

Commissioner of Income Tax Vs Maharashtra Electros melt Ltd.

Court: Bombay High Court

Date of Decision: Dec. 1, 1994

Acts Referred: Income Tax Act, 1961 " Section 14, 15, 16, 17, 18

Citation: (1995) 124 CTR 117 : (1995) 214 ITR 489

Hon'ble Judges: S.M. Jhunjhunwala, J; B.P. Saraf, J

Bench: Division Bench

Judgement

S.M. Jhunjhunwala, J.

By this reference made u/s 256(1) of the Income Tax Act, 1961, the following question has been referred to this

court for opinion at the instance of the revenue :

Whether, on the facts and in the circumstances of the case, the interest income of Rs. 3,14,366 and miscellaneous income of Rs. 2,742 are not

taxable u/s 56 of the Income Tax Act, 1961, under the head "Income from other sources" for the assessment year 1977-78 ?

2. The assessee is a limited company incorporated for doing business as a manufacturer of ferro-manganese. The assessment year involved in this

reference is 1977-78, the previous year of which was the year ended on 30 June, 1979. During the assessment year under consideration, the

assessee was engaged in the erection of a smelter for the purpose of manufacturing ferro-manganese. The commercial production had not started.

The total expenses incurred during the year amount to Rs. 83,32,473. The assessee had realised a sum of Rs. 3,14,366 as interest on short term

deposits of the funds not immediately required by the assessee. At the same time, the assessee had paid a sum of Rs. 58,51,595 as interest on

funds borrowed by it for the purpose of its business. Out of the total expense of Rs. 83,32,473 incurred during the year, the assessee treated a

sum of Rs. 1,04,190, as an item which could not be capitalised. Out of the balance amount of Rs. 82,28,293, the assessee deducted the two items

of income, viz., interest and miscellaneous income, amounting in all to Rs. 3,17,108 and capitalised the balance of Rs. 79,11,172. Hence, the

assessee adjusted the income earned by it during the period of construction against its other expenses and took the net amount as the expense of

construction.

3. The Income Tax Officer held that the said two items of income amounting to Rs. 3,17,108 were assessable as the income of the assessee under

the head "Income from other sources." The Income Tax Officer, accordingly, made the assessment and raised a demand on the assessee. The

assessee appealed to the Commissioner of Income Tax (Appeals). The Commissioner of Income Tax (Appeals) agreed with the contention of the

assessee and held that the said two items of income referred to above, arose in the course of the business carried by the assessee and not out of

any separate source of income. The Commissioner of Income Tax (Appeals) directed the Income Tax Officer not to assess the said two items of

income amounting to Rs. 3,17,108 as "income from other sources" but accepted the adjustment as made by the assessee in its accounts. In the

departmental appeal filed before the Income Tax Appellate Tribunal, the department contend that the Commissioner of Income Tax (Appeals)

erred in his decision. The Tribunal noticed that the treatment given by the assessee to the said two items of income was in accordance with the

principles laid down by the Institute of Chartered Accountants of India, which is a recognised authority on accounting principles, and upheld the

decision of the Commissioner of Income Tax (Appeals). The appeal filed by the department was dismissed. In these circumstances, the above

question has been referred to this court at the instance of the Revenue.

4. The total income of an assessee (subject to statutory exemption) is chargeable u/s 4(1) of the Income Tax Act, 1961 (for short, "the Act").

Section 14 of the Act enumerates the six heads under which the income of an assessee falls to be charged. It reads as under :

14. Save as otherwise provided by this Act, all income shall, for the purposes of charge of Income Tax and computation of total income, be

classified under the following heads of income :

A. Salaries.

B. Interest on securities

C. Income from house property.

D. Profits and gains of business or profession.

E. Capital gains.

F. Income from other sources.

5. In order to be chargeable, an income has to be brought under one of the aforesaid six heads. "Total income" has been defined in section 2(45) of

the Act to mean " the total amount of income referred to in section 5, computed in the manner laid down in this Act." Section 15 to 59 of the Act

lay down the rules for computing income for the purpose of chargeability to tax under the aforesaid six heads. The classification made by section

14 under the distinct heads of income is attributable to the source of income from which the respective income is derived. Therefore, the income

derived from a distinct source falling under the specific head has to be computed for the purposes of taxation in the manner provided by the

appropriate sections. Section 56 contains provisions about the residuary head, viz., "Income from other sources", and it does not come into

operation until the preceding five heads mentioned above and contained in section 14 are excluded. As per section 56, income of every kind which

is not to be excluded from the total income under the 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 items "A" to "E" mentioned in section 14 of the Act. However, section 56 does

not apply to income which is not includible in the total income of the assessee at all or to a receipt which cannot be considered as income of the

assessee.

