

(1996) 03 KL CK 0004

In the High Court Of Kerala

Case No : IT Ref. No. 103 of 1991, July 10, 1996.

COMMISSIONER OF INCOME TAX

APPELLANT

Vs

AUTOKAST LTD.

RESPONDENT

Date of Decision : 10-03-1996

Acts Referred:

COMPANIES ACT, 1956 — Section 208
Constitution of India, 1950 — Article 141
Income Tax Act, 1961 — Section 32, 57

Citation : (1997) 138 CTR 75

Hon'ble Judges : V. V. Kamat, J

Bench : Division Bench

Judgement

V. V. KAMAT, J. :

The question for answer is as follows :

"Whether, on the facts and in the circumstances of the case, the interest income is not assessable to tax in the hands of the appellant ?"

The Tribunal has chosen to refer this question, as according to it there is "a sharp cleavage of judicial opinion on the question whether such interest income earned by a company should be assessed as income from "other sources" or it should be held to be as part of the interest amount that should be capitalised.

2. In the reference order itself decisions in favour of the assessee as well as in favour of the Revenue are specified.

3. The factual matrix presents no difficulty whatsoever. The assessment year is 1985-86. Shorn of all unnecessary details, we are concerned with the assessee borrowing from the Industrial Development Bank of India Ltd., (IDBI) Bombay, an amount of rupees three crores which was left in deposit with the State Bank of Travancore, till the assessee found it necessary to use the said amount either in the purchase of plant and machinery or in installing them or in running its establishment. Some portion of this amount was also deposited with the

Chartered Bank, Cochin. With the help of the bank, the assessee became a member of the bill market which fetched considerable income in the accounting year. Various such deposits earned income by way of interest in regard to which an amount of Rs. 5,05,711 got accumulated along with the above deposits which were borrowed as stated above by the assessee from the Development Bank.

4. It needs to be mentioned that the amounts of borrowings received from the IDBI for which there was no immediate necessity were kept in deposit with the above banks in this State and in regard thereto the assessee had taken the specific approval of the IDBI to have the unutilised money left with the assessee in the bank account for the purpose of its use in the bill market. Naturally such deposits earned a return at the bank rate of interest.

5. As and when the plant and machinery as ordered by the appellant would be delivered and equally well in the same way, as and when the installation of such machinery would be done, followed by the requirements for the maintenance of the establishment, the funds borrowed were to be withdrawn from the concerned banks.

6. The details of the current account and the deposit account placed on record show that with the State Bank of Travancore at Trivandrum as well as with the Chartered Bank, Cochin, on 3rd July, 1984, Rs. 3 crores came to be deposited as a loan from the IDBI drawn by the assessee. This was initially with the State Bank of Travancore at Trivandrum as stated on 3rd July, 1984 and within four days Rs. 2.50 crores also was taken out by the assessee and was put in the current account of the assessee with the Chartered Bank, Cochin. This came to be transferred as a short term deposit for a period of 30 days with the said bank from and out of the said amount.

7. There is no dispute that the money left in the current account was utilised to meet the cost of the project and on maturity of the term of deposit in August, 1984, the money was drawn for the use of the project. During this period of interregnum, certain short-term deposits with duration of 15 to 45 days were also taken out from the current account and this related to the money found surplus for the present and was deposited in temporary short-term deposit. As stated above, the income earned in this way by way of interest came to Rs. 5,05,711 as interest earned on short-term deposits with the banking institutions.

8. In the proceedings before the ITO (Annexure A) by the order dt. 18th Nov., 1986, it was held that the said amount is to be treated as the income of the assessee under the head "other sources" and in regard thereto the contention of the assessee that the interest amount as above did not constitute income in the real sense, but going to reduce the overall cost of the project was rejected.

