Supreme Court of India
Tuticorin Alkali Chemicals And ... vs Commissioner Of Income Tax, ... on 8 July, 1997
Author: Warrington
Bench: S.P. Bharucha, Suhas C. Sen, M. Jagannadha Rao

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            CASE NO.:
Tax Reference Case  1-2 of 1992

PETITIONER:
TUTICORIN ALKALI CHEMICALS AND FERTILIZERS LTD. MADRAS

RESPONDENT:
COMMISSIONER OF INCOME TAX, MADRAS

DATE OF JUDGMENT: 08/07/1997

BENCH:
S.P. BHARUCHA & SUHAS C. SEN & M. JAGANNADHA RAO

JUDGMENT:
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JUDGMENT 1997 Supp (1) SCR 528 The Judgment of the Court was delivered by SEN, J. M/s. Tuticorin Alkali Chemicals and Fertilizers Limited formerly known as Tuticorin Alkali Limited was incorporated on 3.12.1971 for the purpose of, inter alia, manufacturing heavy chemicals such as ammonium chloride and soda ash. The trial production of the factories of the Company commenced on 30.6.1982. For the purpose of setting up of the factories, the Company had taken term loans from various banks and financial institutions. That part of the borrowed funds which was not immediately required by the Company was kept invested in short- term deposits with banks. Such investments were specifically permitted by the Memorandum and Articles of Association of the Company.

The Company had also deposited certain sums with the Tamil Nadu Electricity Board. It had also given interest-bearing loans to its employees , to purchase vehicles. Upto the assessment Year 1980-81, interests earned by the Company from the various loans given by the Company and also from the bank deposits were shown as income and was taxed accordingly.

For the accounting year ending on 30.6.1981, (assessment year 1982-83), the assessee received a total amount of interest of Rs. 2,92,440. In its return of income filed on 22.6.1982, the Company disclosed the said sum of Rs.2,92,440 as "Income from other sources". It also disclosed business loss of Rs. 3,21,802. After setting off the interest income against business loss, the Company claimed the benefit of carry forward of net loss of Rs. 29,360.

The Company later on realised its mistake and on 26.12.1984, it filed a revised return showing business loss of Rs. 3,21,802. It claimed that according to the accepted accounting practice, interest and finance charges along with other pre-production expenses will have to be capitalised, and that, therefore, the interest income of Rs. 2,92,440 should go to reduce the pre- production expenses (including interest and finance charges), which would ultimately be capitalised. In this connection, the Company high-lighted the fact that during the previous year relevant to the assessment year

1982-83, it had incurred a sum of Rs. 1,13,06,068 as and by way of interest and finance charges, which had to be capitalised along with other pre-production expenses. In other words, according to the assessee, the interest income of Rs. 2,92,440 was not exigible to tax.

The Income Tax Officer rejected the assessee's claim that the interest income was not exigible to tax. The view of the Income Tax Officer was upheld by the Commissioner of Income Tax appeals. The Company's further appeal to the Income Tax Appellate Tribunal was dismissed.

We are also concerned in this case with the assessment year 1983-84. During the previous year relevant to this assessment year, the assessee had received interest income of Rs. 1,08336. The assessee filed its return in which.it claimed that the interest income of 1,08336 should go to reduce the pre-production expenses including the interest and finance charges which would ultimately be capitalised. This contention was once again negatived by the income Tax Officer. The view of the income Tax Officer was upheld by the Commissioner of Income Tax (Appeals) and the Tribunal. Two applications were made for referring questions of law arising out of the order of the Tribunal as to the right of the Company to treat the receipt of interest on capital account and adjust it against preliminary expenditure incurred by the Company. The attention of the Tribunal was drawn to two conflicting decisions on the point of law involved in this case.

The view taken by the Madras High Court in the case of Commis-sioner of Income-Tax v. Seshasayee Paper and Board Ltd., (156 ITR 543) was that the interest earned by the assessee on investment of share capital in call deposits even before production commenced could be assessed separately under the head "Other Sources". The Andhra Pradesh High Court took a contrary view in the case of CIT v. Nagarjuna Steels Ltd., (171 ITR 663) where it was held that interest received on short-term deposits by a company prior to commencement of production could not be treated as revenue receipt. In view of the aforesaid conflict of decisions between the Madras and Andhra Pradesh High Courts, the Tribunal has referred the following question of law to this Court for decision:

"Whether, on the facts and in the circumstances of the case, interest derived by the assessee from the borrowed funds which were invested in short term deposits with banks would be chargeable to tax under the head 'Income from other sources' or would go to reduce the interest payable by the assessee on the term loans secured by the assessee from financial institutions, which would be capitalised after the commencement of commercial production?"

