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* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

Reserved on: 30.04.2015
Pronounced on: 18.05.2015

\+ **ITA 110/2005**

COMMISSIONER OF INCOME TAX, DELHI ……Appellant

Through: Sh. Rohit Madan, Sr. Standing Counsel.

Versus

M.M. AQUA TECHNOLOGIES LTD. ……..Respondent

Through: Sh. Bishwajit Bhattacharyya, Sr. Advocate with Sh. Chandrachur Bhattacharyya, Advocate.

CORAM:
HON'BLE MR. JUSTICE S. RAVINDRA BHAT
HON'BLE MR. JUSTICE R.K. GAUBA

MR. JUSTICE S. RAVINDRA BHAT

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1. The following question of law arises for determination in this appeal:

> "*Whether the funding of the interest amount by way of a term loan amounts to actual payment as contemplated by Section 43B of the Income-tax Act, 1961?"*

2. The brief facts are that the assessee was heavily indebted to its institutional creditors. ICICI was the lead manager of those creditors. The

accumulated interest on the overdue principal had mounted to ₹3,00,14,900. The assessee was unable to discharge this interest liability due to its financial hardship. On 30-03-1994, the ICICI, by a letter waived a part of the compound interest together with the commitment charges and agreed to accept 3,00,149 convertible debentures of ₹ 100 each, amounting to ₹ 3,00,14,900 in *lieu* of the outstanding interest. On 15-3-1996, consequently, the assessee issued debentures in favour of ICICI. In its income-tax return, the assessee claimed that interest of ₹ 2,84,71,384 was deductible, explaining that it was actually paid by it in the relevant accounting period. Though the debentures issued amounted to ₹ 3,00,14,900, the interest claimed as deduction is a little less (₹ 2,84,71,384) - the difference was explained to be as a result of the fact that a part of the interest was capitalized in the assessee's books as pre-production expenditure. The assessee's stand (of having actually paid, by issuing the debentures) was rejected by the Assessing Officer (AO) on the premise that the debenture issue resulted only in postponement of the interest liability and that the interest could not be considered as having been "actually paid" as required by Section 43B of the Income Tax Act, 1961 ("Act") to qualify for relief. He, therefore, disallowed the claim.

3. In the appeal to CIT (A), the assessee relied on the judgment of the Andhra Pradesh High Court in *CIT v. Mahindra Nissan Allywin Ltd.*, 233 ITR 493 and the order of the Delhi Bench of the ITAT in *Subhra Motel (P.) Ltd.*, 64 ITD 134. It urged that the issue of debentures equivalent to the amount of outstanding interest amounted to actual payment of the interest liability and, therefore, it has to be allowed as a deduction. Based on the judgment of the Supreme Court in the case of *J.B. Boda Co. (P.)*

Ltd. v. Central Board of Direct Taxes, 223 ITR 271, it was contended that in a case involving receipt as well as payment, a single entry for the net effect would suffice instead of a two way traffic of separate entries of receipt and payment. It was urged therefore, that issue of the debentures by the assessee, amounted to actual payment of the interest liability by it and receipt of the debenture amounts from ICICI. The CIT(A) accepted the assessee's contentions and directed the AO to allow the deduction as claimed. The revenue appealed to the ITAT.

4. The ITAT relied on *Mahindra Nissan* (supra) as well as the decision in *J.B. Boda & Co* (supra). It also took note of the decision of the Patna High Court in *Salendra Narain Bhanj Dev v. Asstt. Agricultural Income-tax Orissa*, 30 ITR 801 which too was concerned with the term "actually paid". In that case, maintenance allowance "actually paid" to certain members of the proprietor's family owning the impartible estate to the extent it did not exceed 1/5th of the net income from the estate, was allowed as a deduction Section 3(2) of the Orissa Agricultural Income-tax Rules, 1948. The assessee claimed amounts as deduction on account of maintenance allowance of the widow of the previous proprietor. The actual monthly payment to the widow was ₹ 500 and the balance was towards expenses incurred by the assessee on behalf of the widow on items such as doctor's fees, medicines, religious ceremonies etc. The authorities allowed a deduction of ₹ 6,000 representing the amount actually paid for the year to the widow, but disallowed the other expenses on the ground that they were not actually paid to her. The High Court disapproved this reasoning:

> *"The only contention made by the department is that the assessee is not entitled to deduction of this amount as the amount was not*

"actually paid" as used in the rule itself. In our opinion, the construction proposed by the department is too narrow to be accepted. The term "actually paid" will also include the money actually spent on behalf of the widow for her benefit towards her maintenance expenses. If we accept the construction proposed by Mr. Dhall appearing on behalf of the department, if the widow without actually receiving the amount of allowance directs to spend it in a particular way towards her maintenance expenses and in fact the money is so spent at her direction for her benefit and towards her maintenance, then the amount will not be deducted under the provisions of Rule 3. This seems to be completely unacceptable. Indeed "actually paid" includes the money which has been actually spent on her behalf towards maintenance, but does not include the money which is proposed to be spent for the widow, but not actually spent."

5. After discussing *Mahindra Nissan* (supra), the ITAT ruled that actual payment could not be given a narrow literal meaning, and held as follows:

"In our opinion, this word has been used in the section only to emphasize that the payment should be real and a payment in point of fact and not something which is a pretence or a fiction. In the present case, ICICI has written a letter dated 11-8-1998 to the assessee on the subject. The letter is at page 185 of the paper book. It has been written by ICICI on behalf of the other participating institutions (IFCI & IDBI), in its capacity as trustees for the debentures. The letter is in response to the assessee's letter dated 10-8-1998. ICICI has written to the assessee that "interest for the period up to March 31, 1995 amounting to Rs. 30,014,900 which was funded by the institutions was paid by the company and the amount was utilized to subscribe to the non-convertible debentures of the company. By another letter dated 8-7-1999, a copy of which is placed at page 186 of the paper book, the ICICI has written to the assessee "that the funded interest up to March 31, 1995 aggregating to Rs. 3,00,14,900 was recognized as business income in our accounts".

At page 197, the copy of the statement of taxable income of the assessee for the assessment year 2001-02 has been filed which shows that in the year in which the debentures were redeemed, the assessee did not claim any deduction for the interest. It has thus been proved in the present case, that the payment of interest by conversion of the outstanding liability into convertible debentures, is a real, substantial and effective payment, meeting the requirement of the word "actual and is not a fictional or illusory payment. The parties have understood it as an effective discharge by the assessee of the interest liability. The treatment given in the accounts as well as in their income-tax assessments is in accord with the factual position.

12. In addition to the above, we may also refer to Circular No. 674 dated 20-12-1993 issued by the CBDT. No doubt, this circular refers only to the sales-tax deferral scheme announced by the State Governments and says that section 43B is to be applied with reference to them. Nevertheless, it gives a clue to the intention behind the section. In para, 3, it has been stated that the Board have considered the matter and are of the opinion that such deferral scheme notified by the State Govt. through Govt. orders meet the requirements of the earlier Circular No. 496 dated 25-9-1987, "in effect though in a different form". What is thus contemplated is that the payment must be real, substantial and effective and so long as this condition is satisfied, there can be no objection to allowing the same, without insisting that the amount has to be paid in cash or cheque or any other mode, i.e., in a physical sense. In this connection, it may be pertinent to observe that in the present case, we are concerned with a contractual liability as opposed to statutory liability. Parties are free to enter into contracts in relation to their business and there is no prohibition in law against such freedom, provided the contracts are not opposed to public policy or order or morality or are not violative of any other provisions of law. In the present case, the parties have agreed between themselves that the interest would be funded and convertible debentures would be issued in an amount identical to the funded interest and that this arrangement would be accepted by both of them as actual discharge of the liability to pay interest. In our opinion, nobody

> *has the right to intervene and rewrite the arrangement for the parties and say that the parties cannot agree between themselves that this will be taken as actual discharge of the liability to pay interest. The apprehension expressed by the legislature while introducing the provisions of section 43B was that the assessee were not discharging their income-tax liabilities by paying them and in fact, some of them were even obtaining a stay from the Courts and at the same time claiming such liability as deductions in their income-tax assessments. This apprehension, which was the rationale behind section 43B when it was introduced in 1984, appears to us to be misplaced in the present case… "*