9. In reaching this conclusion although the ITO referred to the decision of the Supreme Court in Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, to the effect that the interest paid before the commencement of the production on amounts borrowed by the assessee for the acquisition or

installation of plant and machinery form part of the "actual cost", it is observed 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 in the actual cost of such asset. The ITO further observed, referring to the situation w.e.f. 1st April, 1984, vide Finance Act, 1986, that the interest upto the stage when the asset is first put to use has to be considered as part of the "actual cost" within the meaning of s. 43(1) of the Act. Proceeding with the reasoning in this fashion, it is observed further that the interest received by the assessee during the year in question cannot be set off against the interest payable to the IDBI. The ITO took the view that the amount of loan obtained on interest from the Government for erection of the industry if it was kept in deposit with the bank till the utilisation for stipulated purpose and interest was earned thereon, it will have to be considered as an income relatable to "other sources" and would become liable to tax and no deduction has sought to be claimed. Although in a summary manner the conclusion is reached, the ITO has passingly referred to the following decisions, viz., Commissioner of Income Tax (Central) Vs. New Central Jute Mills Co. Ltd., , ADDITIONAL COMMISSIONER OF Income Tax, MADRAS-I Vs. MADRAS FERTILISERS LTD., , Traco Cable Company Ltd. Vs. Commissioner of Income Tax, and MADHYA PRADESH STATE INDUSTRIES CORPORATION LTD. Vs. COMMISSIONER OF Income Tax, M.P., .

10. The first appellate authority [the CIT(A)], Trivandrum by the order dt. 9th Jan., 1987, also considered the decision of the Supreme Court (Challapalli Sugars Ltd. vs. CIT) (supra) to understand it as confined to the question of interest paid on borrowings taken for the purpose of acquisition of capital assets as forming part of the capital cost of the project till the project starts yielding results. The first appellate authority has specially observed as follows in the context :

"In other words, the Supreme Court upheld the contention of the taxpayer that the interest costs incurred on loans taken should form part of the capital costs till the production period was reached."

It is this principle that is sought to be applied by the first appellate authority after observing that the above principle is given clear expression in regard thereto by the decisions of the other High Courts. The first appellate authority in conclusion has observed in the following manner :

"In this background, therefore, the attempt of the learned representative to go beyond these decisions and seek a distinction between the facts noticed in those cases and now found in the case of the appellant for the application of the decision of the Tribunal appear to me to be an exercise fraught with uncertainty."

The order of the ITO was upheld by dismissing the appeal.

11. The assessee's appeal before the Tribunal was allowed by the order dt. 20th March, 1989. In paragraph 8 of the order undisputed factual positions summarised hereinbefore have been narrated and a finding in regard thereto is

recorded in the following manner :

"These materials clearly establish a nexus between the amounts borrowed by the appellant from the IDBI and the investment in banks and in bill discounting, in accordance with the terms and conditions entered into by the appellant and IDBI, with their approval."

12. It is this undisputed factual matrix that is taken up for consideration by the Tribunal which ultimately answered the question in favour of the assessee that the amount could not be considered in any way as income from "other sources" and in regard thereto deduction in terms of s. 57(iii) of the IT Act, 1961, would have to be granted.

13. In the process of this reasoning, the Tribunal has taken up for consideration obviously the decision of this Court *Traco Cable Company Ltd. Vs. Commissioner of Income Tax*, . The Tribunal has observed with reference to the above decision that the dispute was in respect of Rs. 34,130 claimed by the assessee as business expenditure which was disallowed by the Departmental authorities on the ground that there was no business income against which it could be allowed. The Tribunal has held that in the context of undisputed factual matrix, the decision could not be said to be against the assessee.

14. Thereafter, as stated at the outset, the Tribunal has observed that the decisions of the High Courts present a situation of a sharp cleavage of judicial opinion in regard to the question as to whether the interest amount would have to be understood as income from "other sources" or whether it should be held to be as part of the interest amount having nexus with the capital assets and as a consequence enough to attract the provisions of deduction under s. 57(iii) of the Act.

15. The Tribunal has proceeded further and has considered the decision of the Andhra Pradesh High Court in *Commissioner of Income Tax Vs. Nagarjuna Steels Ltd.*, and other revision cases and has observed that where the object of the assessee is to do business and in the course of setting up a plant, if the borrowed amount is not required at once and if it is kept as surplus in short-term deposits, the interest earned on such short-term deposits could not be considered as income in the sense of the situation and would have to be set off against the interest required to be paid by the assessee on the amount of loan borrowed for the purpose of setting up of the industry and allied situations. In the result, the Tribunal found that this amount of Rs. 5,05,711 would not be assessable to tax in the hands of the appellant as income from other sources.

