(1994) 04 BOM CK 0049

Bombay High Court

Case No: Income-tax Reference No. 185 of 1982 with Notice of Motion No. 909 of 1982

Commissioner of Income Tax, Bombay City Iii, Bombay		APPELLANT
	Vs	
Citibank N.A.		RESPONDENT

Date of Decision: April 12, 1994

Acts Referred:

- Income Tax Act, 1961 - Section 145, 145(1), 147, 28

Citation: (1994) 208 ITR 930

Hon'ble Judges: Sujata V. Manohar, C.J; B.P. Saraf, J

Bench: Division Bench

Advocate: Dr. V. Balasubramaniam, for the Appellant; Soli Dastur, for the Respondent

Judgement

DR. B.P. Staff, J.
By this reference, the Income Tax Appellate Tribunal has referred the following two questions two questions of law to this court at the instance of the Revenue for opinion u/s 256(1) of the Income Tax Act, 1961 ("the Act", for short) :

"(1) Whether, on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the instructions of the Central Board of Direct Taxes contained in circulars in force in the relevant previous year as well as in the assessment year were applicable so that the interest recorded in the memorandum account should not have been included in the assessable profits, even though the instructions were withdrawn on June 20, 1978?

(2) Whether, on the facts and in the circumstances of the cases and having regard to the fact that the assessee''s method of accounting for its banking business was mercantile, the Tribunal was right in law in holding that the interest recorded in the memorandum account in the relevant previous year was not liable to inclusion in the assessee''s total income having regard to the provisions of sections 28 and 145 of the Act?"

2. The facts of the case giving rise to this reference, briefly stated are as follows :

(a) The assessee is a banking company (hereinafter referred to as "the assessee-bank"). The relevant assessment years are 1973-74, 1974-75 and 1975-76. The assessee-bank followed a policy of classifying the loans into "ordinary loans" and "problem loans". "Problem loans" were those which were problematic from the point of view of recoverability. In order to ensure effective credit control, the assessee used to scrutinise the loan portfolio at regular intervals and classify the loans into different categories. All loan accounts in respect of which interest payments were not forthcoming for a period of 180 days or more and in respect of which the principal amounts were in jeopardy were placed on a non-accrual basis in books of account of the assessee and in the interest thereon was not debited in the books to such accounts or credited to the profit and loss account. The assessee, however, maintained a memorandum record of interest due on such accounts. If any interest recorded in the memorandum record was subsequently received by the assessee, it was taken into account as interest received. This procedure was consistently followed by the assessee-bank. Following the same in the assessment year 1973-74, the assessee-bank did not credit eight parties to whom loans had been advanced with interest due on such loans. Such interest amounted to Rs. 4,75,450. The particulars of these parties and the interest that would be due from them was recorded only in the memorandum record. No entries were made in the books of account in respect thereof. The above amount of interest was neither debited to the accounts of the concerned parties nor credited to the profit and loss account. It was claimed by the assessee that it was following a sort of hybrid system of accounting inasmuch as interest in respect of the doubtful loans was not taken into account for any purpose. It was taken into account only on realisation thereof and shown as a profit of that year. It may be pointed out that this practice was followed by the assessee-bank not for the first time in the year under consideration but was consistently followed and accepted by the Revenue throughout in the past. However, in the assessment for the assessment year 1973-74, the Income Tax Officer did not accept the contention of the assessee-bank. It was observed by him that the assessee-bank had not written off the principal amount and interest and that it was still claiming interest from the parties to whom loans were advanced. The Income Tax Officer also observed that the circular of the year 1952 and the subsequent circular of the year 1973 issued by the Board having been withdrawn by the Board, the amount of interest recorded in the memorandum record was liable to be included in the income of the assessee as its accrued income.

The facts are identical in so far as the other two assessment years 1974-75 and 1975-76 except that the amount involved in the year 1974-75 was Rs. 10,14,755 and in the year 1975-76 was Rs. 15,55,481.

It may also be pertinent to mention that in the assessment years 1973-74 and 1974-75, the Income Tax Officer himself has accepted the claim of the

assessee-bank in the original assessment made by him. The above amounts were added to its income for the two assessment years by reopening the assessments u/s 147(b) of the Act whereas for the assessment year 1975-76, the addition was made in the original assessment itself.