The facts of this case are not in dispute. In usual course, interests received by the Company from bank deposits and loans would be taxable as income under the head 'income from other sources' under Section 56 of the Income Tax Act. It is argued on behalf of the Company that it had not yet commenced its business and in any event the income was derived from funds borrowed for setting up the factory of the company and should be adjusted against the interest payable on the borrowed funds.

In our judgment neither of the two factors can affect taxability of the income earned by the Company. Under the Income Tax Act, 1961, the total income of the company is chargeable to tax under Section 4. The total income has to be computed in accordance with the provisions of the Act. Section 14 lays down that for the purpose of computation, income of an assessee has to be classified under six heads:

(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.

By an amendment made in 1988 'interest on securities ' has been made chargeable to tax as business income when such interest forms part of business profits and in all other cases under Section 56 (2) (i-d) as income from other sources. The amendment made in 1988 has no relevance for the purpose of this case. We shall take this Act as it stood at the material time in the assessment year 1983-84.

The computation of income under each of the above six heads will have to be made independently and separately. There are specific rules of deduction and allowances under each head. No deduction or adjustment on account of any expenditure can be can made except as provided by the Act. The basic proposition that has to be borne in mind in this case is that it is possible for a company to have six different sources of income, each one of which will be chargeable to income tax. Profits and gains of business or profession is only one of the heads under which the company's income is liable to be assessed to tax. If a company has not commenced business, there cannot be any question of assessment of its profits and gains of business. That does not mean that until and unless the company commen-ces its business, its income from any other source will not be taxed. If the company, even before it commences business, invests the surplus fund in its hand for purchase of land or house property and later sells it at profit, the gain made by the company will be assessable under the head 'Capital gains'. Similarly, if a company purchases a rented house and gets rent, such rent will be assessable to tax under Section 22 as income from House property. Likewise, a company may have income from other sources. It may buy shares and get dividends. Such dividends will be taxable under Section 56 of the Act. The Company may also, as in this case, keep the surplus fund in short-term deposits in order to earn interest. Such interests will be chargeable under Section 56 of the Act.

The Company has chosen not to keep its surplus capital idle, but has decided to invest it fruitfully. The fruits of such investment will clearly be of revenue nature. This position in law was explained by Sir George Lowndes in the off-quoted passage in the case of Commissioner of Income Tax, Bengal v. Shaw Wallace & Co., (1932) 59 I.A. 206 :

"Income, their Lordships think, in this Act connotes a periodical monetary return 'coming in', with some sort of regularity or expected regularity from definite sources. The source is not necessarily one which is expected to be continuously productive, but it must be one whose object is the production of a definite return, excluding anything in the nature of a mere windfall. This income has been likened pictorially to the fruit of a tree, or the crop of a field. It is essentially the produce of something which is often loosely spoken of as 'capital'."

In other words, if the capital of a Company is fruitfully utilised instead of keeping it idle the income thus generated will be of revenue and not accretion of capital. Whether the Company raised the capital by issue of shares or debentures or by borrowing will not make any difference to this principle. If borrowed Capital is used for the purpose of earning income that income will have to be taxed in accordance with law. Income is something which flows from the property. Something received in place of the property will be capital receipt. The amount of interest received by the Company flows from its investments and is its income and is clearly taxable even though the interest amount is earned by utilising borrowed capital.

It is true that the Company will have to pay interest on the money borrowed by it. But that cannot be a ground for exemption of interest earned by the Company by utilizing the borrowed funds as its income. It was rightly pointed out in the case of Kedar Narain Singh v. Commissioner of Income Tax, (6 I.T.R. 157) that "anything which can properly be described as income is taxable under the Act unless expressly exempted". The interest earned by the assessee is clearly its income and unless it can be shown that any provision like Section 10 has exempted it from tax, it will be taxable. The fact that the source of income was borrowed money does not detract anything from the revenue character of the receipt. The question of adjustment of interest payable by the Company against the interest earned by it will depend upon the provisions of the Act. The expenditure would have been deductible as incurred for the purpose of business if the assessee's business had commenced. But that is not the case here. The assessee may be entitled to capitalise the interest payable by it. But what the assessee cannot claim is adjustment of this expenditure against interest assessable under Section 56. Section 57 of the Act sets out in its clauses (i) to (iii) the expenditures which are allowable as deduction from income assessable under Section 56. It is not the case of the assessee that the interest payable by it on term loans are allowable as deduction under Section 57 of the Act.

If that be so, under which other provision of law can the assessee claim deduction or set-off of his income from other source against interest payable on the borrowed fund?

