

PETITIONER:
COMMISSIONER OF INCOME-TAX, LUCKNOW

Vs.

RESPONDENT:
BAZPUR CO-OPERATIVE SUGAR FACTORY LTD.

DATE OF JUDGMENT 01/05/1989

BENCH:
PATHAK, R.S. (CJ)
BENCH:
PATHAK, R.S. (CJ)
SHARMA, L.M. (J)

CITATION:
1989 AIR 1866 1989 SCR (2) 840
1989 SCC Supl. (2) 240 JT 1989 (2) 562

ACT:

Income Tax Act, 1961: Section 36(1)(iii)--Cooperative Society--Amounts deposited by members in Loss Equalisation and Capital Redemption Fund--Whether deduction admissible.

HEADNOTE:

The respondent-assessee is a co-operative society running a sugar mill. With a view to inducing its members to make further contribution to its capital it incorporated a bye-law which provided for the establishment of a 'Loss Equalisation & Capital Redemption Reserve Fund'. Every producer-shareholder was required to deposit every year an amount to this fund which was to be utilised for the purpose of making the partly paid shares fully paid, and after defraying the loan taken from the Industrial Finance Corporation the balance was to be refunded to the members. The money available in the Fund was utilised by the society for the purpose of its business. A part of the amount was eventually utilised for converting the partly paid shares into fully paid shares. It was then decided by the society to pay interest on the balance available in the Fund. The interest thus paid to its members was sought to be claimed as deduction in computing the income of the assessee.

The Income Tax Officer rejected the claim holding that the amount did not represent loans taken by the assessee or capital borrowed for the purpose of its business. The Appellate Assistant Commissioner confirmed the disallowance. The Income Tax Appellate Tribunal accepted the second appeal of the assessee and held that it was not necessary that borrowing must contain an element of payment of interest and that even if a deposit was made by the members of the society which was utilised for the purpose of the business of the assessee, the funds represented by such deposit would be 'capital borrowed' for the purpose of s. 36(1)(iii) of the Income Tax Act, 1961. The High Court agreed with the view taken by the Appellate Tribunal and answered the questions referred to it in favour of the assessee and against the Revenue.

While allowing the appeals and answering the questions in the negative in favour of the Revenue, this Court.

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HELD: (1) Section 36(1)(iii) of the Income Tax Act, 1961

provides that in computing the income chargeable under the head 'profits and gains of business or profession' a deduction shall be allowed of the amount of interest paid in respect of capital borrowed for the purposes of the business or profession. [845G,H]

(2) The words 'borrowed money' should not be given a strained meaning and it should be considered whether in ordinary commercial usage the relationship was that of a borrower and lender and the transactions were loan transactions. To constitute borrowed money there must be a real borrowing and a real lending. [846B,D]

(3) It is apparent that the deposits made by the members cannot be regarded as loans advanced by the members to the assessee. There was never any intention between the assessee and its members to treat the deposits made by the members as loans and that the relationship between the assessee and the members should be that of borrower and lender., [847F,G]

Port of London Authority v. Commissioner of Inland Revenue, [1922] 2 KB 599 (CA); Commissioner of Inland Revenue v. Port of London Authority, [1923] AC 507; Inland Revenue Commissioner v. Rowntree & Co. Ltd., [1948] 1 ALL ER 482 (CA); Commissioner of Income-tax, Gujarat v. Rajkot Seeds, Oil & Bullion Merchants Association Ltd., [1975] 101 ITR 748; Commissioner of Excess Profits Tax, Central Calcutta v. Bhartia Electric Steel Co. Ltd., [1954] 25 ITR 192; Bombay Steam Navigation Co. [1953]; Private Ltd. v. Commissioner of Income-tax Bombay, [1965] 56 ITR 52 and Madhav Prasad Jatia v. Commissioner of Income-tax Uttar Pradesh, [1979] 118 ITR 200, referred to.

(4) A loan necessarily supposes a return of the money loaned. The circumstance that there was no certainty that any balance would remain for refund to the members would in itself indicate that the deposits could not be regarded as loans. [847G,H]

JUDGMENT:

CIVIL APPELLATE JURISDICTION: Civil Appeals Nos. 1358-61 of 1979.

From the Judgment and Order dated 6.9.78 of the Allahabad High Court in I.T.R. No. 114/78.

B .B. Ahuja, K.C. Dua and Miss. A. Subhashini for the appellants.

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S.C. Manchanda, Mrs. A.K. Verma and Joel Pares for the respondent.

