

(1974) 07 BOM CK 0020

Bombay High Court

Case No: Income-tax Reference No. 9 of 1965

COMMISSIONER OF
Income Tax, BOMBAY
CITY I

APPELLANT

Vs

H. H. MAHARANI SHRI
VIJAYKUMVERBA
SAHEB OF MORVI
AND OTHERS.

RESPONDENT

Date of Decision: July 10, 1974

Acts Referred:

- Estate Duty Act, 1953 - Section 74(2)
- Income Tax Act, 1922 - Section 12(2)

Citation: (1975) 100 ITR 67

Hon'ble Judges: Tulzapurkar, J

Bench: Division Bench

Judgement

TULZAPURKAR J. - The question that has been referred to us for our decision at the instance of the Commissioner of Income Tax, Bombay City-I, Bombay, runs as follows :

"Whether, on the facts and in the circumstances of the case, interest paid by the trustees on the loan obtained from the Bank of India Ltd. for the payment of estate duty chargeable on the trust property was an admissible deduction from the income of the trust assessable u/s 12 of the Act for all the three assessment years 1959-60, 1960-61 and 1961-62 ?"

The facts giving rise to the question may briefly be stated : By an indenture of trust dated October 6, 1955, executed by late His Highness Maharaja Shri Mahendrasinhji of Morvi, His Highness Maharaja created a trust in favour of his son, Prince Mayurdhwansinhji. The trust property comprised of shares and securities and the income of the trust was by way of dividends from shares and interest on securities. His Highness Maharaja died on

August 17, 1957, and by reason of the fact that the settlement in favour of his son was created by the deceased within two years before his death, the property comprised in the trust was includible in the property passing on the death of Maharaja Mahendrasinhji which was liable to pay estate duty. The estate duty return in the case of the estate of the deceased was filed on March 3, 1958. The provisional assessment was completed and estate duty liability determined on that basis was apportioned among different accountable persons and the amount allocated to the trustees under the deed of indenture dated October 6, 1955 (who were the assessee in question), came to Rs. 8,25,000. The assessee paid the estate duty immediately on March 26, 1958, by borrowing the amount from the Bank of India Ltd. The amount borrowed was repaid in three subsequent years, partly by selling the shares belonging to the trust and partly out of accumulated income. However, the trustees had to pay interest amounting to Rs. 23,592 in the first year (assessment year 1959-60), Rs. 15,666 in the second year (assessment year 1960-61) and Rs. 9,619 in the third year (assessment year 1961-62) on the borrowings from the bank till the whole amounts was repaid some time in 1962. The trustees claimed these amounts as deduction against their income under the heads "Dividends" and "Interest on securities". The Income Tax Officer rejected the claim of the assessee for deduction of interest. The claim, which was pressed u/s 12 (2) of the Indian Income Tax Act, 1922, was rejected on the ground that the said deduction was admissible only if funds had been borrowed for the purpose of making investments. In the appeal preferred by the trustees the Appellate Assistant Commissioner also rejected the claim for deduction. He took the view that section 12 of the Act permitted the deduction of any expenditure other than capital expenditure incurred solely for the purpose of making or earning such income and since the expenditure claimed was not so incurred, the deduction was not permissible. Before the Tribunal the assessee contended that the interest was clearly deductible from the trustees income from the other sources because the trustees had, of necessity, to borrow the amounts in order to discharge the estate duty liability which would have otherwise forced them to part with some of the shares held by them under the trust and it was contended that, if interest on moneys borrowed for acquiring a source of income could be allowed as a deduction u/s 12 (2), interest on amounts borrowed for the purpose of preserving a source of income or avoiding the dissipation of a source of income should also be allowed. The Tribunal found that the arrangement for borrowing the moneys was directly related to the source of income held by the trustees and the interest paid on these amounts was a proper charge against the income derived from that source. It also found that the amounts were in effect borrowed to preserve the source yielding income. The Tribunal noticed that the estate duty was the first charge on the assets themselves and the trustees had, therefore, to devise the most prudent way of discharging the liability, keeping in mind their main purpose of safeguarding the interest of the beneficiaries. It took the view that on the death of the settlor, in view of the statute, the assets became subject to the charge and the income from the assets could not be determined without taking into account the liabilities attached to the assets and the expenditure which resulted from that liability has, therefore, a direct bearing on the maintenance of the assets and the income therefrom. In

this view of the matter the Tribunal allowed the deduction claimed by the assesseees. At the instance of the Commissioner of Income Tax, Bombay City-I, the question set out above has been referred to this court by the Tribunal for our decision.

