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of the mortgagee must, in that context, be understood with reference to the sufficiency of the right assigned to enable the sub-mortgagee to sue the original mortgagor in his own right, so as to bring the relevant provisions of the Act into play as between them. The reservation made by their Lordships in the case of a sub-mortgage containing only a *charge* on the original mortgage is significant and supports this view. I do not consider, therefore, that there is any inconsistency between *Promode Kumar Roy v. Nikhil Bhusan Mukhopadhyaya*<sup>(1)</sup> and the earlier decisions, and even if there be any such inconsistency it has no relevance to the present case.

In the result I agree that the appeal fails and should be dismissed with costs.

*Appeal dismissed.*

Agent for the appellants : *R. R. Biswas.*

Agent for the respondent : *Sukumar Ghose.*

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### EASTERN INVESTMENTS LTD.

V.

### COMMISSIONER OF INCOME-TAX, WEST BENGAL.

[SHRI HARILAL KANIA C. J., PATANJALI SASTRI,

S. R. DAS and VIVIAN BOSE JJ.]

*Indian Income-tax Act (XI of 1922), s. 12(2)—Business expenditure—Interest on debentures—Reducing capital of company by taking over shares and giving debentures to shareholder—Income of company reduced—Interest on debentures, whether allowable.*

A private limited company formed for dealing in shares and securities had a share capital of 250 lacs of rupees of which shares of the face value of 50 lacs were held by A and the remaining shares were held by his nominees. As the company was in need of money it was resolved, with the consent of A, to reduce the share capital by 50 lacs by the company taking over the 50 lacs shares which were held by A and giving to A instead debentures of the face value of Rs. 50 lacs carrying interest at 5 per cent. per annum. The Income-tax Appellate Tribunal and

the High Court held that the interest on the debentures could not be allowed as business expenditure under s. 12(2) of the Income-tax Act, the main grounds on which this conclusion was arrived at being (i) the purpose of the transaction was to effect the conversion, (ii) the taxable income of the company was reduced, (iii) it was the same person who brought about the transaction, to whom the share money was paid and who took the debentures, (iv) the transaction was more in the interest of that person than the company, (v) the capital of the company could have been reduced in other ways :

*Held by the Full Court (KANIA C. J. PATANJALI SASTRI, DAS and BOSE, JJ.)* that the test for deciding whether the expenditure was allowable under s. 12(2) was whether the transaction was properly entered into as part of the company's ordinary undertakings to facilitate the carrying on of its business for the purpose of earning income, and in the absence of fraud the High Court was not justified in coming to the conclusion that the interest on the debentures was not allowable on the considerations mentioned above. On the facts it was clear that the transaction was entered into in order to facilitate the carrying on of the business of the company and that it was made on the ground of commercial expediency. The interest on the debentures was accordingly allowable under s. 12(2). *Farmer v. Scottish North American Trust Ltd.* [1912] A. C. 118 referred to.

CIVIL APPELLATE JURISDICTION. Civil Appeal No. 89 of 1950. Appeal against the Judgment and Order dated 5th July, 1949, of the High Court of Judicature at Calcutta (G. N. Das and Mukherjee JJ.) in Income-tax Reference No. 11 of 1948.

*S. Mitra* (*S. N. Mukherjee*, with him) for the appellant.

*M. C. Setalvad*, Attorney-General for India (*S. M. Sikri*, with him) for the respondent.

1951. May 4. The Judgment of the Court was delivered by

BOSE J.—This is an assessee's appeal from a judgment of the High Court at Calcutta delivered on a reference made to it under section 66(1) of the Income-tax Act.

*Bose J.*

The question submitted for the High Court's opinion was as follows :—

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“Whether in the circumstances of this case, the interest paid by the assessee on debentures was incurred solely for the purpose of making or earning such income, profits or gains which are assessable under sub-section (1) of section 12.”

The assessee is a private limited company which was incorporated on 3rd January, 1927. It is an investment company known as the Eastern Investments Limited. The objects set out in the memorandum of association are to buy, sell and otherwise deal with shares, securities, bonds and so forth generally. The company was originally formed for acquiring, holding and otherwise dealing with shares and Government securities which had previously belonged to one Lord Cable. The share capital of the company at the date of its incorporation was 250 lacs and consisted partly of preference shares and partly of ordinary shares. Of these Lord Cable held the majority including the 50,000 ordinary shares of the face value of Rs. 50,00,000 with which we are here concerned. The rest of the share capital was held by the nominees of the late Lord Cable.

