purpose of business as it ensured utilization of the infrastructure of the assessee and helped in furthering the business prospects. Moreover, the amount which was advanced to Reliance Industries Ltd. was towards a guarantee which that Company had to execute at the behest of the assessee in favour of certain financial institutions who had extended credit facilities to third parties. The Tribunal has relied upon the judgment of the Supreme Court in S.A.Builders Ltd. vs. CIT(A),2 observing also that the judgment of this Court in Phalton Sugar Works (supra) which was relied upon by the Assessing Officer has been overruled by the Supreme Court.

7. Counsel appearing on behalf of the Revenue has submitted that (i) Under Section 36(1)(iii), the assessee is entitled to a deduction in computing income under the head of profits and gains of business or profession in respect of the amount of interest paid in respect of capital borrowed for the purpose of the business or profession; (ii) In S.A.Builders, the assessee had been found by the Assessing Officer to have advanced borrowed funds to a sister concern without charging any interest. In the present case, the 2 (2007) 288 ITR 1 (SC) VBC 8/15 itxa3155.09-28.3 assessee had not made any advance in respect of the transaction with its wholly owned subsidiary Reliance Infocomm Ltd. but had invested its funds in the subsidiary against the allotment of shares.

An advance must be distinguished from an investment; (iii) The reasoning of the Assessing Officer in paragraph 4 of the assessment order would indicate that the assessee had used interest bearing funds either for making advances to RIL or for investing in the shares of Reliance Infocomm Ltd. A pro rata disallowance of the interest claimed was hence warranted.

8. On the other hand, Counsel appearing on behalf of the Assessee submitted that (i) There is a concurrent finding of fact both by the CIT(A) and the Tribunal that borrowed funds were not used by the assessee for the purpose of the investment, or as the case may be, for the grant of advances; (ii) Even if borrowed funds were utilized for investments, no case for disallowance would exist so long as the business of the assessee is furthered. In the present case, there is a factual finding by both the CIT(A) as well as by the Tribunal that the business of the assessee was being furthered.

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9. At the outset, it would be necessary to note that the Assessing Officer in making a disallowance, pro rata, of the deduction claimed by the assessee under Section 36(1)(iii) relied upon a judgment of a Division Bench of this Court in Phalton Sugar Works Ltd. vs. CWT (supra). In that case, a Division Bench had observed that moneys borrowed were utilized in the business of a subsidiary of the assessee and not in the business of the assessee as such and that consequently the Tribunal was not justified in holding that interest on loans borrowed for advances to the subsidiary was allowable under Section 36(1)(iii). The view which has been taken by the Division Bench of this Court in Phalton Sugar Works has expressly now been overruled by the Supreme Court in S.A. Builders vs. CIT(A).3 Consequently, it would be necessary to turn to the judgment in S.A. Builders which now reflects the governing position in law.

10. In S.A. Builders, the Assessing Officer had observed that the assessee had transferred a certain amount to its subsidiary out of a cash credit account in which there was a debit balance. The 3 (2007) 288 ITR 1 (SC) VBC 10/15 itxa3155.09-28.3 Assessing Officer found that the assessee had diverted its borrowed funds to a sister concern without charging any interest and that consequently, a proportionate part of the interest relating to that amount, out of the total interest paid by the assessee to the Bank, had to be disallowed. The CIT(A) had observed that out of the total amount advanced by the assessee to its subsidiary, only an amount of Rs.18 lakhs had a nexus with borrowed funds and he had directed the Assessing Officer accordingly to calculate the disallowance. The Tribunal allowed the appeal by the Revenue and dismissed the appeal of the assessee. The order was confirmed by the High Court. The Supreme Court observed that the Income Tax authorities, the Tribunal as well as the High Court had approached the matter from an erroneous perspective. The Supreme Court held that where the assessee had borrowed funds from a Bank and lent some of them to a subsidiary as an interest free loan, the test to be applied is whether this was a matter of commercial expediency.

The expression "commercial expediency", held the Supreme Court, is an expression of wide import and includes such expenditure as a prudent businessman incurs for the purpose of business. An expenditure, which is commercially expedient, may not be incurred VBC 11/15 itxa3155.09-28.3 under a legal obligation, but so long as it meets the requirement of commercial expediency, it has to be allowed. However, the Supreme Court held that it is not in every case that interest on borrowed loans would have to be allowed if the assessee advanced the money to a sister concern. Where the amount is advanced to a sister concern, for the personal benefit of its directors, for instance, it would not qualify to be regarded as commercial expediency.