Mr. Joshi, appearing for the revenue, has contended before us that under the provisions of the Estate Duty Act, 1953, the liability of the trustees to pay proportionate estate duty was the personal liability of the trustees to pay proportionate estate duty was the personal liability of the trustees and the borrowings in question had been made by the trustees for the purpose of discharging their personal liability, though the motive behind the borrowings might have been to preserve the shares or the securities being the corpus of the trust and since the borrowings were not made "solely for the purpose of making or earning such income" as required by section 12(2) of the Indian Income Tax Act, 1922, the same was not allowable as a deduction under that provision. In support of his contention he relied upon a decision of the Gujarat High Court in the case of Commissioner of Income Tax v. Mrs. Indumati Ratanlal. In that case the facts were these. The assessee's husband died leaving a will bequeathing half of his estate to his wife and the other half to his minor son. The estate consisted mainly of shares and securities. For the assessment year 1962-63, the assessee claimed that an amount of Rs. 15,397, being one-half of the interest on money borrowed for payment of estate duty, was deductible u/s 57(iii) of the Income Tax Act, 1961, from the dividends derived from the shares and securities. The court held that there was no difference between interest paid on money borrowed to pay Income Tax and interest on money borrowed to pay estate duty. Just as the former was not paid for the purpose of making or earning the income, the latter was not made for the purpose of making or earning the estate. If there was a charge on the property received by a person for payment of a liability and moneys were borrowed for clearing that liability, the interest paid on such borrowed moneys would be an allowable expenditure. Mr. Joshi pointed out that in that case two aspects were considered by the Gujarat High Court, one based on personal liability of the accountable person to pay the estate duty and the other based on the charge which is statutorily created on the property passing on the death of an assessee u/s 74 of the Estate Duty Act and he pointed out that, so far as the first aspect of the question was concerned, the Gujarat High Court categorically took the view that, if the moneys were borrowed for the purpose of meeting personal liability, then the interest paid on such borrowings would not fall within the purview of section 57(iii) of the Income Tax Act, 1961, which is equivalent to section 12(2) of the Indian Income Tax Act, 1922, though he fairly conceded that on the latter aspect the High Court has made the observation to the effect that, if the property was received by an assessee subject to charge for payment of liability and the moneys were borrowed for clearing that liability, the interest paid on such borrowed moneys would be an allowable expenditure. He pointed out that in that particular case the question arising under the second aspect was referred back by the High Court to the lower authority to decide the matter in accordance with law after recording certain findings of facts which had not been recorded when the matter was decided by the High court. He, therefore, contended before us that in the instant case also, unless the court found as a fact that there was a

statutory charge on the shares and securities which were the subject-matter of the trust in the hands of the trustees u/s 74(2) of the Estate Duty Act, the expenditure in the shape of interest paid on the borrowings could not be allowed as a permissible deduction u/s 12 (2) of the Act. He, however, fairly conceded that it would be difficult for him to contend, in view of the provisions of section 74 (2) of the Estate Duty Act, that there was no charge on the movable property which had been held by the trustees which was the subject-matter of the trust and all that he contended in that behalf was that the Tribunal has not given any finding on this particular aspect and, therefore, the deduction claimed by the assessee ought not to have been allowed as a deduction u/s 12 (2) of the Act,

On the other hand, Mr. Palkhivala, appearing for the assessee, has invited our attention to a decision of this court in the case of Bai Bhuriben Lalubhai v. Commissioner of Income Tax and he contended that in view of this decision the deduction claimed would be perfectly allowable u/s 12 (2) of the Act, inasmuch as, in this case, it could not be disputed that the borrowings had been made by the trustees "solely for the purpose of earning such income" within the meaning of sub-section (2) of section 12, for the only option which the trustees at the material time had was either to borrow the moneys and meet the estate duty liability or to sell some of the shares or securities at that very moment for the purpose of meeting that liability, and the trustees, in fact, acted in the interest of the beneficiaries in making borrowings for the purpose of meeting the estate duty liability as, by doing so, they were enabled to maintain or preserve the source of income, namely, the subject-matter of the trust. He also contended in the alternative that, even otherwise, since there was a charge on the movable property which was in the hands of the trustees for payment of proportionate estate duty u/s 74 (2) of the Estate Duty Act, the interest paid on the borrowings incurred to meet that liability would be clearly admissible as a permissible deduction.