Lord Cable died on the 28th of March, 1937, leaving an estate in Great Britain as well as in India. One Geoffrey Lacy Scott was appointed administrator of his estate in India and held these 50,000 shares in question in that capacity.

According to the statement of the case drawn up by the Income-tax Appellate Tribunal in its reference to the High Court, “money was needed by the executors of Lord Cable”, and accordingly the administrator of the estate in India reached an agreement with the company on 9th February, 1937, the terms of which were as follows:—

The company agreed to reduce its share capital by Rs. 50 lacs and to do it by taking over from Scott the 50,000 shares mentioned above which stood in Lord Cable's name at the rate of Rs. 100 a share. Scott on his part agreed to forego cash payment and agreed instead to receive debentures of the face value of

Rs. 50 lacs carrying interest at 5 per cent. per annum "redeemable at the option of the registered holder at any time". The sanction of the Calcutta High Court was obtained in due course and the agreement was carried out by the parties.

The 5 per cent. interest paid to Scott on these debentures forms the subject-matter of the question before the Court. The company claims to deduct this from its income as part of its working expenses under section 12(2) of the Income-tax Act, that is to say, to use the words of the section, as

"expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of making or earning such income, profits or gains."

This contention failed before the Income-tax Appellate Tribunal and also before the High Court. It was agreed all through that the expenditure was not in the nature of capital expenditure, but the view of the Income-tax Commissioner is that (a) it is not expenditure incurred for the purpose of earning the income, profits and gains of the company and (b) that even if it is, it is at any rate not expenditure incurred *solely* for that purpose. In general, the Income-tax Appellate Tribunal and the High Court both took that view.

The grounds on which these conclusions were based may be summarised as follows :

(1) the purpose of the agreement was to effect the conversion without in any way disturbing the holding of the investments of the company or interfering with the earning of its income ;

(2) by this transaction the taxable of the company was diminished ;

(3) There was complete identity of the person who—

(a) brought about this transaction without disturbing the affairs of the company,

(b) to whom the share money was repaid, and

(c) who took up the debentures ;

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and (4) that the transaction was more in the interest of the shareholder Scott than that of the company.

The decision of this appeal rests on the true construction of section 12(2). In our opinion, the law on this point has been correctly summarised in the judgment of the High Court. The following principles are relevant :

(a) though the question must be decided on the facts of each case, the final conclusion is one of law : *Indian Radio & Cable Communications Ltd. v. The Commissioner of Income-tax, Bombay*<sup>(1)</sup> and *Tata Hydro-Electric Agencies Ltd. v. The Commissioner of Income-tax, Bombay*<sup>(2)</sup> ;

(b) it is not necessary to show that the expenditure was a profitable one or that in fact any profit was earned : *Moore v. Stewart & Lloyds*<sup>(3)</sup> and *Usher's case*<sup>(4)</sup>2;

(c) it is enough to show that the money was expended "not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the ground of commercial expediency, and in order indirectly to facilitate the carrying on of the business" : *British Insulated & Helsby Cables Ltd. v. Atherton*<sup>(5)</sup> ; and

(d) beyond that no hard and fast rule can be laid down to explain what is meant by the word "solely".

A case somewhat similar to the present is *Farmer v. Scottish North American Trust Ltd.* <sup>(6)</sup> where it was held that interest paid on an overdraft required for purchasing shares (the shares purchased being retained as security for the overdraft) was an outgoing which could be deducted from the receipts to ascertain the taxable profits and gains which were earned by them. In our opinion, the present case falls within these principles.

(1) 1937 I.T.R. 270 P.C.

(2) 1937 I.T.R. 202 P.C.

(3) 6 Tax Cases 501

(4) 1915 A.C. 433

(5) 1926 A.C. 205 at 221 and 235

(6) 1912 A.C. 118

One of the points which weighed with the Income-tax Appellate Tribunal and the High Court was that though the conversion did not in any way disturb the holding of the investments of the company or interfere with the earning of its income; it had the effect of diminishing its taxable income. In our judgment, this is not a proper consideration when the transaction is not challenged on the ground of fraud. In the present case there is not even an allegation of fraud.

The next point on which some stress was placed was that there was complete identity of person between the person whose shares were sold and the person who took the debentures and that the transaction resulted in considerable benefit to him. In the absence of a suggestion fraud this is not relevant at all for giving effect to the provisions of section 12(2) of the Income-tax Act. Most commercial transactions are entered into for the mutual benefit of both sides, or at any rate each side hopes to gain something for itself. The test for present purposes is not whether the other party benefited, nor indeed whether this was a prudent transaction which resulted in ultimate gain to the appellant, but whether it was properly entered into as a part of the appellant's legitimate commercial undertaking in order indirectly to facilitate the carrying on of its business.