6. The assessee, in the assessment year under consideration, had credited a sum of Rs. 3,14,366 as interest on call deposits with banks and a sum

of Rs. 2,742 as "miscellaneous income". It appears that during the year, the assessee had borrowed huge amount for the purpose of its business

on which heavy interest aggregating to Rs. 50,61,594 was paid. In order to reduce this burden on account of heavy interest payments, the amounts

of loans not immediately required by the assessee were kept in call deposits with the banks. In the facts of the case, it appears that the whole

arrangement of obtaining the finance and its temporary utilisation formed one composite transaction and, as such, the interest received by the

assessee on account of temporary utilisation of the loans cannot be considered in isolation but has to be viewed in the context of the heavy interest

which the assessee had to pay. The net result of the amount received by the assessee on account of temporary utilisation of the loans by keeping

the same in call deposits with the banks was to reduce the liability of the assessee on amounts borrowed for the purposes of business of the

assessee. After setting off or adjusting the sum of Rs. 3,14,366 received by the assessee by way of interest on account of temporary utilisation of

the loans by keeping the same in call deposits with the banks against the amount of interest which the assessee had to pay on the amounts

borrowed during the assessment year under consideration, it became evident that the assessee did not derive any income by temporary utilisation

of the loans as aforesaid and since no income was derived by the assessee, the question of assessing the sum of Rs. 3,14,366 in the hands of the

assessee as " Income from other sources" did not arise.

7. The Institute of Chartered Accountants of India is a recognised authority on accounting principles. This fact has been recognised by the

Supreme Court in the case of Challapalli Sugar Ltd. Vs. The Commissioner of Income Tax, A.P., Hyderabad, . The following extract from "A

Study on Expenditure during Construction Period" published by the Institute of Chartered Accountants of India supports the case of the assessee :

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 investment of surplus funds 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 is 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 these vehicles. Similarly, interest income earned during the construction period may be

offset against interest expenses incurred during this period.

8. Mr. Jetley, learned counsel appearing for the revenue, in support of his submission that the said amounts of Rs. 3,14,366 and Rs. 2, 742

aggregating to Rs. 3,17,108 ought to be considered as income derived by the assessee from " other sources" has placed reliance on the judgments

of the various High Court including the judgment of the Andhra Pradesh High Court in the case of Commissioner of Income Tax Vs. Derco

Cooling Coils Ltd., . In that case, the Andhra Pradesh High Court has held that the very idea of set off connotes that there is a nexus or correlation

between the item of receipt and the expenditure. It is further held that 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. In that case, in the previous year relevant to the assessment year 1977-

78, the assessee-company had not yet gone into production. For the purpose of setting up the industry, the assessee had borrowed funds and paid

interest of Rs. 2,40,554. The assessee had also earned interest of Rs. 18,913 on share capital monies received from the public which were kept in

fixed deposits with banks. The assessee claimed that the interest income of Rs. 18,913 should be deducted from the interest of Rs. 2,40,554 paid

on term loans. The Income Tax Officer held that the receipt of Rs. 18,913 was taxable as "Income from other sources. The Tribunal accepted the

claim of the assessee. On a reference, the Andhra Pradesh High Courts held :

..... that the amount of expenditure out of which the interest received was sought to be deducted related to term loans used for construction and

setting up of the plant. The receipt in question 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. Section 57(iii) was also not applicable because the provision 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. The amount of Rs. 18,913 was assessable as income from other sources.

9. In the case of Commissioner of Income Tax Vs. Derco Cooling Coils Ltd., , the Andhra Pradesh High Court has referred to its earlier judgment

in the case of Commissioner of Income Tax Vs. Nagarjuna Steels Ltd., and though it accepted the ratio of Commissioner of Income Tax Vs.

