

(1991) 06 AP CK 0026

In the Andhra Pradesh High Court

Case No : Case Referred to 108 of 1983

Commissioner of Income Tax

APPELLANT

Vs

Derco Cooling Coils Ltd.

RESPONDENT

Date of Decision : 28-06-1991

Acts Referred:

Income Tax Act, 1961 — Section 14, 5, 56, 57

Citation : (1992) 104 CTR 55 : (1992) 198 ITR 375

Hon'ble Judges : P. Venkatarama Reddi, J;A. Lakshman Rao, J

Bench : Division Bench

Advocate : S.R. Ashok, for the Appellant; A. Satyanarayana, for the Respondent

Judgement

P. Venkatarama Reddi, J.—This reference u/s 256(1) of the Income Tax Act, 1961, raises the following question of law for our decision :

"Whether, on the facts and in the circumstances of the case, the sum of Rs. 18,913 being interest received by the assessee-company from bank deposits could not be brought to tax for the assessment year 1977-78 and whether the Income Tax Appellate Tribunal was justified in annulling the assessment ?"

The relevant assessment year is 1977-78 for which the previous year ended on September 30, 1976. The respondent-company had not yet gone into production by then. For the purpose of construction and setting up of an industry, the respondent-company borrowed funds and had paid interest thereon to the tune of Rs. 2,40,554. The assessee had also earned interest on share capital monies received from the public which was kept in fixed deposit with the banks. At this stage, it is relevant to point out that no details are forthcoming from the record as to the periods of deposit and the purpose for which the share money was meant to be utilised or actually utilised. The respondent, in its return, originally accepted the interest receipt of Rs. 18,913 as its income. Later on, the respondent claimed that the said amount shall not be treated as income as it is liable to be deducted from the interest paid on term loans and the net interest

arrived at, i.e., Rs. 2,21,641, is to be capitalised. In other words, the contention of the assessee was that the interest received during the pre-production or construction period shall be reflected in the capital cost of the project and it should go to reducing the capital cost. This contention was not accepted by the Income Tax Officer who held that the interest received is not a capital receipt and that it is liable for taxation under the head "Income from other sources". The Commissioner (Appeals) affirmed the order of the Income Tax Officer. On further appeal to the Appellate Tribunal, the Tribunal accepted the contention of the assessee and annulled the assessment. In recording its conclusion, the Tribunal relied on two Special Bench decisions. The first decision was rendered by the Special Bench of the Income tax Appellate Tribunal at Hyderabad in the case of *Nagarjuna Steels Ltd. v. ITO* [1983] 3 ITD 796. The view taken by the Special Bench was endorsed by this court in the case of *Commissioner of Income Tax Vs. Nagarjuna Steels Ltd.*, . It must be noted that the said decision relates to receipt of interest on the deposit of borrowed funds. The Special Bench held that there was a direct nexus between the borrowed funds and the deposited funds and hence the receipt by way of interest can be set off against the interest paid to the bank and the balance amount could be capitalised. As already mentioned, this court affirmed the view taken by the Tribunal. The other decision followed by the Tribunal is that of the Special Bench at Madras in *Arasan Aluminium Industries (P.) Ltd. v. First ITO* [1982] 1 ITD 10, which is on all fours with the present case inasmuch as the eligibility to tax of the interest received from out of the paid up capital amount came up for consideration before the Special Bench. The Special Bench held that there was no distinction in principle between the interest received out of borrowed funds and the interest received out of share money. According to the Special Bench, the source of deposit - whether out of paid up capital or borrowed capital - is a distinction without difference. The Special Bench, therefore, followed the earlier Special Bench decision in the (1983) 3 ITD 796 . However, it is to be noted that the decision of the Special Bench in (1982) 1 ITD 10 must be deemed to have been disapproved by the Madras High Court (vide *Commissioner of Income Tax Vs. Seshasayee Paper and Boards Ltd.*, , in which the reference was answered in favour of the Revenue. The Division Bench held that the interest earned by investing the amount on short term deposits has nothing to do with the actual borrowing and, therefore, the payment of interest has no connection with the receipt of interest on those amounts. In that case, the Madras High Court was also concerned with the question whether the interest received on investment of paid-up share capital could be adjusted against the interest payable on the loans.

2. In both the Special Bench decisions of the Tribunal, it may be noticed that emphasis has been placed on the views of the Research Committee of the Institute of Chartered Accountants of India in its booklet "Study on Expenditure during Construction Period" to which reference will be made later. The fact that the opinion of the Research Committee of the Institute of Chartered Accountants on the allied subject was cited with approval by the Supreme Court in *Challapalli*

Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, was taken into account by the Special Bench. Reliance has been placed before us by both sides on the passages in the same booklet referred to by the Tribunal.