In order to decide the question as to whether the deduction claimed is permissible u/s 12 (2) of the Act, it would be desirable to set out the relevant provisions of section 12 (2) of the Act, which permit certain deductions. Section 12 (2) runs as follows :

"Such income, profits and gains shall be computed after making allowance for any expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of making or earning such income, profits or gains...."

In other words, deduction which is permissible under the aforesaid provision is an expenditure incurred solely for the purpose of making or earning such income which has been subjected to tax and the question is whether the expenditure in the form of interest paid on the borrowings made by the assesseees to meet proportionate estate duty liability could be said to be an expenditure incurred solely for the purpose of making or earning such income. Mr. Palkhivala for the assesseees contended before us that the expression "earning such income" occurring in sub-section (2) of section 12 was important, inasmuch as the word "such" occurring in the said expression was referable even to the quantum of income derived from the particular source, namely, shares and securities and if in this

case the borrowings had not been made by the trustees to meet proportionate estate duty liability, then the only alternative for the trustees was to sell some of the shares or securities which would have definitely resulted in the reduction of income that was otherwise receivable by the trustees and to the extent to which such reduction in income was avoided the trustees could be said to have "earned such income". In other words, according to Mr. Palkhivala, the expenditure in the shape of interest on the borrowings was obviously incurred for the purpose of preserving the particular source of income so that the exact quantum of income hitherto received by them was also preserved and in that sense the expenditure must be regarded as having been incurred "solely for the purpose of earning such income". He further pointed out that it was well settled that if with the borrowings that are made, a source of income like shares or securities is acquired, then obviously the interest paid on such borrowings is a permissible deduction u/s 12 (2) of the Act and if that be so, then interest paid over the borrowings made for the purpose of maintaining or preserving the income should also be deductible under the said provision. We find considerable force in this submission of Mr. Palkhivala.

We may point out that the correct test which is to be applied for invoking sub-section (2) of section 12 has been clearly indicated in *Bai Bhuriben Lallubhai v. Commissioner of Income Tax*. Chief Justice Chagla at page 547 has set out the test in the following words :

"The deduction which is permissible under sub-section (2) of section 12 is an expenditure incurred solely for the purpose of making or earning the income which has been subjected to tax. Therefore, in order to decide whether a deduction is permissible under sub-section (2), we have to examine the nature of the expenditure. The purpose for which the expenditure is incurred must be in order to earn the income. The expenditure may be incurred for any commercial purpose. The connection between the expenditure and the earning of the income may not be direct. However indirect the connection may be, there must be a connection or nexus between the expenditure incurred and the income earned."

It may be pointed out that it was after applying this test to the facts in that case that the court came to the conclusion that the interest which was claimed by the assessee on the borrowings made by her for the purpose of purchasing jewellery or meeting household expenditure or meeting advance payment of tax was not a permissible deduction and each one of the three purposes for which the borrowings were made has been separately dealt with by the court. As regards borrowings made for the purpose of purchasing jewellery this is what the court has observed :

"Now the purpose for which this interest was paid was in order that she should have money to buy the jewellery. This is clearly the purpose and obviously that purpose has no connection whatever direct or indirect with the income which she earns from her fixed deposit. The purchase of jewellery does not facilitate the earning of the income. Her fixed deposit is not affected by the fact of her purchasing the jewellery or not purchasing jewellery. But what is rather ingeniously urged by Mr. Mehta is that the assessee had the

option either of taking the money from the fixed deposit and thereby reducing the income or borrowing money and paying interest on it. Inasmuch as she exercised the option of borrowing money, she preserved the source of the income and, therefore, this expenditure is an allowable expenditure.

Now what sub-section (2) emphasises is the purpose for which the expenditure is incurred. The court is not concerned with the motive of the assessee and what Mr. Mehta in fact asks us to do is to probe into the motive of the assessee. It may be that the assessee's motive was to save her fixed deposit and interest accruing from it and to purchase the jewellery by means of loan borrowed from some person or other. But that consideration is entirely irrelevant. What we are concerned with is the actual action on the part of the assessee and not of the action she could have taken under the circumstances. If she had chosen to purchase this jewellery by withdrawing money from the fixed deposit, then undoubtedly her income would have been reduced and to that extent the tax on that income would also be reduced. But because she chose to borrow money to buy the jewellery, it does not establish the purpose, namely, that she borrowed money in order to maintain or preserve the fixed deposit or help her to earn interest."