(b) The assessee appealed against the orders of reassessment for the first two years and the order of assessment for the third year before the Commissioner of Income Tax (Appeals). The Commissioner affirmed the reopening of the assessment for the first two assessment years. However, on the merits, for all the three years the Commissioner decided in favour of the assessee on the ground, inter alia, that the assessee had been following the system of accounting regularly and consistently.

(c) The Revenue appealed to the Tribunal. The Tribunal upheld the order of the Commissioner (Appeals) and dismissed the appeals of the Revenue. It was observed by the Tribunal that it was not a case where the assessee had changed its method of accounting and was trying to show that the same were bona fide and should be accepted. On the contrary, it was where the assessee has all along been following a particular system of accounting regularly and systematically and the same had been accepted by the Revenue as a proper system of accounting throughout in the past. The Tribunal also observed that the Department could not successfully contend before it that the manner of keeping the accounts by the assessee was such that the points and gains could not be properly deduced therefrom. The Tribunal, thereafter, held that in the above situation one cannot say that the proviso to section 145(1) of the Act can be pressed into service by the Department. In this regard, the Tribunal also referred to the Board''s circulars, which will be referred to a little later. The Tribunal, therefore, affirmed the order of the Commissioner (Appeals) and held that the Income Tax Officer was not justified in including the amount of interest of certain loans recorded by the assessee-bank in the memorandum record. Hence this reference at the instance of the Revenue.

3. The assessee-bank had taken out a notice of motion in this reference. According to the assessee-bank, in view of the circulars of the Board, it was not open to the Revenue to treat the amount of interest as the income of the assessee. The assessee, therefore, contends that question No. 2 referred to us should be considered only if question No. 1 is answered in favour of the Revenue. The second contention of the assessee is that the second question, as formulated by the Tribunal, proceeds on an erroneous assumption that the method of accounting followed by the assessee for its banking business was mercantile which, according to it, is contrary to the findings of fact arrived at by the Tribunal itself. According to the assessee, the system of accounting followed by it was a mixture of the mercantile as well as the cash system which is normally known as the "hybrid system" of accounting. The assessee, therefore, wants, question No. 2 to be reframed accordingly.

4. We have considered the submission of the assessee in the notice of motion. We feel that the controversy should be gone into on the merits first and if on the merits, it is found that the system of accounting followed by the assessee was wholly mercantile, then only reference to the circulars of the Board may be necessary. In that view of the matter, we are of the opinion that we should first take up question No. 2 for consideration and only thereafter, if necessary, decide question No. 1. We, therefore, renumber question No. 2 as question No. 1 and reframed it as under :

"(1) Whether, on the facts and in the circumstances of the case and having regard to the system of accounting followed by the assessee-bank in its banking business, the Tribunal was right in law in holding that the interest recorded in the memorandum record in the relevant previous year was not liable to inclusion in the assessee''s total income having regard to the provisions of sections 28 and 145 of the Income Tax Act, 1961?"

5. Question No. 1 referred by the Tribunal is renumbered as question No. 2 and it shall be answered only if our answer to question No. 1 is the negative and in favour of the Revenue.

6. We now turn to the merits of question No. 1 set out above. We have perused the facts of the case and carefully gone through the order of the Tribunal and also the findings recorded by it. On perusal of the same, we find that the Tribunal has arrived at the following findings of fact :

(1) That in order to ensure effective credit control, the assessee bank had been following a policy of classifying certain loans as problem loans from the point of view of recoverability;

(2) That for this purpose, the assessee-bank used to scrutinise the loan portfolio at regular intervals and classify loans in different categories. Loans in respect if which interest payments were not forthcoming for a period of 180 days or more and in respect of which the principal amounts were in jeopardy were placed on non-accrual basis in its books of account. No interest was debited in the books of account of the assessee to the accounts of such parties or credited to the profit and loss account, but a memorandum record of the interest due on such amounts was maintained. If any interest recorded in the memorandum record was subsequently received by the assessee, it was duly accounted for in the year of receipt :

(3) That the assessee had been following the above system of accounting in respect of the above category of loans regularly and systematically throughout in the past which was also accepted by the Revenue;