However, noted the Supreme Court, where a holding company "has a deep interest in its subsidiary advances borrowed money to a subsidiary and the same is used by the subsidiary for some business purposes, the assessee would .. ordinarily be entitled to deduction of interest on its borrowed loans." The Supreme Court accordingly set aside all the orders passed by the authorities below including the judgment of the Tribunal and of the High Court and remanded the matter for a fresh decision.

11. In the present case, there is a finding of fact by the CIT(A) and by the Tribunal that as a matter of fact, borrowed funds were not used by the assessee for the purposes of investment in the shares of its wholly owned subsidiary Reliance Infocomm Ltd. or VBC 12/15 itxa3155.09-28.3 for making advances to Reliance Industries Ltd. But independent of that, in view of the decision of the Supreme Court in S.A.Builders what is significant is as to whether the investment and the advances made were commercially expedient and for the purpose of business. In this regard, the assessee had pointed out before the CIT(A) that it is engaged in the business of providing telecommunication infrastructure which mainly consists of a Pan India Fibre Optic Network. Reliance Infocomm Ltd. is a wholly owned subsidiary of the assessee which is engaged in the business of providing telecommunication services. The assessee made investments in the equity shares of its subsidiary and claimed that this was with a view to provide integrated telecommunication services. The case of the assessee was that those investments were to ensure the utilization of the telecommunications infrastructure of the subsidiary and was a strategic investment for furthering business prospects in the area of providing telecommunication services. As regards the advance which was made by the assessee to Reliance Industries Ltd. (RIL) the assessee pointed out to the CIT(A) that it was required to import equipment under the EPCG Scheme. The obligations under the EPCG Scheme were required to VBC 13/15 itxa3155.09-28.3 be backed by bank guarantees which in turn demanded security for the issuance of guarantees. The assessee entered into an arrangement with RIL to which it advanced a sum of Rs.476 crores against which RIL provided counter guarantees to financial institutions equivalent to three times the amount of the margin kept by the assessee with RIL

12. Now, having regard to this factual background, both the CIT(A) and the Tribunal held that the investments made in the wholly owned subsidiary and the money advanced to RIL were for furthering the business of the assessee. The findings of both the CIT(A) and of the Tribunal are consistent with the judgment of the Supreme Court in S.A.Builders. Where the assessee, as in the present case, has significant interest in the business of the subsidiary and utilizes even borrowed money for furthering its business connection, there is no reason or justification to make a disallowance in respect of the deduction which is otherwise available under Section 36(1)(iii). Counsel appearing on behalf of the Revenue submits that there is a distinction between an advance, which is a payment handed over to some one as a loan and an VBC 14/15 itxa3155.09-28.3 investment which is money placed into financial schemes, shares or property with the expectation of making a profit. 4 We are unable to accept that such a distinction will have any legal consequence in so far as the entitlement of the assessee to claim a deduction under Section 36(1)(iii) is concerned. In the present case, when the assessee advanced an amount to RIL that was with a view to furthering the business of the assessee. RIL in turn was to execute counter guarantees in favour of financial institutions for the benefit of the discharge of the EPCG obligations by the assessee. That was a security for the guarantees which those institutions were required to execute under the EPCG Scheme. The funds which were invested in the wholly owned subsidiary were again for the purposes

of the business of the assessee. There is evidently a significant interest of the assessee in the business of its subsidiary since both the assessee and the subsidiary are engaged in providing telecommunication services. Consequently, we are not inclined to interfere with the order of the Tribunal. There is a finding of fact that interest free funds borrowed are not utilised for the purposes of both the transactions. But quite apart from that, the finding is 4 Compact Oxford Reference Dictionary pages 11 and 436 VBC 15/15 itxa3155.09-28.3 that the funds were deployed as a matter of commercial expediency and to further the business of the assessee. The latter finding is independent of whether borrowed funds were or were not utilized, for in view of the judgment of the Supreme Court held, the fact that borrowed funds were utilized for making investments or, as the case may be, for making advances would not disentitle the assessee to the deduction so long as business expediency exists.

13. Consequently, we answer the questions of law as framed in the affirmative. The appeal shall accordingly stand disposed of.

There shall be no order as to costs.

(Dr.D.Y.Chandrachud, J.) (M.S.Sanklecha, J.)