3. Let us now notice the rival submissions in brief. It is the contention of learned standing counsel for the Income Tax Department, Mr. S. R. Ashok, that the accountancy principle enunciated by the Research Committee of the Institute of Chartered Accountants does not either help the assessee or it should not have a bearing on the true nature of the receipt - whether it is income or not. He contends that the interest received from paid up share capital is nothing but income unless there is a direct nexus between the receipt and expenditure which is sought to be capitalised. Mr. Ashok, while distinguishing the decision of the Supreme Court in *Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad*, and of this court in *Commissioner of Income Tax Vs. Nagarjuna Steels Ltd.*, , has, inter alia, relied upon an unreported decision of this court in R.C. No. 229 of 1982, dated November 19, 1986 (since reported in *Andhra Pradesh Carbides Ltd. Vs. Commissioner of Income Tax*, (Appendix) (infra)). Learned standing counsel argues that the set-off claimed by the assessee is not permissible in law. On the other hand, learned counsel for the assessee, Mr. A. Satyanarayana, submits that the accountancy principle stated by the Research Committee of the Institute of Chartered Accountants of India has to be given due weight as held by the Supreme Court in *Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad*, , and that, according to the said principle, the receipt cannot be treated as income at all but it has the effect of abating the construction cost of the project. According to learned counsel, the deposit of share capital money was not by way of any investment but it was only a method of keeping the surplus money in deposit till such time as the company itself may require the same. He contends that the ratio of the judgement in *Commissioner of Income Tax Vs. Nagarjuna Steels Ltd.*, , squarely applies to this case as well and it does not make any difference as to whether the surplus funds represent the company's own funds or borrowed funds. Learned counsel finally submits that, having regard to the opinion expressed by the Research Committee of the Institute of Chartered Accountants, the interest receipt cannot be treated as "income from other sources" irrespective of the fact as to whether it is a revenue or a capital receipt. It must be mentioned that learned counsel has not rested his case on section 57(iii) and rightly so.

4. As already noticed, the sheet anchor of the assessee's contention and the substratum of the Tribunal's conclusion are based upon the accountancy principle enunciated in the booklet "Study on Expenditure during Construction Period" published by the Institute of Chartered Accountants of India. In the 1982, Reprint Edition of this booklet, at paragraph 8, it is stated as follows (see *Commissioner of Income Tax Vs. Nagarjuna Steels Ltd.*, :

"8. Income during the construction or pre-production period :

8.1. It is possible that a new project may earn some income from miscellaneous

sources during its construction or pre-production period. Such income may be earned by way of share transfer fees or by way of interest from the temporary investments of surplus funds prior to their utilisation for capital or other expenditure.

8.2. Where a particular item of miscellaneous income can be directly related to a particular item of expenditure, it is suggested that it should be set off against the expenditure, and the net amount of the expenditure should be treated in the appropriate manner, depending upon its nature, in accordance with the various principles suggested above. For example, income from share transfer fees may be set off against the various corporate expenses incurred during the construction or pre-production period and income, if any, from lending transport vehicles to outsiders may be set off against the expenditure incurred in operating and maintaining those vehicles. Similarly, interest income earned during the construction period may be set off against interest expenses incurred during this period..."

With regard to interest charges incurred during the period of construction, it is stated as follows :

"There is no doubt that interest charges and commitment fees incurred after the date of commencement of commercial production should be treated as revenue expenditure in the normal way. However, during the period of construction, both these charges would represent indirect construction expenditure and should be added to the total capital cost of the project. (....) These remarks would apply with particular force in the case of loans which have been taken for the purchase of capital assets or for incurring capital expenditure.... This view has not been accepted by the Supreme Court of India in the case of Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, . With regard to interest charges and commitment fees on loans taken specifically and exclusively for the purpose of providing working capital, the treatment suggested above may not be proper and, in this case, it will be more appropriate to transfer the interest charges and commitment fees during the period of construction to a separate account which is carried forward in the balance sheet under the group heading of "Miscellaneous expenditure" until it is subsequently written off to profit and loss account after the commencement of commercial production, over a period not exceeding 3 to 5 years."

In Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, , the Supreme Court, after extracting the passages from the Statement on Auditing Practices issued by the Institute of Chartered Accountants of India (1974), observed 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."