16. After hearing the learned senior standing counsel for the Revenue and the counsel for the assessee, we have been pointed out the decision of the Supreme Court in *Chellapalli Sugars Ltd. vs. CIT* (supra). We have also been taken through the other decisions and justifiably in view of the Tribunal finding the situation of a sharp cleavage of judicial opinion. In our judgment, the spirit of Art. 141 of the Constitution of India takes us straight to consider the decision of the Supreme

Court to appreciate as to what is the declaration of law of the apex Court in the context. This is more so because on going through the other decisions, we find a distinct advantage to go through the decision of the apex Court with greater seriousness, care and sincerity. In the context we feel that it is really necessary.

17. The legal sweep of Art. 141 of the Constitution of India takes the situation out of the usual circular limits of ratio decidendi, obiter dictum and casual observations. Once the declaration of law is succinct and clear, any attempt to distinguish the decision on facts or to say that the factual position is little otherwise is impermissible. The declaration of law has a binding force and in that regard the position has a special characteristic as distinct from the strength or weakness of a judicial precedent under the theory of precedence. It is not permissible to bypass the decision of the apex Court with observation that the apex Court was dealing with almost the other side of the coin of a two-sided question.

18. Challapally Sugar Ltd.s case (supra) considered the question relating to the problem of deduction, depreciation and development in the matter of the question of knowing as to what is to be understood as "actual cost" in regard thereto. The judgment of the apex Court rendered by Justice Khanna considered the question with manifold aspects in regard thereto. Copious references to the standard treatises not only on the first principles of accounting, but also advance accounting, relevant provisions of the Companies Act, 1956 (especially s. 208 thereof) together with decided cases not only of the apex Court, but also of English cases will find adorning the reasoning recording conclusions in regard thereto.

19. In the process it is available as found out as to what the first principles of accountancy understand by the term "cost". It is observed that the word is not synonymous with "price". In the process of analysis this difference in the shape of meaning with regard to these two terms had been carried to its logical conclusions, with reference to the relationship of the amount in question, whether it is in relation to "cost" or it is in relation to "price". It is observed that anything that gets closer to the concept of "cost" by reason of its nexus thereto, if it is relating to the amount of interest payable or receivable of course, it acquires an additional qualification of it being capitalised. The amount in connection with the cost in regard thereto is understood in the process of accountancy and book keeping as "capitalised interest" meaning thereby it has nexus or co-relation with the cost in regard thereto. In a similar way taking the process of reasoning further in the context, situation over a long period referable to the capital expenditure is invariably understood with reference to the question of interest as an additional cost. The final cost of construction constitutes the cost of the machinery, material, labour, supervision, establishment charges plus interest on the capital employed which, but for its employment in that way, would be invested in good securities paying reasonable rate of interest.

20. Proceeding further, referring to s. 208 of the Companies Act, 1956, dealing

with payment on share capital in certain contingencies, emphasis is shown to s. 208(1)(b) with regard to the interest paid to the capital to be understood as part of the cost of construction or the work or building or the provision of the plant.

21. It is then observed that any amount used to finance capital expenditure would include interest paid or payable in respect of borrowings required to finance such expenditure ultimately. The reasoning proceeds further that there are occasions where money is borrowed by a newly started company which is in the process of construction and erecting its plant and before the commencement of production actually, interest gets accrued as by its very character, interest is sleepless and in such an event, the situation is understandable as a process of capitalisation, the interest getting added to the cost of the fixed assets. This is invariably in a situation where the construction activity is contemplated through the borrowing channel.

22. It is also observed in the process of reasoning that the expression "actual cost" has not been defined in the Act and, therefore, whether the interest paid before the commencement of production on the amount borrowed for the acquisition and installation of the plant and machinery can be considered to be part of the actual cost of the assets to the assessee requires an understanding in the context, meaning thereby whether it is to be understood as carrying the attributes of price or carrying the attributes of its annexation with cost of construction.

