
(1986) 03 KAR CK 0030

In the Karnataka High Court

Case No : Income Tax R.C. No"s. 38, 39 and 40 of 1982

Commissioner of Income Tax

APPELLANT

Vs

Cap Steel Ltd.

RESPONDENT

Date of Decision : 15-03-1986

Acts Referred:

Income Tax Act, 1961 — Section 256 (1)

Citation : (1986) 57 CTR 134 : (1986) ILR (Kar) 3306 : (1986) 162 ITR 533

Hon'ble Judges : Jagannatha Shetty, Acting C.J.;N.D. Venkatesh, J;Mohammad Sharif, J

Bench : Full Bench

Advocate : K. Srinivasan, for the Appellant; K.R. Prasad, for the Respondent

Judgement

Jagannatha Shetty, Actg. C.J.

1. These references are u/s 256(1) of the Income Tax Act, 1961. The common question referred by the Tribunal for the opinion of this court is as follows : "Whether, on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the net interest income should be capitalised in each year ?" 2. The assessee-company borrowed funds from financial institutions for the purpose of installation of plant and machinery and also for construction of buildings. After spending certain amounts, it deposited the excess money available with it in term deposits and earned some interest income out of those deposits. Before the Income Tax Officer, the assessee contended that the interest income should not be brought to tax and that it should be given set off against the interest payable on that part of the borrowings. The Income Tax Officer did not accept that contention. He held that the gross interest payable should be capitalised along with the other expenses and no deduction of the interest earned was permissible. The assessee preferred an appeal before the Appellate Assistant Commissioner. The Appellate Assistant Commissioner held that the interest earned should be allowed as a deduction in the computation of the total income of the assessee. He, however, held that such net interest should not be

capitalised. 3. The assessee preferred an appeal against the order of the Appellate Assistant Commissioner. It was contended before the Tribunal that the net interest should be capitalised. The Tribunal accepted that contention by following the judgment of the Patna Bench of the Tribunal in the case of Bihar Alloys v. ITO, reported in Taxman, December, 1978, issue at page 339. It has, however, held : "Therefore, following the aforesaid decision of the Patna Bench of the Tribunal, with respect, we hold that the assessee is to be taxed in each year on the net interest and the amount of such net interest is to be capitalised in each year." 4. Before us, there is no dispute and, indeed, there cannot be any dispute as to capitalisation of the interest on the borrowers. The dispute, however, is only "whether it should be net interest or gross interest ?" 5. Shri Srinivasan, for the Revenue, contended that in a case like this, only the gross interest requires to be capitalised and not the net interest. In support of the contention, reliance was placed on the decision of the Supreme Court in Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, and in particular, the following portion (at page 175) : "It would appear from the above that the accepted accountancy rule for determining the cost of fixed assets is to include all expenditure necessary to bring such assets into existence and to put them in working condition. 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 which have been created as a result of such expenditure. The above rule of accountancy should, in our view, be adopted for determining the actual cost of the assets in the absence of any statutory definition or other indication to the contrary." 6. Of course, the Supreme Court in Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, was not concerned as to what should happen to the interest earned out of the borrowed capital. But, the fact, however, is clear that the interest paid on borrowers must be capitalised and added to the cost of the fixed assets which have been created as a result of such borrowings. The Supreme Court has also observed that this principle would be applicable "in the absence of any statutory definition or other indication to the contrary". 7. Mr. Prasad, for the assessee, also justified the view taken by the Tribunal on the ground that such practice of capitalisation of net interest is in accordance with the principles of accountancy. He referred us to the following passage from "Study on Expenditure during Construction Period", issued by the Research Committee of the Institute of Chartered Accountants of India : "... Similarly, interest income earned during the construction period may be set off against interest expenses incurred during this period." 8. This principle recommended by the Institute is no doubt useful to the assessee in the case, but we are afraid that it cannot be taken advantage of by the assessee since it appears to be contrary to the statutory tax-ability of the interest income. Under the Income Tax Act, interest earned or interest income accrued to the assessee, whether out of borrowed money or out of one's own capital, is liable to tax. We, therefore, reject the contention urged for the assessee. 9. Before parting with the case, we

may point out that the question referred contains inaccurate wordings. It refers to the net interest income to be capitalised in each year. The word "income" is inappropriate. It should be only "net interest". The question is, therefore, recast as follows : "Whether, on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the net interest should be capitalised in each year ?" 10. Our answer to this question is in the negative and, to be more specific, we make it clear that what should be capitalised is gross interest and not net interest.