Similar was the position in regard to the other purpose as the borrowing was made to meet the household expenditure. As regards the borrowings made for the purpose of paying advance tax, the contention urged before the court was that by paying such advance Income Tax, the assessee earned interest at 2% of the advance payment and inasmuch as she had to borrow money in order to pay the advance tax and earn 2% interest, she should have been allowed deduction at least to that extent. This contention was negated by the court by observing as follows :

"It may be that if an assessee borrows money in order to purchase securities which would earn interest, the interest which she may have to pay on the loan would be a permissible deduction. But then the purpose of borrowing the money is to purchase securities which is the source of the income. In this case, the purpose of borrowing the money in order to pay advance tax was not to earn 2 per cent. interest. Obviously the purpose was to discharge the statutory obligation which was upon the assessee to make the advance tax payment. The simple test that may be applied is whether the assessee could have claimed this deduction if no interest was payable to her on the advance tax payment. Mr. Mehta had to concede that if no interest was payable, the assessee could not have claimed the payment of interest on the moneys borrowed for the purpose of paying this tax as a permissible deduction. If she could not have claimed interest paid by her on the loan borrowed for the purpose of making advance tax payment and if no interest was payable on the advance tax payment, it is difficult to understand how on principle she can claim this deduction merely because the legislature provided that she should receive interest on the advance tax payment. Payment of interest is purely incidental; so is the receipt of the interest. The only purpose which the assessee had in mind when she borrowed the money was, as we said before, to discharge her statutory obligation."

It will thus appear clear from the above decision that the question of making a distinction between the purpose of the loan and the motive for the loan arose with regard to the moneys borrowed by the assessee for the purpose of purchasing jewellery and it was in that context that the court observed that it was not concerned with the motive of the assessee. The purpose of the borrowings was obviously to purchase jewellery and, therefore, the interest paid on such borrowings could not be allowed as a deduction u/s 12 (2) of the Act. But, in the same context, the court has observed that if the assessee had borrowed the moneys in order to maintain or preserve the fixed deposit or help her to earn interest, then obviously the deduction would be permissible u/s 12 (2) of the Act. The ratio of the decision has been set out in the last portion of the judgment at page 550 of the report and the relevant observations run as follows :

"If an assessee has no option except to incur an expenditure in order to make the earning of an income possible, then undoubtedly the exercise of that option is compulsory and any expenditure incurred by reason of the exercise of that option would come within the ambit of section 12 (2). But where the option has no connection with the carrying on of the business or the earning of the income and the option depends upon personal considerations or upon motives of the assessee, that expenditure cannot possibly come within the ambit of section 12 (2)."

Now, applying this ratio to the facts of the instant case before us, it seems to us clear that the assessee in this case also had no other option except to incur expenditure in order to make the earning of an income possible and that the exercise of the option, in the circumstances of the case, was compulsory. The Tribunal has observed that the trustees could either have disposed of the shares and securities immediately regardless of the consideration whether the ruling rates were favourable or not, or they could have waited till a suitable time came for disposal of shares and in the meantime borrowed the money to meet the estate duty liability and the trustees considered the latter course to be the expedient one, thereby maintaining the income at its old level subject to the amount payable on moneys borrowed from the bank. In our view, therefore, it is clear that the expenditure in the form of interest paid on the borrowings during the concerned years will have to be regarded as expenditure incurred solely for the purpose of earning such income and the deduction would fall within section 12 (2) of the Act. In this context it would be useful to refer to another decision of this court in the case of Smt. Nirmala M. Doshi v. Commissioner of Income Tax, where the assessee was required to pay interest on call monies in respect of the shares which had been allotted to her after she had received notice as to why the shares should not be forfeited and this court took the view that the payment of interest amounting to Rs. 9,020 was not capital expenditure but a payment made for the purpose of earning dividend income. On behalf of the assessee a submission was made that if default had been made in the payment of interest as fixed by the notice served upon the assessee by the company, the company was entitled to proceed to forfeit all the 2,700 shares, and that the asset of the shares and investment in these shares which was the source for dividend income would have altogether become

destroyed if the assessee had failed to pay the interest of Rs. 9,020 and, therefore, the interest paid should be allowed as a deduction u/s 12 (2) of the Act. This contention was accepted by the court and the court took the view that the aforesaid facts clearly establish the position that the sum of Rs. 9,020 was paid "solely for earning dividend income". Relying upon this decision Mr. Palkhivala contended before us that if the payment of interest made for the purpose of avoiding forfeiture of shares that had been allotted to the assessee was regarded as permissible deduction u/s 12 (2) of the Act, then in the instant case the payment of interest for the purpose of preserving the assets and avoiding the dissipation thereof should be regarded as permissible deduction u/s 12 (2) of the Act. In our view, the contention is well-founded and will have to be accepted.