23. As an aid in the process reference is also made to the literature captioned "Statement on Auditing Practices" circulated by the Institute of Chartered Accountants of India (1974) is also valuably sought to know what comprises "fixed assets" and observes in connection therewith that cost includes all expenditure necessary to bring the assets into existence and to put them in working condition. Emphasis is given where this inclusive character is illustrated stating it to include "interest on borrowings to the extent specified in paragraph 2.22" of the above statement. Reference to the said paragraph 2.22 also is found to record the accepted view that in the case of a newly started company which is in the process of constructing and erecting its plant, the interest incurred before production commences has to be capitalised.

24. As seen above, the relationship with the capital assumes importance because the situations are in abundance that the construction activity gets erected only on the principal strength of borrowing in regard thereto.

25. It is declared that in case money is borrowed by a newly started company which is in the process of constructing and erecting its plant, the interest incurred before the commencement of production on such borrowed money can be capitalised and added to the cost of the fixed assets created as a result of such expenditure.

26. The decision of the apex Court is based on the emphasis of the absence of synonymity of cost and price together with the necessity of understanding the

nexus or relationship of the amount in dispute with the cost aspect of the project. If this is the situation, whether this relationship as seen is the vital element while considering the case of interest payable, there cannot be any reason to consider the reasoning and apply it to a situation with regard to the interest receivable by the assessee engaged in the process of construction. As stated at the outset, the two sides of the coin can never divide the coin, but both the sides are available for sight without which the knowledge that the article is a coin would remain incomplete. The sight is obviously the same looking at one side and the other side may be in the different discretions.

27. It must be stated that the learned counsel for the assessee adopted by way of his argument, part of the commentary dealing with the situation of interest and other sums paid or received during the period of construction and thereafter from the Law and Practice of Income Tax by Kanga & Palkhivala 8th Edn., Vol. I at p. 506 on s. 32 of the IT Act, 1961, dealing with the problem of depreciation. The learned counsel urged that a company which has borrowed moneys for erecting its plant may, during the period of construction, keep in temporary deposits the unutilised portion of the loan with a view to reducing the burden of interest payable on the loan. The learned counsel submitted that everything depends on the nexus or relationship, there being no difference in the situation as to whether the amount of interest is payable or receivable, the real situation being its connection with what is understood as "cost" and "actual cost" which is required to be determined.

28. For our purpose to understand the head "income from other sources" with regard to the claim for deduction, it is important to emphasise that under such head in accordance with the provisions of s. 57 of the Act has to be computed after making deductions specified therein. Sec. 57(iii) also provides an aid to what is its connection with the characteristics of income in regard to the category under consideration. Sec. 57(iii) is as follows :

"57. Deductions. - The income chargeable under the head "Income from other sources" shall be computed after making the following deductions, namely :

x

x

x

(iii) any other expenditure (not being in the nature of capital expenditure) laid out or expended wholly and exclusively for the purpose of making or earning such income" :

It means that any expenditure laid out or expended wholly or exclusively for the purpose of making or earning such income as an exception, and the exception is of the capital expenditure in the context.

29. In spite of this situation, we must record that at least three High Courts have

considered the situation otherwise. The Madras High Court **ADDITIONAL COMMISSIONER OF Income Tax, MADRAS-I Vs. MADRAS FERTILISERS LTD.**, was dealing with the situation of income from other sources relating to expenditure with regard to borrowings from foreign bank for the cost of construction of the plant and held that under s. 57(iii) of the Act it would not be an allowable deduction. It must be stated that although the Madras High Court decided the question by the judgment dt. 7th Dec., 1978, the decision of the apex Court in **Challapalli Sugar Ltd.s** case (supra) was not before it. Therefore, the situation has to be appreciated in the context.

30. The Karnataka High Court in **Commissioner of Income Tax Vs. Cap Steel Ltd.**, was also dealing with the situation of borrowings of funds for installation of plant and machinery and held that the interest paid on borrowings must be capitalised and added to the cost of the fixed assets which had been created as a result of such borrowings and what should be capitalised was the gross interest in each year and not the net interest. The decision in **Challapalli Sugars Ltd.s** case (supra) was in the forefront before the Karnataka High Court and added to it reference is also made to the literature "Study on Expenditure during Construction Period" by the Research Committee of the Institute of Chartered Accountants of India.