There are specific provisions in the Income Tax Act of setting off of loss from one source against income from another source under the same head of income (Section 70), as well as setting off of loss from one head against income from another (Section 71). In the facts of this case the Company cannot claim any relief under any of these two Sections, since its business had not started and there could not be any computation of business income or loss incurred by the assessee in the relevant accounting year. In such a situation the expenditure incurred by the assessee for the purpose of setting up its business cannot be allowed as deduction, nor can it be adjusted against any other income under any other head. Similarly any income from a non-business source cannot be set off against the liability to pay interest on funds borrowed for the purpose of purchase of plants and machineries even before commencement the business of the assessee.

It has been argued that the source from which the Company has earned interest is borrowed capital. The Company has to pay interest to its creditors on the same borrowed capital . Having regard to the identity of the fund on which interest is earned and interest is payable, the Com-pany should be allowed to set off its income against interest payable by it on the same fund. We are of the view that no adjustment can be allowed except in accordance with the provisions of the income Tax Act. However desirable it may be from the point of view of equity, this adjustment cannot be made unless the law specifically permits such adjustment.

Next it has been argued that according to well-established account-ancy practice the interest earned by the Company even before commence-ment of business from investing borrowed capital will have to be set off against interest payable by the Company on that borrowed capital. The argument based on accountancy practice has little merit if such practice cannot be justified by any provision of the statute or is contrary to it.

In the case of B.S.C. Footwear Ltd. v. Ridgway (Inspector of Taxes), [1972] 83 I.T.R. 269, Russell, L.J. while rejecting an argument based on well- settled accountancy practice pointed out that the Income Tax law does not march step by step in the divergent footprints of the accountancy profession.

The view of Russell, L.J. was upheld by the House of Lords on appeal. It was observed by Lord Reid (83 I.T.R. 269, 283) "Whatever merits there may be in the company's accountancy methods for the purposes of its internal affairs I am not persuaded that Cross J. and the Court of Appeal were wrong in finding them unacceptable for tax purposes."

In the case before us the Company had surplus funds in its hands. In order to earn income out of the surplus funds, it invested the amount for the purpose of earning interest. The interest thus earned is clearly of revenue nature and will have to be taxed accordingly. The accountants may have taken some other view but accountancy practice is not necessarily good law. In B.S.C. Footwear's case, the House of Lords had no hesitation in holding that the accounting practice for calculating its profit followed by the assessee and accepted by revenue for 30 years could not be treated as sanctioned by law and was not acceptable for the purpose of computation of taxable income.

There is another aspect of this matter. The company, in this case, is at liberty to use the interest income as it likes. It is under no obligation to utilise this interest income to reduce its liability to pay interest to its creditors. It can re-invest the interest income in land or share, it can purchase securities, it can buy house property, it can also set up another line of business, it may even pay dividends out of this income to its shareholders. There is no overriding title of anybody diverting the income at source to pay the amount to the creditors of the company. It is well-settled that tax is attracted at the point when the income is earned. Taxability of income is not dependent upon its destination or the manner of its utilisation. It has to be seen whether at the point of accrual, the amount is of revenue nature. If so, the amount will have to be taxed. Pondicherry Railway Company Ltd. v. C.I.T. AIR (1931) P.C. 165.

Our attention was drawn to two other decisions where the view of the Andhra pradesh High Court was followed. In the case of Commissioner of Income-Tax v. Electrochem Orissa Ltd., 211 ITR 552, the Orissa High Court preferred the view expressed by the High Court of Andhra Pradesh to the view expressed by the Madras High Court in Seshasayee Paper and Board Ltd.'s case on the ground that the Madras case was based on a finding of fact that there was no direct connection between the interest paid and the interest received. In our view it will not be right to read the judgment in Seshasayee Paper and Board Ltd.'s case in that way. The Court's finding in Seshasayee Paper and Board Ltd.'s case was that the interest earned by the assessee from the bank deposits had to be assessed under the head "Other sources". Consequently, the interest paid on the borrowing for the purpose of purchase of plants and machineries could not be allowed or adjusted against this income under Section 57(iii) nor were such adjustment permissible under Sections 70 or 71 of the Act because the business of the assessee had not commenced. The Madras high Court categorically held : "In this case, admittedly, the borrowing has not been made exclusively and solely for the purpose of earning interest in which case alone it should be taken as an income which should be deducted from the interest receipts."

An assessee-company may have raised its capital by issue of shares or debentures or by borrowing. But when that capital or a portion of it was utilised for whatever reason, even for a short period, to earn interest that interest must be treated as revenue receipt and will have to be taxed accordingly. Any set off or deduction of any expenditure can only be made in accordance with the provisions of the Act.