The Judgment of the Court was delivered by

PATHAK, CJ. These appeals by special leave are directed against the judgment of the High Court at Allahabad disposing of an Income-tax Reference in favour of the assessee and against the Revenue.

The assessee is a co-operative society running a sugar mill. For the assessment year 1968-69 it claimed payment of interest amounting to Rs. 1,81,7 16. This was interest paid to the accounts of its members, who had deposited certain amounts with the assessee in accordance with Bye-law No. 50 and it was debited by the assessee to its profit and loss account. In the initial years of the working of the Society, certain partly paid shares were allotted to its farmer members. With a view to inducing these members to make further contribution to the capital of the Society, bye-law No. 50 was incorporated in the Bye-laws of the Society. The bye-law as amended provides:

"50. There shall be established a 'Loss Equalisation &

Capital Redemption Reserve Fund' in the society. Every producer-shareholder shall deposit every year a sum not less than 0.32 paise and not more than 0.48 paise per quintal of the sugarcane supplied by him to the society, as may be determined by the Board until the shares to be subscribed by the members are fully paid-up. The amount standing to the credit of this fund presently or to be credited in future, shall be used for making the partly paid shares fully paid up. The balance of the said amount shall be refunded to the members soon after the present loan from the Industrial Corporation of India is repaid, whereafter the fund shall cease to exist."

The money available in the 'Loss Equalisation and Capital Redemption Reserve Fund' was utilised by the assessee for the purpose of its business. A part of the amount was also utilised for converting the partly paid up shares into fully paid up shares. On 8 September, 1967 the Board of Directors of the Society decided in their meeting to pay interest at 6% on the balance available in the aforesaid Fund to its various members to whom the balance money belonged. It was on this account that the Society claimed an amount of Rs. 1,18,716 for the assessment year 1968-69.

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The claim was rejected by the Income Tax Officer. He took the view that the amounts deposited by the members of the Society in the 'Loss Equalisation and Capital Redemption Reserve Fund' did not represent loans taken by the assessee but constituted a contribution by the members to convert partly paid up shares into fully paid up shares and they could not be considered as capital borrowed for the purpose of its business. He held that s. 36(1)(iii) of the Income-tax Act did not apply to such interest and that it was not admissible as a deduction in computing the total income of the assessee. For the assessment years 1969-70 to 1972-73 the claim to deduction on this account was as follows:

1969-70	...	Rs. 1,34,609
1970-71	...	Rs. 1,34,609
1971-72	...	Rs. 1,34,609
1972-73	...	Rs. 1,34,609

The Income Tax Officer took the same view for these assessment years as he did for the assessment year 1968-69.

In appeals preferred by the assessee the Appellate Assistant Commissioner of Income-tax confirmed the disallowance for the assessment year 1968-69 on the ground that Bye-law No. 50 did not provide for the refund of the amount standing to the credit of the members at any time before the payment of the loan to the Industrial Finance Corporation of India, that the loan was still outstanding on 30 June 1967, the last day of the previous year relevant to the assessment year 1968-69, and moreover the Bye-law did not provide for payment of interest at all. He observed that the Directors could not pay any interest unless the Bye-law was amended by the members of the assessee. He observed that the interest paid must be regarded as an exgratia payment to the producer members of the society who had contributed to the Fund, and that it was not made for the purpose of the business of the assessee or on the ground of commercial expediency. The same order was passed by the Appellate Assistant Commissioner on the appeals for the remaining years.

In second appeals filed by the assessee for all the assessment years the Income Tax Appellate Tribunal held that the amount standing to the credit of the 'Loss Equalisation and Capital Redemption Reserve Fund' which was utilised by the assessee for the purpose of its business represented moneys borrowed for the purpose of its business and that

interest paid on such moneys was eligible for deduction under

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s. 36(1)(iii) of the Income-tax Act, 1961. The Appellate Tribunal negatived the contention of the Revenue that only such deposits could constitute 'capital borrowed' within the meaning of s. 36(1)(iii) of the Act which were initially borrowed with the stipulation to pay interest thereon. The Appellate Tribunal observed that the expression 'capital borrowed' had not been defined in the Income-tax Act and that its ordinary meaning would have to be gathered in construing the meaning of s. 36(1)(iii). It said that it was not necessary that borrowing must contain an element of payment of interest and that even if a deposit was made by the members of the society which was utilised for the purposes of the business of the assessee, the funds represented by such deposit would be 'capital borrowed' for the purposes of s. 36(1)(iii) of the Act. The Appellate Tribunal also recorded that it was not disputed that the deposits were taken for the purposes of the business. In the circumstances, the Appellate Tribunal held that when the Board of Directors of the assessee considered it proper to pay interest on those deposits, such interest was admissible under s. 36(1)(iii) of the Act.