Mr. Joshi, for the revenue, contended that the immediate purpose for borrowings in the instant case should be regarded as discharging personal liability which the trustees were under an obligation to do and the ultimate motive on the part of the trustees may be to preserve or maintain the trust property so as to maintain the same old income that was being received. It is not possible to accept this submission of Mr. Joshi. It is undoubtedly true that since the trustees held the trust property as legal owners they would as such legal owners be under a liability to meet the proportionate estate duty but all the same that liability which the trustees were required to meet in the discharge and management of the trust which they had undertaken under the deed of indenture dated 6th October, 1955. Moreover, the estate duty liability was the first charge on the movable property held by them as trustees. Further, though in a sense it is the personal liability of the trustees, ultimately the trustees are entitled to reimburse themselves out of the trust funds. The test for allowing a deduction u/s 12 (2) of the Act would not be whether the liability that was to be discharged was personal liability or not but whether the expenditure in the shape of interest that was incurred had any direct or indirect connection with the earning of the income, which expression would include maintaining the income or preserving the income at the old rate. Since on the facts in this case it is clear that the borrowings were made by the trustees avowedly for the purpose of meeting the estate duty liability which attached to the property which was the subject-matter of the trust and that too for the purpose of maintaining or preserving the erstwhile income that was being received from the corpus of the said trust, in our view, the nexus between the expenditure incurred and the earning of the income could be said to be easily established. Therefore, in our view, the expenditure in the instant case will be a permissible deduction u/s 12 (2) of the Act since the test indicated in *Bai Bhuriben Lallubhai v. Commissioner of Income Tax* has been satisfied. The Gujarat High Courts decision in *Commissioner of Income Tax v. Mrs. Indumati Ratanlal* was not concerned with the case of a trustee but dealt with the case of legal representatives.

In any event there can be no doubt that the expenditure incurred in this case will have to be allowed as a permissible deduction on the alternative ground which has been indicated above. Even the Gujarat High Court in *Commissioner of Income Tax v. Mrs. Indumati Ratanlal* has clearly taken the view that if property was received by an assessee

subject to a charge for payment of a liability, and moneys were borrowed for clearing that liability, the interest paid on such borrowed moneys would be an allowable expenditure, inasmuch as the purpose of the borrowing would be to save the property by freeing it from the encumbrance and thus to facilitate the earning of the income and there would accordingly be the requisite connection or nexus between the borrowing of the moneys and the earning of the income. If, therefore, at the time when the estate duty was paid by the assessee in the instant case, the shares and securities were charged with payment for the estate duty, then interest paid on moneys borrowed for the purpose of discharging that liability would be admissible expenditure u/s 12 (2) of the Act. The relevant provision creating statutory charge in respect of estate duty liability is to be found in section 74 (2) of the Estate Duty Act, which runs as follows :

"74. Estate duty a first charge on property liable thereto. - (1)....

(2) A rateable part of the estate duty on an estate, in proportion to the value of any beneficial interest in possession in movable property which passes to any person (other than the legal representative of the deceased) on the death of the deceased shall be a first charge on such interest".

It was not disputed by Mr. Joshi for the revenue that in view of the aforesaid provision at the date when the proportionate estate duty was paid by the assessee in this case, the movable property, viz., shares and securities which were held by them on trust must be regarded as having been charged with the liability to pay the proportionate estate duty on the movable property which passed on to them on the death of the deceased. In this view of the matter it would be clear that the interest paid by the trustees on the borrowings made for the purpose of payment of proportionate estate duty liability will have to be allowed as a deduction u/s 12 (2) of the Act. The question will have, therefore, to be answered in the affirmative and in favour of the assessee.

Revenue will pay the costs of the reference to the assessee.

Question answered in the affirmative.