(2010) 01 KL CK 0136

In the High Court Of Kerala

Case No : Income Tax A. No. 402 of 2009 (A.Y. 1996-97 and 1997-98)

CIT APPELLANT

Vs

Merchem Ltd. RESPONDENT

Date of Decision : 29-01-2010

Acts Referred:
Income Tax Act, 1961 — Section 28, 29, 30, 35D, 36

Citation : (2012) 344 ITR 625

Hon'ble Judges : P.S. Gopinathan, J;C.N. Ramachandran Nair, J

Bench : Division Bench

Advocate : Jose Joseph, for Income-tax, for the Appellant; R. Vijayaraghavan and Saji Varghese, for the Respondent

Final Decision : Dismissed

Judgement

C.N. Ramachandran Nair, J.—The question raised in the connected appeals filed by the Revenue against the very same assessee is whether the Tribunal was justified in holding that pre-operation expenditure incurred by the assessee for setting up of a new industrial unit by way of expansion of production is allowable as revenue expenditure. We have heard standing counsel appearing for the appellant and Sri R. Vijayaraghavan, counsel appearing for the respondent-assessee. The assessee is engaged in the manufacture of rubber chemicals and it had a factory at Edayar in Ernakulam. However, during the previous years relevant for the assessment years 1996-97 and 1997-98, the assessee was engaged in setting up of a new industrial unit which was also for manufacture of the same product or in other words, the new industrial unit was set up in the same line of business by way of expansion of production. For the assessment year 1996-97, the assessee claimed deduction of Rs. 24,21,333 towards various items of expenditure incurred in the setting up of the new factory. Similarly, for the next assessment year 1997-98, the assessee claimed deduction of Rs. 54,04,739 out of which Rs. 25,69,663, according to the statement furnished by the assessee in court, represents interest paid by the assessee for the term loan availed of from IDBI. From the break-up details of the disputed expenditure furnished by the assessee, it is clear that the entire items of expenditure claimed, which are in the nature of staff welfare expenses, vehicle running and maintenance charges, advertisement charges, etc., represent expenditure attributable exclusively to the new factory set up by the assessee at Eloor. Standing counsel appearing for the Revenue mainly relied on the decision of the Supreme Court in Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, and contended that the assessee is entitled to claim deduction of preliminary expenditure incurred for setting up of the new factory, irrespective of whether it is under expansion scheme or not. He has relied on the statutory provisions, namely, the definition of "actual cost" contained in section 43(1) read with Explanation 8 thereto, section 37(1) and section 36(1)(iii) and its proviso for the proposition that interest paid on borrowed funds for acquisition of plant and machinery and other capital goods-up to the date of commissioning should be treated as part of actual cost on which the assessee is entitled to depreciation and other eligible, deductions on, the capital employed and under no circumstance interest on borrowed funds could be allowed as deduction in the computation of income of the previous year in which such plant and machinery was not put to use. Counsel appearing for the assessee relying on several judgments and particularly that of the Supreme Court in Deputy Commissioner of Income Tax, Ahmedabad Vs. Core Health Care Ltd., contended that irrespective of whether the amount borrowed is for acquisition of capital asset or for meeting revenue needs, interest is allowable u/s 36(1)(iii) of the Act. So far as the other items of expenditure are concerned, his contention is that the entire expenditure is allowable as revenue in nature. Even though counsel for the assessee has relied on the decisions of various High Courts, we do not think there is any need to go into those decisions because the two decisions of the Supreme Court above referred are essentially on the same question.

2. We feel, it would be useful to refer to the relevant statutory provisions, and accordingly section 36(1)(iii) with its proviso, section 43(1) with Explanation 8 and section 37(1) are extracted hereunder for easy reference:

36. Other deductions.--(1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28--....

(iii) the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession :

Provided that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized in the books of account or not); for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.

37. General.--(1) Any expenditure not being expenditure of the nature described

in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head Profits and gains of business or profession...

43. Definitions of certain terms relevant to income from profits and gains of business or profession.--In sections 28 to 41 and in this section, unless the context otherwise requires--

(1) actual cost means the actual cost of the assets to the assessee, reduced by that portion of the" cost thereof, if any, as has been met directly or indirectly by any other person or authority...

Explanation 8.--For the removal of doubts, it is hereby declared that where any amount is paid or is payable as interest in connection with the acquisition of an asset, so much of such amount as is relatable to any period after such asset is first put to use shall not be included and shall be deemed never to have been included, in the actual cost of such asset.