(4) That it is not a case where the assessee changed its method of accounting in the assessment years under consideration and was trying to show that the change was bona fide and should be accepted :

(5) That it was not a case where the proviso to section 145(1) of the Act can be pressed into service on behalf of the Department because it was not in the case that the above method of accounting employed by the assessee was such that the income of the assessee could not properly be deduced therefrom. On the other hand, it has been accepted as a proper method throughout, including for two of the assessment years under consideration where the contention of the assessee was duly accepted in the original assessment but was rejected later and the amounts added to the income subsequently by reopening the assessment in exercise of power u/s 147(b) of the Income Tax Act, 1961.

It is clear from the above findings of the Tribunal that though the assessee has been following generally for most of the transactions the mercantile system of accounting, it was following a different system of accounting for a certain category of loans, the recovery whereof was doubtful. There is also a clear finding of the Tribunal that the method of accounting followed by the assessee in respect of the loans in questions was not the mercantile system of accounting. The question that arises for consideration is whether the assessee can follow such a system of accounting or, to put it differently, whether it is incumbent upon the assessee to follow either of the known systems of accounting i.e., the cash system or the mercantile system of accounting.

Though the cash system and mercantile system of accounting are the two most common systems of accounting prevalent in the country, there can be no dispute about the fact that there are also innumerable other systems of accounting besides these two systems. Such systems are commonly known as "hybrid systems of accounting". In such a system, there is certain element of both cash and mercantile systems. An assessee following such a system may employ one method of accounting for one class of business or one class of customers or transactions and a different method of another class. If an assessee follows such a hybrid system and in respect of certain loan transactions does not follow the mercantile system of accounting for debiting interest to the accounts of the parties and crediting the same to the profit and loss account, no fault as such can be found with the system followed by the assessee. The only power the Income Tax Officer has in such cases is the power under the proviso to section 145(1) of the Act which permits him, on being satisfied that the method employed by the assessee is such that his income cannot be properly deduced therefrom to compute his income upon such basis and in such a manner as he may determine. Evidently this is not a case falling under the proviso to section 145(1) in view of the categorical finding of the Tribunal in this regard. Besides, the Income Tax Officer himself has been accepting this system which had been followed by the assessee throughout in the past as a proper method of accounting and profits had in fact been determined on the basis thereof in the past as well as in two of the three assessment years under consideration. The fact that the assessee, for its convenience, kept a separate note of all those parties in whose case the mercantile system of accounting had not been followed and the

interest on the amounts due from them had not been debited to their accounts cannot in any way militate against the fact that the assessee was not following the mercantile system of accounting in respect of the loans in question. The system of accounting followed in respect of interest on such loans was in fact the cash system. The above system of accounting followed by the assessee does not in any way affect the real income of the assessee because, as soon as the amount of interest is recovered on any such loan a record of which is kept in the form of a memorandum record, it is treated as income of the assessee of that year and subjected to taxation. We, therefore, do not find any infirmity in the finding of the Tribunal. According to us, the Tribunal was justified in holding that having found no fault with the method of accounting followed by the assessee, it was not open to the Income Tax Officer to compute interest on the loans in question on the presumption that the assessee having generally followed the mercantile system of accounting in respect of most of its transactions it was not open to its to follow a different system of accounting in respect of a category of loans classified by the assessee as "problem loans."

7. On behalf of the Revenue, reliance is placed on the decision of the Supreme Court in State Bank of Travancore Vs. Commissioner of Income Tax, Kerala, . According to the Revenue, the controversy in this case is fully covered by the above decision in favour of the Revenue. According to learned counsel for the assessee, reliance of the Revenue on the above decision is wholly misplaced in view of the factual findings of the Tribunal in this case. According to the assessee, in the case before the Supreme Court, the admitted position was that interest was charged on the doubtful loans by the assessee by debiting the concerned parties but instead of crediting the same to the profit an loss account, such interest was credited to a separate account called "Interest suspense account". It was in such circumstances, the Supreme Court held that having received the amount of interest in respect of the loans in question and having debited the parties with the amount of interest on such loans, it was not open to the assessee to keep the amount away from the assessable profits merely by not crediting it to the profit and loss account but to a separate interest suspense account.