The High Court doubted whether the transaction could be brought within the functions of an investment company and found it difficult to reconcile it with the objects set out in the Memorandum of Association. But we see no such difficulty. Clause 5 empowers a reduction of capital of the company and clause 3(3) empowers the company to borrow or raise money by the issue of debentures. The matter is clearly "writ in the bond". Moreover, we do not think that this inquiry is relevant, for we are dealing with a question of income-tax and not judging the legality or propriety of the transaction on an application to reduce the capital of the company. The only question is whether this was done in the ordinary course of business for the purposes we have already

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pointed out, however mistaken the directors and shareholders of the company may have been.

Therefore, as stated by the Income-tax Appellate Tribunal in its statement of the case, the executors of Lord Cable's estate needed money. In the next place, the transaction was brought about "at instance of the holder of the majority of ordinary shares", and also that the shares were originally held by Lord Cable and his nominees. It seems evident therefore that Scott could have compelled the company to pay him cash for the shares. He seems to have had the whip hand. Instead of doing that he entered into an arrangement which, while giving him the necessary facilities, appears to have satisfied the company by allowing it to retain its investments without a precipitate liquidation of a large portion thereof. It does not matter whether the company was right in this view or wrong, and in any event we are in no position to judge of the soundness of its decision because we have not all the materials before us. It has to be remembered that considerations of this kind go deeper than the apparent profit or loss on an isolated transaction standing by itself. It is not enough to say that the 50,000 shares which were cancelled earned in the following year only  $3\frac{1}{2}$  per cent. interest as against 5 per cent. on the debentures because we do not know to what extent the holdings of the company would have been disturbed if this had not been done. What we do know is what the Income-tax Appellate Tribunal has stated, namely, that—

"the change brought about had been so designed that the investments of the company were not to be disturbed and as a consequence the income accrued was in no way to be affected."

This has only to be stated to show the commercial nature of the transaction from the company's point of view.

The High Court considered that the capital of the company could have been reduced in other ways. But that again is not point. There are usually many

ways in which a given thing can be brought about in business circles but it is not for the Court to decide which of them should have been employed when the Court is deciding a question under section 12(2) of the Income-tax Act.

It was argued on behalf of the respondent (basing the same on paragraph 7 of the appellant's application to the High Court dated 5th April, 1947) that the company had at the time sufficient liquid resources to effect the reduction of capital desired and so it was not necessary to resort to this process. But that again is not the point. The company chose to do it this way, and as there was not even a suggestion of fraud, the only question is whether it was gone through as an ordinary commercial proposition. But we doubt if that is what paragraph 7 meant because in paragraph 4 of the application to the High Court dated 11th February, 1944, the petitioner stated that the money on hand and at short notice was only Rs. 8,94,379. That is a good deal short of 50 lacs. However, we need not enter into this in detail.

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 in 1939.

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. Whether the loan is taken on an overdraft, or is a fixed deposit or on a debenture makes no difference in law. The only argument urged against allowing this deduction to be made is that the person who took the debentures was the party *who sold the ordinary shares*. It cannot be disputed that if the debentures were held by a third party, the interest payable on the same would be an

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allowable deduction in calculating the total income of the assessee company. What difference does it make if the holder of the debentures is a shareholder? There appears to be none in principle in view of the fact that no suggestion of fraud is made in respect of the transaction which is carried out between the company and the Administrator and which has been sanctioned by the Court. If the debentures had been paid for in cash by the same party, no objection could have been taken to allowing the interest amount to be deducted. In principle, there appears to us no difference, if instead of paying in cash the payment of the price is in the shape of giving over shares of the company, when the transaction is not challenged on the ground of fraud and is approved by the Court in the re-organisation of the capital of the company. In our opinion, therefore, the ground on which the Income-tax Appellate Tribunal and the High Court disallowed the claim of the assessee is not sound.

In our opinion, the High Court has failed to appreciate the true position and the question submitted for its opinion should be answered in the affirmative. The appeal is therefore allowed. The respondent will pay the costs of the appeal in this Court and of the reference in the High Court.

*Appeal allowed*

Agent for the appellant: *P. K. Chatterjee.*

Agent for respondent: *P. A. Mehta.*

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