3. The scheme of the Act provides for computation of various heads of income after granting eligible deductions and allowances which are specifically provided under the Act. Section 29 of the Act says that income from business or profession has to be computed in accordance with the provisions of sections 30 to 43D. Among the various provisions providing for deductions and allowances, it is pertinent to note the scope of section 37(1) which is the residuary provision for allowing all items of business expenditure which are not otherwise eligible for deduction under the Act with the exclusion of personal expenditure and expenditure that is of a capital nature. In our view, it is the duty of the assessee to claim under what provision of the Act, he seeks to claim deduction of an expenditure in the computation of business income and unless it is proved that, that item falls under the provision under which it is claimed, the Assessing Officer is not free to allow it. In this case, admittedly the assessee has claimed the entire pre-operation expenditure in respect of new industrial unit that was being set up in the two previous years relevant for the assessment years as revenue expenditure allowable u/s 37(1) of the Act. However, the Assessing Officer on verifying the accounts noticed that in the balance-sheet the assessee has styled the pre-operation expenditure as one to be carried forward to be capitalized and apportioning to various assets on commissioning of the project. In other words, the assessee which showed in its books of account the entire pre-operation expenditure as a capital expenditure, claimed the same as revenue expenditure for the purpose of deduction under the Act. As already stated, section 37 prohibits granting of any deduction which is of a capital nature. Admittedly the assessee has incurred expenditure only for the purpose of setting up of new industrial unit which was not commissioned in any of the two previous years relevant for the assessment years involved. Therefore, in our view, the entire expenditure incurred for setting up of new industrial unit, though under expansion scheme, for the manufacture of very same product, is capital in

nature. Business expenditure of a revenue nature allowable u/s 37 are those incurred for carrying on, existing business and not investments made for setting up of a new plant for operation in future.

4. So far as the claim of deduction of interest on term loan borrowed for acquisition of plant and machinery is concerned, the assessee has heavily relied on the decision of the Supreme Court in Core Health Care Ltds. (2008) 298 ITR 194 (SC) referred to above, wherein the Supreme Court has distinguished its earlier decision in Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, , where pre-operation expenditure was held to be not allowable as revenue expenditure. Standing counsel appearing for the Revenue submitted that the Supreme Court has only considered the interest paid on funds borrowed for purchase of two items of machinery, which were not commissioned in the relevant previous years. However, according to the standing counsel, in this case, it is not purchasing of one or two items of machinery, but it is a case of setting up of a factory as such, and so much so, the decision of the Supreme Court does not apply as such. On going through the judgment of the Supreme Court we notice that the Supreme Court has not considered the scope of the proviso introduced to section 36(1)(iii) which expressly bars granting of deduction of revenue expenditure on funds borrowed for acquisition of capital asset until the asset is put to use. When this provision is read along with the definition of "actual cost" contained in section 43(1) read with Explanation 8 thereto, what emerges is that actual cost of plant and machinery or capital asset will be increased by interest on borrowed funds up to the date of commissioning of plant and machinery. Therefore, after introduction of the proviso to section 36 (1)(iii) the decision of the Supreme Court in Deputy Commissioner of Income Tax, Ahmedabad Vs. Core Health Care Ltd., referred to above and relied on by the assessee has no more application and the interest paid on borrowed funds for acquisition of capital asset cannot be allowed as deduction but the assessee is only entitled to claim depreciation and other allowances of actual cost by adding interest incurred on the borrowed funds up to the date of commissioning to the actual cost. However, in our view, the amendment introducing the proviso by the Finance Act, 2003, with effect from April 1, 2003, is only clarificatory in nature and the position is the same even for the period prior to that. Therefore, in our view, interest on borrowed funds for the acquisition of capital asset is not allowable as revenue expenditure until the asset is put to use and accrued interest until the asset is put to use by the assessee will only form part of actual cost for the purpose of depreciation and other allowances allowable under the Act. Even though our observations and findings are in the above lines, we are still not inclined to interfere with the order in appeal because the Tribunals orders are consistent with the decision of the Supreme Court above referred and relied on by the assessee. Further, we notice that many of the items of expenditure would have been allowed by way of amortisation u/s 35D of the Act which provides for deduction of preliminary expenditure which is nothing but pre-operation expenditure otherwise not allowable under the Act. In other words, the

assessee would have been entitled to amortisation of most of the items of expenditure in the course of 10 years u/s 35D of the Act. So far as interest on borrowed funds, the assessee would have at least got depreciation benefit by adding interest to the actual cost up to the date of commissioning of the project. We, therefore, dismiss the appeals filed by the Revenue. However, we make it clear that it is for the officer to verify whether interest is capitalised along with cost of plant and machinery and fixed assets, and if so interest component of the claim allowed by the Tribunal for the year 1997-98 will stand disallowed.