31. The Calcutta High Court (1979) 118 ITR 1008 also relying on the decision of the apex Court in **Challapali Sugars Ltd.s** case (supra) held that the interest paid to the Government would have to be capitalised and added to the cost of the plant which was being set up and the same amount could not be treated differently in the accounts of the assessee. Even after accepting this position that there was connection or nexus between the interest paid to Government and the interest earned by the bank, and the nexus is relatable to earning of interest or payment thereof, both with, it is observed that the assessee therein had failed to establish that it was its purpose or one of its purposes to utilise the amount received on loan for earning interest. It is because of this factual position that the assessee had not established that the expenditure incurred was solely and wholly for the purpose of earning interest from the bank. Accepting the general proposition, the Calcutta High Court did not allow deduction as claimed by the assessee in regard to the amount of interest. The decision of the Calcutta High Court is centered round its own factual matrix, although there is a reference to the above decision of the apex Court.

32. The Tribunal has relied on the decision of the Andhra Pradesh High Court in **CIT vs. Nagarjuna Steel Ltd.** (supra) dealing with the situation of a plant under construction and surplus of the borrowing amount kept in short-term deposits by the assessee on his own, the Andhra Pradesh High Court has independently ruled that where the object of the assessee is to do business and in the course of setting up a plant for the purpose, in a situation that all borrowed money is not required at once, thought of keeping such surplus funds in short-term deposits and interest is earned in the process of such short-term deposits, with regard

thereto, the amount would have to be set off against the interest paid or payable by the assessee on his borrowings leaving the balance, if any, for getting income with the process of capitalisation.

33. The learned senior standing counsel for the Revenue showed us the decision of the Andhra Pradesh High Court in Commissioner of Income Tax Vs. Derco Cooling Coils Ltd., in fairness where it is observed that the very idea of set off connotes that there is a nexus or co-relation between the item of receipt and the expenditure and, therefore, it is not permissible to set off an item of interest from out of an item of expenditure unrelated to the former or incurred in a different connection. Even though the proposition deducible from the decision of the apex Court in Challapalli Sugars Ltd.s case (supra), the Andhra Pradesh High Court observed on facts therein that the questioned receipt of the amount arose out of share capital deposited with the bank which might or might not be utilised for the purpose of setting up of the plant. On facts it was held that the amount could not have any connection with the capital expenditure and was held to be assessable as income from other sources.

34. The learned senior counsel for the Revenue also brought to our notice the decision of the Madhya Pradesh High Court in Commissioner of Income Tax Vs. Hindustan Electro Graphites Ltd., where, relating to interest on fixed deposit and late payment of call money prior to setting up of business, showing no nexus or relation with capital expenditure, deduction was refused. The Madhya Pradesh High Court has put the decision of the apex Court (supra) in the forefront, but emphasised in regard thereto that the question before the apex Court was whether the interest paid was before the commencement of production on amounts borrowed by the assessee for the acquisition and installation of the plant and machinery, forming part of the "actual cost" of the asset. We find that the facts before the Madhya Pradesh High Court did not require direct application and even then the proposition is accepted.

35. We have referred, although really unnecessary in view of the law declared by the Supreme Court (supra) especially because the reference comes before us with an observation of the Tribunal that there was a sharp cleavage of judicial opinion on the question. In our judgment the decision of the apex Court is more than sufficient to dissolve this so-called cleavage of judicial opinion. It must be emphasised that although in the order of the ITO, the first appellate authority concerned, there is a reference to Challapalli Sugars Ltd.s case. It has to be stated that neither the first appellate authority nor the Tribunal has taken the trouble to read and appreciate the decision of the apex Court in which case the situation would have been quite contrary and the authorities would not have been found to be clustered in the so-called judicial cleavage. Even in the statement of case the decision of the apex Court is conspicuous by its absence. It is unnecessary, but, as we have emphasised at the outset the weightage of the decision of the apex Court, it is disheartening that the said decision, we are afraid, has not been referred to satisfactorily in the decisions placed for our

consideration, some of which have been referred to by us. Much judicial time could have been avoided had this been done which is essential in constitutional law.

36. For the above reasons the question is answered in the affirmative - against the Revenue and in favour of the assessee.