Supreme Court of India
Kerala Financial Corpn vs Cit on 12 May, 1994
Equivalent citations: 1994 AIR 2416, 1994 SCC (4) 375
Author: H B.L.
Bench: Hansaria B.L. (J)

PETITIONER:
KERALA FINANCIAL CORPN.

Vs.

RESPONDENT:
CIT

DATE OF JUDGMENT12/05/1994

BENCH:
HANSARIA B.L. (J)
BENCH:
HANSARIA B.L. (J)
KULDIP SINGH (J)

CITATION:
1994 AIR 2416 1994 SCC (4) 375
JT 1994 (4) 191 1994 SCALE (2)1026

ACT:

HEADNOTE:

JUDGMENT:

The Judgment of the Court was delivered by HANSARIA, J.- In this batch of appeals, we are concerned with the question as to how interest accruing on 'sticky advances' has to be taxed. The appellants being various leading financial institutions of the country, the answer has to be not on 'sticky ground' but on terra-firma. We would not, however, be required to labour hard to base our conclusion on firm ground because much of the ground has already been covered by a three-Judge Bench of this Court which decided the case of State Bank of 'Travancore v. CITI.

2.Those advances are called 'sticky' in commercial parlance whose recovery becomes highly improbable or doubtful. The interest accruing on such advances are debited to the parties concerned by those institutions which maintain their accounts on mercantile system, and at the same time instead of carrying such an interest to the profit and loss account, the same is credited to a separate account styled as suspense account or interest suspense account. 1 (1986) 2 SCC 11: 1986 SCC (Tax) 289: (1986) 158 ITR 102

3.In State Bank of Travancore case' this Court was called upon to decide as to how accrual of interest on such advances has to be taxed under the Income Tax Act, 1961 (hereinafter referred to as the Act). The Bench differed in its ultimate conclusion and the majority view was taken by Mukharji, J., as he then was, with whom Misra, J., as he then was, agreed. Tulzapurkar, J., was in minority. As leading legal luminaries of the taxation world had appeared to assist this Court in answering the aforesaid question, all that could reasonably be said on both the sides was done by persuasive and forceful arguments advanced, inter alia, by Shri Palkhivala, Shri Desai and Dr Pal. Fundamentals of law and principles of taxing income were brought to the notice of the Court along with many decided cases of various courts of the country and the English law.

4.The crux of the argument on behalf of the assessee was that accrual of interest on such advances does not produce real income, and so, despite the mercantile system of accounting such interest should be taxed only when it is really recovered. The majority too had no reservation in accepting the submission that the income which really accrues can be taxed. The question examined was when can such an income be said to have really accrued? Mukharji, J. observed in para 67 of the judgment that whether an accrual has taken place or not must be judged on the principles of real income theory; and in determining whether the income is hypothetical or real various factors have to be taken into account. The learned Judge observed that it would be difficult and improper to extend the concept of real income to all cases depending upon the 'ipse dixit of the assessee which would then become a value judgment only. It was opined that the question has to be considered from the point of view of real income "taking the probability or improbability of realisation in a realistic manner and dovetalling of these factors to-ether"; but once the accrual takes place, on the conduct of the parties subsequent to the year of closing, an income which has accrued, cannot be made 'no income'.

5.The learned Judge thereafter formulated eight propositions which according to him emerged as a result of the discussion undertaken. These propositions mentioned in para 69 read as below: (SCC pp. 66-67) "(1) It is the income which has really accrued or arisen to the assessee that is taxable. Whether the income has really accrued or arisen to the assessee must be judged in the light of the reality of the situation.

(2)The concept of real income would apply where there has been a surrender of income which in theory may have accrued but in the reality of the situation no income had resulted because the income did not really accrue.

(3)Where a debt has become bad deduction in compliance with the provisions of the Act should be claimed and allowed.

(4)Where the Act applies the concept of real income should not be so read as to defeat the provisions of the Act.

(5)If there is any diversion of income at source under any statute or by overriding title then there is no income to the assessee. (6)The conduct of the parties in treating the income in a particulate manner is material evidence of the fact whether income has accrued or not.

(7)Mere improbability of recovery, where the conduct of the assessee is unequivocal, cannot be treated as evidence of the fact that income has not resulted or accrued to the assessee. After debiting the debtor's account and not reversing that entry but taking the interest merely in suspense account cannot be such evidence to show that no real income has accrued to the assessee or treated as such by the assessee.

(8)The concept of real income is certainly applicable in judging whether there has been income or not but in every case it must be applied with care and within well recognised limits."

6.Insofar as the method of accounting is concerned, which has been dealt by Section 145 of the Act, to which our attention has been invited by Shri Salve also, Mukharji, J. stated in para 46 that the method of accountancy regularly employed by the assessee helps computation of income, profits and gains under Section 28 of the Act and the taxability of that income under the Act will then have to be determined. The question in this context is whether the income which has been computed according to the method of accounting followed regularly by an assessee can be diminuted or diminished by any notion of real income, which aspect has to be judged in the light of the well-settled principles. What these principles are, we have already noted.

7.Shri Salve has, in this connection, brought to our notice the decision of thePrivy Council in CIT'v. Maharaja adhiraja Ka eshwar Singh 2 of which it hasbeen stated that what the Income Tax Officer has to compute is the assessee's income and when the assessee 'so chooses to treat it'. This observation has relevance only qua the method of accounting adopted by the assessee. If it be mercantile system, the assessee chooses to treat the income on the basis of accrual of the same; but if the assessee were to adopt cash system, he chooses to treat the income actually received as his income. Once the selection relating to the method of accounting has been made, what has been observed by Mukharji, J. in para 46 (supra) follows. The Privy Council case' has not said anything to the contrary.