Thus, it is settled law that interest incurred during the period of construction of plant should be treated as an addition to the cost of the project unless of course the loan is borrowed for working capital purposes. Such interest goes into the capitalisation account. The decision of this court in Commissioner of Income Tax Vs. Nagarjuna Steels Ltd., had gone a step further. In that case, the question was whether the bank interest received during the stage of construction of the factory on account of depositing a part of the borrowed money in the bank should be treated as "income from other sources" or whether it should go towards reducing the actual capital cost of the assets. This court put its seal of approval on the accountancy principle stated in paragraphs 8.1 and 8.2 of the booklet "Study on Expenditure during Construction Period". This court observed at page 667 that :

"On the facts found in this case, we are of the opinion that the reasoning adopted by the Tribunal is the correct one and is a realistic assessment of the situation. The company was incorporated for setting up a plant and to manufacture certain products and to deal in them. During the relevant accounting year, it was in the course of setting up the plant. For that purpose, it had borrowed certain amounts upon which it was paying interest. All the amount borrowed was not needed at once. A portion of the said amount was kept in deposit, until needed. Those deposits earned some interest. Would it be realistic to say that is income from other sources or would it be more appropriate to adopt the approach indicated by the Institute of Chartered Accountants of India and their "A Study on Expenditure during Construction Period", relied upon by the Tribunal ? ...

In our opinion, the course indicated by the Institute of Chartered Accountants of India is the proper one to be adopted in such circumstances..."

Consequently, the view taken by the Tribunal was endorsed by this court. It is relevant to mention that the Tribunal took notice of the fact that there was a direct nexus between the borrowed funds and the deposited funds inasmuch as the deposited funds came out of the borrowed amounts. The Tribunal also observed that, in the circumstances, the interest paid by the assessee on the loans and the interest earned by the assessee on those loans should constitute one single account and, therefore, the interest received - Rs. 15,092 - should be set off against the interest payment of Rs. 7,94,389 and the balance should be considered for capitalisation purpose. In that view of the matter, the interest received on account of deposit of borrowed funds was held to be not an "income from other sources". The question is whether the same principle can be extended

to a case like the present one where the interest is earned on an amount unrelated to the amount for which interest was paid. In other words, the question is whether the amount received by way of interest on share capital amount could be set off against the interest payment made by the assessee during the same accounting year in respect of a different source of money, viz., borrowed loan amount. As already noticed, the view of the Tribunal as well as the contention of the assessee is that the source of money which has given rise to interest liability and interest receipt is really irrelevant. However, we do not find any warrant in law in extending the principle of the decision of this court in Commissioner of Income Tax Vs. Nagarjuna Steels Ltd., to a case of interest earned from a different source, viz., share money. Neither the accountancy principle laid down by the Institute of Chartered Accountants of India nor the reasoning contained in the decision of the Supreme Court in Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, and of this court in Commissioner of Income Tax Vs. Nagarjuna Steels Ltd., would merit the acceptance of the assessee's contention in this behalf.

5. No doubt, it is stated in the last sentence in paragraph 8.2 of the booklet referred to above that "Similarly, interest income earned during the construction period may be off-set against interest expenses incurred during this period." This sentence may be suggestive of the meaning that whatever interest is received from any source can be set off against the interest expenses incurred on whatsoever account. However, in our view, the last sentence in paragraph 8.2 shall not be read in isolation but in the context of and in conjunction with the preceding sentences. If so read, it is doubtful whether the Research Committee of the Chartered Accountants of India meant to lay down a broad proposition that every receipt of interest during the pre-production period should be linked with interest payment so as to be reflected in the actual capital cost of the assets. The above passage at paragraph 8.2 can be better understood by referring to the "Summary of Conclusions" recorded at paragraph 17.11 of the same booklet which reads as follows :

"17.11. During the construction period, a project may earn income from miscellaneous sources - for example, share transfer fees, interest income, income from hire of equipment or assets, and income from sale of products manufactured during the period of test runs and experimental production. It is recommended that such income should be set off against the related items of expenditure so that only the net amount of the expenditure is capitalised or treated as deferred revenue expenditure, as the case may be. In either case, consideration may have to be given to the question of providing for the income tax liability on such income (paragraph 8.4)."

Prima facie, the term "related items of expenditure" is suggestive of a nexus between the two transactions giving rise to receipt and expenditure but not a broad nexus based upon capital or revenue character of the receipt and expenditure. At any rate, in view of the apparent ambiguity, it is not possible to

lay undue emphasis on the passages quoted above which, as already stated, furnished the main basis for the argument of the assessee's counsel.