6. Learned counsel for the revenue argued that the impugned order is contrary to the decision of the Madras High Court in *Kalpana Lamps and Components Ltd. v. DCIT*, (2001) 255 ITR 491. In that case, it was held in the context of a claim under Section 43B that a mere postponement of the liability to pay interest does not amount to discharge, whether actual or constructive and, therefore, the conversion of the outstanding interest into a term loan liability, albeit with the consent of the lender, cannot be considered as a constructive discharge of the interest liability. It was submitted that the impugned order to the extent it relied on Circular No. 674 dated 20-12-1993 issued by the CBDT, was misplaced and untenable. It was highlighted that in view of the structure of sales tax enactments, schemes made, whereby the sales-tax liabilities were converted into loans by the State Governments, were allowed as a deduction in the assessment for the previous year in which such conversion was allowed. The schemes were statutory and the application of the Circular was limited to the instance it catered to. The ITAT could not have carried the analogy beyond the instance mentioned in the circular, to dilute the rigors of Section 43B which mandated actual payment. Learned counsel relied on the

amendments made to Section 43B by virtue of Finance Act, 2006 with retrospective effect from 01.04.1989 by insertion of Explanation 3C and Explanation 3D meant that actual payment had to necessarily be made to qualify for deduction.

7. Learned senior counsel for the assessee, Mr. Biswajit Bhattacharya, relied on *J.B. Boda & Co* and further argued that debentures are securities within the meaning of the expression understood in Section 2 (ac) and (h) of the Securities Contract Regulation Act, 1956 and freely tradable. Thus, the moment the debentures were issued to ICICI, the latter could realize the money value thereof. It was submitted that the AO's inability to understand the nature of debentures, which, unlike shares, were transferrable without any prescribed mode, led to his holding that payment through debentures did not amount to actual payment. Learned senior counsel also relied on the Constitution Bench decision in *Standard Chartered Bank v Andhra Bank*, 2006 (6) SCC 94 where the Supreme Court held, *inter alia*, that:

> *"A debenture is an actionable claim. However, Section 137 of the Transfer of Property Act exempts debentures inter alia from the provisions of Sections 130 to 136 of the TP Act. Thus, with respect to debentures, there is no prescribed mode of transfer of property under the TP Act."*

Counsel also relied on *Vinir Engineering (P) Ltd. v Deputy Commissioner of Income Tax* 313 ITR 154 and the Jharkhand High Court decision in *Commissioner of Income Tax v Shakti Spring Industries (P) Ltd*, [2013] 219 Taxman 124 to say that not all payments need to be in cash and that

debenture payouts as part of arrangements with banks and financial institutions are deemed sufficient under Section 43B.

8. Section 43B, to the extent relevant for the present case, now reads as follows:

> *"**Section 43B. Certain deductions to be only on actual payment**: Notwithstanding anything contained in any other provision of this Act, a deduction otherwise allowable under this Act in respect of -*
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> *(a) ****
>
> *(b) ****
>
> *(c) *****
>
> *(d) any sum payable by the assessee as interest on any loan or borrowing from any public financial institution or a State Financial Corporation or a State Industrial Investment Corporation, in accordance with the terms and conditions of the agreement governing such loan or borrowing, or*
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> *(e) any sum payable by the assessee as interest on any loan or advances from a scheduled bank in accordance with the terms and conditions of the agreement governing such loan or advances, or*
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> *Explanation 3C.- For the removal of doubts, it is hereby declared that a deduction of any sum, being interest payable under clause (d) of this section, shall be allowed if such interest has been actually paid and any interest referred to in that clause which has been converted into a loan or borrowing shall not be deemed to have been actually paid.*

Explanation 3D.- For the removal of doubts, it is hereby declared that a deduction of any sum, being interest payable under clause (e) of this section, shall be allowed if such interest has been actually paid and any interest referred to in that clause which has been converted into a loan or advance shall not be deemed to have been actually paid.

Explanation 4.- For the purposes of this section,-

(a)" public financial institution" shall have the meaning assigned to it in section 4A of the Companies Act, 1956 (1 of 1956)"

Explanations 3C and 3D quoted above, were introduced by Finance Act, 2006 with retrospective effect, from 01.04.1989 and 01.04.1997 respectively. Thus, these two explanations were not present at the time the impugned order was passed.