8.As against the above, Tulzapurkar, J. stated that even under the mercantile system accounting, it is only the accrual of real income which is chargeable to tax, which aspect has to be decided on commercial principles having regard to the business character of the transactions and the realities and specialties of the situation; and cannot be determined by adopting purely theoretical or doctrinaire or legalistic approach. The learned Judge then observed in para 19-that he failed to understand why interest on sticky loans, 2 (1933) 1 ITR 94, 102: AIR 1933 PC 108: 60 IA 146 which has theoretically accrued but has not factually resulted or materialised at all should not be regarded as hypothetical income and not real income? He further opined that there was no reason why the factum of stickiness of loans operating throughout the accounting period should not have, on being objectively established to the satisfaction of taxing authorities as distinguished from mere ipse dixit of the assessee, the effect of preventing the accrual of interest as real income of the assessee? The objections taken by the counsel for Revenue, one of which was that the only provision under the Act was to exclude such accrual of interest on debts which have become irrecoverable was met in para 20 by stating, inter alia, that though there is a distinction between an irrecoverable loan and a sticky loan the same bei ng that in former the chance of a recovery are almost nil whereas in latter there is high degree of improbability of recovery, interest on the latter is hypothetical and not real; and so,

the distinction is not material.

9. We have duly applied our mind to the rival views expressed in the aforesaid case and with respect we are in agreement with the stand taken by the majority. The reason is that, according to us, the majority's assessment is more logical and sound, because in every case accrual of such income cannot be presumed to be hypothetical, as would be the result if minority view were to be accepted. Further, the stand taken by the majority takes care of probable injustice (which may be caused) because of what has been stated in its proposition no. (3) above, which is that where a debt has become bad, deduction would be allowed. We would therefore, observe that though Misra, J., while agreeing with Mukharji, J., stated, inter alia, ill para 74 that in a taxing statute, where the law is clear, considerations of even injustice do not afford Justification for exempting income from taxation, as opined in Mapp v. Oram3 no injustice would really be caused in the cases at hand,inasmuch as if the advance in question can ultimately be established to have become bad debt, the assessee would be entitled to refund of the tax already paid by him in this regard. This has not been disputed by Shri Ramamurti appearing for the Revenue.

10. May it be stated that another two-Judge Bench of this Court of which one of us (Kuldip Singh, J.) was a member, had also accepted that majority view as correct in State Bank of Travancore v. C1T4 because of which the appeal and application for intervention were dismissed.

11. Shri Salve has made heroic efforts to satisfy us that the majority view may be taken as per incuriam inasmuch as it had not applied its mind to the effect of some circulars issued by the authorities concerned as empowered by Section 1 19 of the Act. This is sought to be brought home to us by referring to the observations of Mukharji, J. at the end of para 42 that in the appeals the Court was "not concerned with the actual effect of these circulars and these need not be set out and examined". This observation had 3 (1969) 3 All ER 215: (1969) 3 WLR 557 4 (1990) 186 ITR 187 (SC) been made after noting the circulars to which attention of the Court had been drawn.

12.Though it is correct that among the circulars brought to the notice of the Court the one which Shri Salve mentions, namely one issued in October 1984, was not brought to the notice of the Bench deciding the aforesaid case that is not material, because we are in agreement with Mukharji, J. when he stated at the end of para 43 that the circulars "cannot detract from the Act".

13.Shri Salve would however, urge that a little different view of the matter had been taken by two-Judge Bench of this Court in K.P. Varghese v. IT05 in which it was observed (at ITR p. 613: SCC p. 188) that circulars issued under the aforesaid provisions are binding on all officers "even if they deviate from the provisions of the Act". As to what was sought to be conveyed by the word 'deviate' is not clear to us. This much, however, is apparent that this Court did not mean, while saying as above, that circulars can override any provision of the Act or to put in the language of Mukharji, J. detract from the Act. Though Shri Salve has urged that the decision in Varghese has been affirmed by a Constitution Bench in C.B. Gautami v. Union of India6, reference to that case shows that Varghese case5 was mentioned in para 22 while stating that the conclusion arrived at, namely, that the provisions of Chapter XX-C of the Act are to be resorted to only where there is significant undervaluation of the immovable property with a view to evading tax, finds support from the

decision in Varghese. This shows that what was stated about permissibility of circulars to 'deviate' from the provisions of the Act was not one which was affirmed by the Constitution Bench.

14.The fact that the circular to which Shri Salve has referred is one which had been issued in exercise of powers conferred by Section 1 19 of the Act has no significance insofar as the point under consideration, namely, whether the circular can override or detract from the provisions of the Act, is concerned, inasmuch as what Section 1 19 has empowered is to issue orders, instructions or directions for the "proper administration" of the Act or for such other purposes specified in sub-section (2) of the section. Such an order, instruction or direction cannot override the provisions of the Act; that would be destructive of all the known principles of law as the same would really amount to giving power to a delegated authority to even amend the provision of law enacted by Parliament. Such a contention cannot seriously be even raised.

15.The result is that we follow and affirm the view taken by the majority by this Court in State Bank of Travancore case' and hold that the interest which had accrued on the sticky advance has to be treated as income of the assessee and as such taxable. We would add that 'If ultimately it would be established by the assessee that the advance has taken the shape of bad 6 (1993) 1 SCC 78 debt refund of the tax paid on the interest would become due and the same can be claimed by the assessee in accordance with law.

16. The appeals have no force as the view taken in the impugned judgments is in accord with the majority ,s stand in State Bank of Travancore case1. They are, therefore dismissed. No order as to costs.