6. Section 56 of the Income Tax Act, 1961, enjoins that income of every kind which is not to be excluded from the total income under this Act shall be chargeable to income tax under the head "Income from other sources", if it is not chargeable to income tax under any of the heads specified in section 14, items A to E. We will assume that an item of receipt that could be set off against or deducted from an item of expenditure which ought to be capitalised for accounting purposes shall not be treated as income in the ordinary sense of the term. Even then, to fall within the ambit of this principle, the receipt in question must be capable of being legitimately set off against a particular expenditure. The very idea of set-off connotes that there is a nexus or correlation between the item of receipt and the item of expenditure. In our view, it is not permissible to set off an item of receipt from out of an item of expenditure unrelated to the former or incurred in a different connection. That is why the nexus theory has been applied in several cases for the purpose of determining the character of receipt during pre-production period. In the very decision of this court in *Commissioner of Income Tax Vs. Nagarjuna Steels Ltd.*, , this court did apply the principle of nexus for reaching the conclusion it did, though it has not been stated in so many terms in the judgment. While distinguishing the decisions in *Commissioner of Income Tax, Bombay City-II Vs. United Wire Ropes Ltd.*, and *ADDITIONAL COMMISSIONER OF Income Tax, MADRAS-I Vs. MADRAS FERTILISERS LTD.*, , this court adverted to the finding recorded in those cases to the effect that there was no connection or nexus between the two transactions of payment of interest and receipt of interest and held that it remained as a distinguishing factor. We are of the view that the theory of transposing an item of receipt - which is prima facie income - into capitalisation account by resorting to an omnibus set off, cannot be countenanced. As already observed, the set-off must be in respect of a related item of expenditure.

7. In the instant case, the amount of expenditure out of which the interest amount is sought to be deducted relates to term loans used for construction and setting up of the plant. The receipt in question arises out of share capital money deposited with the bank which may or may not be utilised or meant to be utilised for the purpose of setting up of the plant. This again emphasises that the interest received may not stand on the same footing as the interest incurred during the pre-production period so that one could be set off against the other.

8. We may also add that although section 57(iii) as such has not application to the instant case, if we apply the principle underlying the said clause, the result will be the same. Section 57(iii) envisages that deduction of expenditure (not being capital expenditure) could be claimed only if it is expended wholly and exclusively for the purpose of making or earning the income from other sources. In considering a similar question from the standpoint of section 57(iii), a Division Bench of this court, in R.C. No. 229 of 1982, dated November 19, 1986 Andhra

Pradesh Carbides Ltd. Vs. Commissioner of Income Tax, (infra)), rejected the assessee's plea that the interest earned on share capital could be set off against the interest paid on loans.

9. Jeevan Reddy J. (who also spoke for the Bench in Commissioner of Income Tax Vs. Nagarjuna Steels Ltd., , observed :

"We are inclined to agree with the view taken by the Tribunal. We are unable to see any connection between the two amounts. The amount upon which interest was paid to A.P. Industrial Development Corporation Limited was raised by way of loan for setting up the plant and the interest income was earned on the contributions made by the shareholders towards the shares allotted to them. Both are distinct items and it is not possible to see any reasonable connection between them. Neither by section 57(iii) of the Income Tax Act, 1961, nor by applying the test of prudent person managing his affairs, can it be said that the interest earned on the contributions made by the shareholders can be set off against the interest by the assessee."

Viewed from any angle, we do not think that there is any justification to treat the amount of interest received on share capital as something other than income. To treat the receipt in question as income will not in any way do violence to the normal or ordinary meaning of the term "income". We are, therefore, of the view that the amount of Rs. 18,913 has been rightly treated by the Income Tax Officer as income from other sources u/s 56 of the Act and the Tribunal erred in law in annulling the assessment. We are fortified in the view which we have taken by the decision of the Madras High Court in Commissioner of Income Tax Vs. Seshasayee Paper and Boards Ltd., and of this court in R.C. No. 229 of 1982 Andhra Pradesh Carbides Ltd. Vs. Commissioner of Income Tax, , though there is a certain amount of overlapping in the discussion in regard to the allowability of deduction u/s 57(iii) and the treatment of the receipt for the purpose of capitalisation. Reference may also be made to the judgment of the Patna High Court in Bokaro Steel Ltd. Vs. Commissioner of Income Tax (No. 2), , and the judgment of the Kerala High Court in Traco Cable Company Ltd. Vs. Commissioner of Income Tax, , wherein the interest income received on share capital money during construction period was held to be eligible to tax though the issue was considered from a different standpoint.

10. For the aforesaid reasons, we hold that the sum of Rs. 18,913 being interest received by the assessee-company from bank deposits could be brought to tax for the assessment year 1977-78 and the Income Tax Appellate Tribunal is not justified in annulling the assessment. We answer the question accordingly in favour of the Revenue and against the assessee. No costs.