9. From the AO's order, it is evident that the loans, in respect of which the assessee claims deduction of interest under Section 43B, were taken from ICICI, IDBI and IFCI. These entities are included within the definition of 'public financial institution' set out in Section 4A of the Companies Act, 1956 (applicable for the purposes of the instant case as it relates to AY 1996-97). Consequently, by virtue of Explanation 4(a) to Section 43B, these entities would also constitute public financial institutions for the purposes of Section 43B and the interest on loan taken by the assessee from these entities would fall within the purview of Section 43B(d) of the Act.

10. Now, Explanation 3C, having retrospective effect with effect from 01.04.1989, would be applicable to the present case, as it relates to AY 1996-97. Explanation 3C squarely covers the issue raised in this appeal, as it negates the assessee's contention that interest which has been converted into

a loan is deemed to be 'actually paid'. In light of the insertion of this explanation, which, as mentioned earlier, was not present at the time the impugned order was passed, the assessee cannot claim deduction under Section 43B of the Act.

11. In so concluding, this Court is supported by the decision of the Madhya Pradesh High Court in *Eicher Motors Ltd. v. Commissioner of Income Tax*, 315 ITR 312 and subsequently, the judgment of the High Court of Telangana and Andhra Pradesh in *Commissioner of Income Tax v. Pennar Profiles Limited*, (ITA No. 289 of 2003, decided on 11.02.2015). In *Eicher Motors*, the Court noted:

> *"7. As observed supra, the Expln. 3C has now in clear terms provided that such conversion of interest amount into loan shall not be deemed to be regarded as "actually paid" amount within the meaning of Section 43B. In view of clear legislative mandate removing this doubt and making the intention of legislature clear in relation to such transaction, it is not now necessary for this Court to interpret the unamended Section 43B in detail, nor it is necessary for this Court to take note of facts in detail as also the submissions urged in support of various contentions except to place reliance on Expln. 3C to Section 43B and answer the questions against the assessee and in favour of Revenue."*

The Court in *Pennar Profiles Limited (supra)* considered the decisions in *Mahindra Nissan* (supra), *Vinir Engineering* (supra) and *Eicher Motors* (supra) and held as follows:

> *"8. In this backdrop, we have perused the provisions contained in Section 43B of the Act, in particular, Explanation 3C thereof, which was inserted by the Finance Act, 2006 with retrospective effect from 01.04.1989. This provision was inserted in 2006 and*

hence, this Court in Mahindra Nissans case, had no occasion to deal with the case in the light of this provision. Insofar as the Karnataka High Court is concerned, though this provision was existing on the date of judgment, it appears that it was not brought to the notice of learned Judges and hence, the Division Bench proceeded to consider and decide the appeal of the assessee without referring to Explanation 3C appended to Section 43B of the Act.

9. As a matter of fact, from reading of Explanation 3C, in our opinion, the question as raised in the present appeals stands answered without further discussion. This provision was inserted for removal of doubts and it was declared that deduction of any sum, being interest payable under clause (d) of Section 43B of the Act, shall be allowed if such interest has been actually paid and any interest referred to in that clause, which has been converted into a loan or borrowing, shall not be deemed to have been actually paid. Thus, the doubt stands removed in view of Explanation 3C. This provision was considered by the Madhya Pradesh High Court in Eicher Motors Limited v. Commissioner of Income Tax to hold that in view of the Explanation 3C appended to Section 43B with retrospective effect from 01.04.1989, conversion of interest amount into loan would not be deemed to be regarded as actually paid amount within the meaning of Section 43B of the Act."

12. In light of the introduction of Explanation 3C, this Court does not consider it necessary to discuss the precedents relied upon by the assessee delivered prior to the enactment of Finance Act, 2006. As regards the decision in *Shakti Spring Industries* (supra), the interest due in that case was offset against a subsidy which the assessee was entitled to, and it did not involve an instance where it was "*converted into a loan or borrowing*" within the meaning of Explanation 3C. It is perhaps for this reason that Explanation 3C was not discussed.

13. For the above reasons, the question of law framed is answered in the negative, in favour of the revenue. The appeal is accordingly allowed. There shall be no order as to costs.

S. RAVINDRA BHAT
(JUDGE)

R.K. GAUBA
(JUDGE)

MAY 18, 2015