During the hearing of the appeals for the assessment years 1970-71 and 1971-72, it was pointed out by the Revenue that the auditors of the assessee had observed in their audit report that the payment of interest on the 'Loss Equalisation and Capital Redemption Reserve Fund' should not have been made by the assessee in view of s. 57 of the Uttar Pradesh Co-operative Societies' Act, which reads:

"Fund not to be divided: Except as otherwise specifically provided in this Act, no part of the Funds other than the net profits of a co-operative society shall be paid by way of bonus or dividend or otherwise distributed among its members:

Provided that a member may be paid remuneration on such scale as may be laid down in the bye laws for any services rendered by him to the co-operative society."

The Appellate Tribunal held that s. 57 was not relevant as the payment of interest to the shareholders, on the amounts deposited by them, did not represent any payment by the Society by way of bonus or dividend or otherwise, of any part of its funds other than its net profits. The Appellate Tribunal also observed that the interest paid by the assessee to the 'Loss Equalisation and Capital Redemption Reserve Fund' was met from out of the net profits of the assessee. It was found that the assessee had sufficient income out of which the interest

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could be paid by it. For these reasons, it held that the payment of interest was not affected by s. 57 of the Uttar Pradesh Co-operative Societies Act.

At the instance of the Revenue the following two questions in respect of the five assessment years were referred by the Appellate Tribunal to the High Court at Allahabad for its opinion.

"1. Whether the credit balances in the Loss Equalisation and Capital Redemption Reserve Fund which were actually used by the assessee for the purposes of its business represented capital borrowed by the assessee for the purpose of its business within the meaning of s. 36(1)(iii) of the Act?

2. Whether the Tribunal was right in law in allowing interest on such balances standing to the credit of the Loss Equalisation and Capital Redemption Reserve Fund as a deduc-

tion in computing the total income of the assessee?"

A further question common to the assessment years 1969-70 to 1972-73 was also framed. It reads:

"Whether the Tribunal was right in law in holding that the impugned payments of interest did not contravene the provisions of s. 57 of the Uttar Pradesh Co-operative Societies Act, 1965?"

The High Court agreed with the view taken by the Appellate Tribunal and answered the questions in favour of the assessee and against the Revenue.

Before us, the parties have confined themselves to the first two questions and it is requested that we need not consider the third question.

In these appeals the question is whether the claim to deduction under s. 36(1)(iii) of the Income-tax Act can be allowed. Section 36(1)(iii) of the Act provides that in computing the income chargeable under the head 'profits and gains of business or profession' a deduction shall be allowed of the amount of interest paid in respect of capital borrowed for the purposes of the business or profession. Can it be said that the credit balance in the 'Loss Equalisation and Capital Redemp-

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tion Reserve Fund' represents capital borrowed by the assessee for the purposes of its business? What is 'borrowed money' has been construed by the Courts in England in a number of cases. In *Port of London Authority v. Commissioner of Inland Revenue*, [1922] 2 KB 599 (CA). Lord Stendale, M.R. observed that in order that there be borrowed money there must be a borrower and a lender, and later, when the Revenue took the case in appeal to the House of Lords, the House of Lords laid down in *Commissioners of Inland Revenue v. Port of London Authority*, [1923] AC 507 that to constitute borrowed money there must be "a real borrowing and a real lending". Again in *Inland Revenue Commissioners v. Rowntree & Co. Ltd.*, [1948] 1 All ER 482 (CA), the Court of Appeal considered the meaning of the words 'borrowed money' and observed that the words should not be given a strained meaning and that it should be considered whether in ordinary commercial usage the relationship was that of a borrower and a lender and the transactions were loan transactions. These cases were relied upon by the Gujarat High Court in *Commissioner of Incometax, Gujarat Iv. Rajkot Seeds, Oil & Bullion Merchants Association Ltd.*, [1975] 101 ITR 748 in support of the conclusion that on the facts of the case before the High Court there was no relationship of borrower and lender between the Rajkot Seeds and Oil and Bullion Merchants Association and its members in so far as deposits by the members were concerned. It was held that the amounts were deposited by way of security taken for the due performance of the, obligation of a member under the Rules of the Association for the discharge of his obligations to the Association and to the other members of the Association. There was no loan or borrowing at all. This question had in fact been considered by the Calcutta High Court as long ago as *Commissioner of Excess Profits Tax, Central, Calcutta v. Bhartia Electric Steel Co. Ltd.*, [1954] 25 ITR 192 in the context of the third proviso to Rule 5A of Schedule I to the Excess Profits Tax Act, 1940. The money in question in that case had been obtained by the issue of shares, and it was held that it could not possibly be said that the persons who had taken up the deferred shares had ever intended to grant a loan or that the Company which had obtained money on the shares had ever intended to borrow. This Court in *Bombay Steam Navigation Co. (1953) Private Ltd. v. Commissioner of*