8. We have considered the rival submissions. We have carefully perused the above cited decision of the Supreme Court. The facts of the case as set out by Sabyasachi Mukharji J. (as his Lordship then was) in his judgment on page 134 of the report, so far as relevant, are as follows : The assessee was a subsidiary bank of the State Bank of India. It used to maintain in the relevant accounting years its accounts on the mercantile system and, therefore, entries were made and income and loss were calculated on accrual basis. The assessee in the course of its banking business used to charge interest on advances, including even those which it considered doubtful of recovery and which the assessee termed as "sticky advances" by debiting the concerned parties, but instead of carrying the same to its profit and loss account, credited the same to a separate account called the "Interest suspense account". In its returns, the assessee disclosed such interest separately and claimed that the

sums were not taxable as income of the concerned years. When the matter went to the High Court, the High Court agreed with the rejection of the contention of the assessee by the Revenue authorities on the following grounds :

(a) The assessee was following the mercantile system of accounting; such interest, therefore, had accrued to the assessee at the end of the accounting year.

(b) The assessee itself has treated such income as accrual of interest by charging the same to the parties concerned by making debit entries in their respective accounts.

9. The above decision of the High Court was upheld by the Supreme Court in State Bank of Travancore Vs. Commissioner of Income Tax, Kerala, . It was observed by Sabyasachi Mukharji J. (at page 136) : that the assessee indubitably maintained its accounts on the mercantile basis and had regularly adopted it. The assessee claimed that the three sums represented interest on what it called "sticky" loans in its books of accounts but having regard to the deteriorating financial position of the concerned debtors and the history of these accounts, the assessee was of the view that in the relevant years, the advances had become so "sticky" that even the recovery of the principal amounts had become highly improbable and extremely doubtful. Therefore, though the assessee charged such interest by debiting the concerned parties yet it credited the said amount to a separate accounts styled as the "Interest suspense account". This the assessee claimed on the theory that it was to avoid showing unreal or inflated profits. The assessee claimed that it was not taxable; as real income had not accrued to it. The Supreme Court, in the above case, was, therefore, required to examine whether an assessee, who had himself shown certain income in his accounts on the mercantile basis as income, can claim the same to be excluded from his income for the purpose of taxation by resorting to the real income theory. The Supreme Court was required to answer how far the concept of real income could defeat accrual of income in any particular case according to the well recognised theory of accounting principles which are accepted by the legal standards so far followed. It is evident from the above that before the Supreme Court, it was not the case of the assessee that the income had not accrued to it. The assessee itself had maintained its accounts in respect of the so-called "sticky" loans on the mercantile basis and debited the accounts of the parties with the amounts of interest which formed part of this income. The assessee, however, wanted to keep the said amount separately in an "Interest suspense account" to avoid taxation in the relevant assessment year by resorting to the real income theory, which was not approved by the Supreme Court.

10. The position is just the reverse in the case before us. Here the undisputed position is that the accounts of the parties were not debited with the amounts of interest nor was any interest credited to a separate account. What the assessee did was that it kept a memorandum record of the accounts of those parties in respect of which the mercantile system of accounting was not followed by it but a different system was followed. As stated earlier, it is the undisputed position that this system

had been regularly followed by the assessee and has in fact been accepted by the Revenue as a proper method of accounting for deducing the profits of the year under consideration. Under these circumstances, in our opinion, the ratio of the above referred judgment of the Supreme Court does not apply to the facts of the present case.

11. In view of the foregoing discussion, we answer question No. 1, as reframed by us and as set out above, in the affirmative and hold that the Tribunal was right in law in holding that the interest shown in the memorandum record by the assessee in the relevant previous years was not liable to inclusion in the assessee''s total income having regard to the provisions of section 28 and 145 of the Act. The said question is, therefore, answered in the affirmative and in favour of the assessee.

12. In view of the answer to question No. 1 being in favour of the assessee, it is not necessary to examine the controversy involved in question No. 2 (originally numbered as question No. 1) and decide the same. We, therefore, decline to answer the same.

13. In the result, this reference is answered in favour of the assessee and against the Revenue. The notice of motion also stands disposed of accordingly.

14. No order as to costs.