Nagarjuna Steels Ltd., as correct, it distinguished it from the facts in the case of Commissioner of Income Tax Vs. Derco Cooling Coils Ltd., . The

facts in the case of Commissioner of Income Tax Vs. Nagarjuna Steels Ltd., have been similar to the facts in the present case. In the case of

Commissioner of Income Tax Vs. Nagarjuna Steels Ltd., , the assessee, after having been incorporated, was engaged in setting up the plant.

During the accounting year relevant to the assessment year concerned herein, it was still at the stage of construction. It had borrowed certain funds

for setting up the plant. A part of the funds which were not immediately required was kept in deposit upon which some interest was earned. On the

amounts borrowed by it, it was paying interest at a much larger figure. It, therefore, sought to deduct the interest earned by it from out of the

interest paid by it and capitalised the balance interest paid. The Income Tax officer, however, did not agree with this method. He treated the

interest earned in a sum of Rs. 15,092 as "Income from other sources" and held that no amount is deductible therefrom as none was expended

wholly and exclusively for earning the said interest amount. In short, he treated the said amount as income of the said year, refusing to allow it to be

deducted from the interest paid by the assessee during the relevant assessment year. On appeal, the Commissioner (Appeal) affirmed the order of

the Income Tax Officer. On further appeal, however, the Tribunal took a different view. Relying upon the notes prepared by the Institute of

Chartered Accountants of India on "A study on expenditure during construction period", the Tribunal held that the proper method to be adopted in

such cases is not to treat the said interest amount of Rs. 15,092 as income from other sources, but to treat the same, as also the interest paid by

the assessee on the loans obtained by it, as one single account. The court, on a reference, held that where the object of the assessee was to do

business and in the course of setting up a plant, since all the borrowed money was not needed at once; it keeps surplus funds in short term

deposits, the interest earned on such short term deposits should be set off against the interest paid by the assessee on the loans obtained by it and

the balance of the interest amount should be capitalised. It is further held that the interest received on such short term deposits is not assessable as

a revenue receipt.

10. In the case of Commissioner of Income Tax Vs. Derco Cooling Coils Ltd., , the Andhra Pradesh High Court took a different view, since the

amount received by way of interest was received on share capital amount which could not 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. In that case, the interest was

earned on an amount unrelated to the amount for which the interest was paid by the assessee.

11. In the instant case, during the assessment year under consideration, the assessee was engaged in the erection of a smelter for the purpose of

manufacturing ferro-manganese. The commercial production had not yet started. The total expenditure incurred by the assessee during the year

amounted to Rs. 83,32,473. Out of which, the assessee capitalised the balance amount of Rs. 79,11,173 as aforesaid. The interest paid on large

borrowings by the assessment year under consideration were inter-connected and had nexus forming part of one composite transaction. In this

view of the matter, since the facts in the various judgments relied upon by Mr. Jetley, including in the case of Commissioner of Income Tax Vs.

Derco Cooling Coils Ltd., being different, the same have no applicability to the facts in the present case. In the case of Godavari Sugar Mills Ltd

Vs. Commissioner of Income Tax, on which also reliance has been placed by Mr. Jetley, the Tribunal had held interest to be "Income from other

sources" on the grounds : (i) that the interest paid by the assessee on borrowings was allowed as a business expenditure and, therefore, those

borrowings must have been used by the assessee for the purpose of its business; (ii) it inferred from the said fact that the monies available for

advancing loans, thus had or could have their sources in the assessee's own reserves and surpluses from the profits; and (iii) that the advances

were mostly to the assessee's subsidiary companies and its allied concerns. On the facts of the case, this court held that the assessee had not

placed any material before the departmental authorities or the Tribunal to show that the monies on which the interest in dispute was earned were

advanced in the course of the assessee's business and that the Tribunal was justified in its conclusion and the income by way of interest received

on loans and advances was taxable as "Income from other sources ". The said decision has also no applicability to the facts of the present case.

The ratio of the judgment in the case of Commissioner of Income Tax Vs. Nagarjuna Steels Ltd., squarely applies to the facts in the present case.

12. The receipt of Rs. 2,742 by the assessee during the year by way of sale of empty gunny bags could not be considered as a profit on sale

thereof. Since it was not a revenue receipt, the said amount could not have been considered as income derived by the assessee from other sources.

13. In the result, we answer the question in the affirmative, that is, in favour of the assessee and against the Revenue.

14. In the facts of the case, there shall be no order as to costs.