Income-tax Bombay, [1965] 56 ITR 52, was dealing with a claim to deduction under s. 10(2)(iii) of the Indian Income-tax Act 1922 in a case where under an agreement certain assets were to be taken over by the assessee from the Scindia Steam Navigation Company Ltd., and part of the consideration was paid by the assessee while the balance remained unpaid. For agreeing to deferred payment of the balance of the consideration, the Scindias
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were to be paid interest. This Court observed:

"An agreement to pay the balance of consideration due by the purchaser does not in truth give rise to a loan. A loan of money undoubtedly results in a debt, but every debt does not involve a loan. Liability to pay a debt may arise from diverse sources, and a loan is only one of such sources. Every creditor who is entitled to receive a debt cannot be regarded as a lender. If the requisite amount of consideration had been borrowed from a stranger, interest paid thereon for the purpose of carrying on the business would have been regarded as a permissible allowance, but that is wholly irrelevant in considering the applicability of clause (iii) of sub-section (2) to the problem arising in this case. The legislature has under clause (iii) permitted as an allowance interest paid on capital borrowed for the purposes of the business: if interest be paid, but not on capital borrowed, clause (iii) will have no application."

The point was also discussed by this Court in Madhav Prasad Jatia v. Commissioner of Income-tax, U.P., [1979] 118 ITR 200 where the question was whether the interest claimed under s. 10(2)(iii) of the Indian Income-tax Act, 1922 related to borrowing for the purpose of the business.

In the present case, Bye-law No. 50 indicates that deposits were to be made by the producer members in the 'Loss Equalisation and Capital Redemption Reserve Fund' for the purpose of making the partly paid shares fully paid up, and it was understood that the balance of the amount would be applied to the loan taken from the Industrial Finance Corporation of India and thereafter whatever remained would be refunded to the depositing members resulting in the extinction of the Fund. It is apparent that the deposits made by the members cannot be regarded as loans advanced by the members to the assessee. The moneys deposited represented contribution by the members for converting the partly paid up shares into fully paid up shares and thereafter for delaying the loan taken from the Industrial Finance Corporation of India. Any balance remaining was to be refunded to the members. The circumstances that there was no certainty that any balance would remain for refund to the members would in itself indicate that the deposits could not be regarded as loans. A loan necessarily supposes a return of the money loaned. Even under the original Bye-law No. 50, which provided for deposits by the members to the
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'Loss Equalisation and Capital Redemption Reserve Fund', it was contemplated that the deposits would be accumulated and be utilised for repayment of the initial loan taken from the Industrial Finance Corporation of India and thereafter for redeeming the 'Government share', and the balance of the deposit after meeting losses would be converted into share capital and each producer member would be issued shares of the assessee. There was never any intention between the assessee and its members to treat the deposits made by the members as loans and that the relationship between the assessee and the members should be that of borrower and lender. The High Court erred in holding that the claim to

deduction on account of interest paid by the assessee to its members was admissible under s. 36(1)(iii) of the Act.

It is urged by learned counsel for the assessee that if the claim to deduction cannot be rested on s. 36(1)(iii) of the Act, it should be regarded as admissible under s. 37 of the Act. We are not satisfied that all the facts necessary for considering a claim for deduction under s. 37 are before us. It will be noticed in *Madhay Prasad Jatia* (supra) that the question of law expressly took in the claim to deduction not only with reference to s. 10(1)(iii) but alternatively with reference to s. 10(2)(xv) of the Indian Income-tax Act, 1922. Whether or not it is still open to the assessee to raise that question before the Appellate Tribunal when the case goes back to it for disposing it of in conformity with the opinion expressed by this Court in these appeals is a question on which we propose to express no view at this stage.

In the result the appeals are allowed, the impugned judgment of the High Court in all these cases is set aside and the first and the second questions framed by the Appellate Tribunal are answered in the negative, in favour of the Revenue and against the assessee. There is no order as to costs.

R.S.S.

Appeals allowed.

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