The other case is a decision of the Bombay High Court in Commissioner of Income-Tax v. Maharashtra Electrosmelt Ltd. 214 ITR 489. In that case the assessee, before commercial production had started, had realised a sum of Rs. 3,14,356 as interest on short-term deposit. At the same time, the assessee had paid a sum of Rs. 58,51,505 as interest on funds borrowed by it for the purpose of its business. The assessee after deducting the receipt of interest from the amount of interest paid by it capitalised the balance amount. The High Court was of the view that the background of raising of the fund by borrowing and temporary utilisation of a portion of that fund by keeping the same in call deposits with the banks went to show that the interest was earned for the purpose of reducing the liability of the assessee. The High Court came to the conclusion that it was evident that the assessee did not derive any income by temporary utilisation of the loans 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.

It is difficult to follow this reasoning. If a person borrows money for business purpose but utilises that money to earn interest, however temporarily, the interest so generated will be his income. This income can be utilised by the assessee whichever way he likes. He may or may not discharge his liability to pay interest with this income. Merely because it was utilised to repay the interest on the loan taken by the assessee, it did not cease to be his income. The interest earned by the assessee could have been used for many other purposes. If the assessee purchased a house or distributed dividend or paid salary of its employees with the money received as interest, will the interest amount be treated as not his income? This is not a case of diversion of income by overriding title. The assessee was entirely at liberty to deal with the interest amount as he liked. The application of the income for payment of interest could not affect its taxability in any way.

The second reason given by the High Court was that the Institute of Chartered Accountants of India was a recognised authority on accounting principles. This fact has been recognised by this Court in the case of Challapalli Sugars Ltd. v. CIT, (1975) 98 ITR 167. Therefore, its view has to be respected.

It is true that this Court has very often referred to accounting practice for ascertainment of profit made by a company or value of the assets of a company. But when the question is whether a receipt of money is taxable or not or whether certain deductions from that receipt are permissible in law or not, the question has to be decided according to the principles of law and not in accordance with accountancy practice. Accounting practice cannot override Section 56 or any other provision of the Act. As was pointed out by Lord Russell in the case of B.S.C. Footwear Ltd, the Income Tax law does not march step by step in the footprints of the accountancy profession.

The question in Challapalli Sugar Ltd. 's case was about computation of depreciation and development rebate under the Indian Income Tax Act, 1922. In order to calculate depreciation and development rebate it was necessary to find out 'the actual cost' of the plant and machinery purchased by the Company. This Court held that 'cost' is a word of wider connotation than 'price'. There was a difference between the price of a machinery and its cost. This Court thereafter pointed out that the expression "actual cost" had not been defined in the Act. It was, therefore, necessary to find out the commercial sense of the phrase. Khanna, J. (as his Lordship then was) observed :

"As the expression "actual cost" has not been defined, it should, in our opinion, be construed in the sense which no commercial man would misunderstand. For this purpose it would be necessary to ascertain the connotation of the above expression in accordance with the normal rules of accountancy prevailing in commerce and industry. The accepted accountancy rule for determining 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 created as a result of such expenditure."

This Court also took note of the provisions of the Companies Act and in particular Section 208 (l)(b). It observed :

"Clause (b) of sub-section (1) of that section provides that in case interest is paid on share capital issued for the purpose of raising money to defray the expenses of constructing any work or building or the provision of any plant in contingencies mentioned in that section, the sum so paid by way of interest may be charged to capital as part of the cost of construction of the work or building or the provision of the plant. The above provision thus gives statutory recognition to the principle of capitalising the interest in case the interest is paid on money raised to defray expenses of the construction of any work or building or the provision of any plant in contingencies mentioned in that section even though such money constitutes share capital. The same principle, in our opinion, should hold good if interest is paid on money not raised by way of share capital but taken on loan for the purpose of defraying the expenses of the construction of any work or building or the provision of any plant. The reason indeed would be stronger in case such interest is paid on money taken on loan for meeting the above expenses."

This Court also relied on an English case in support of this conclusion in Hinds v. Buenos Ayres Grand National Tramways Co. Ltd., [1906] 2 Ch. 654. In Hinds' case dealing with the question of capitalisation of interest paid on loans taken to install electric traction for tram lines, it was held by Warrington J. :

"Now, what is it that the company are really proposing to do? They are creating a capital asset by means of which they will hereafter earn, or they hope to earn, profits for the company. They are not simply employing contractors to find the money and do the work. They are finding the money themselves, and they find the money by borrowing it. What does each mile of line cost them under these circumstances -what is that they expend in construction each mile of line, taking the amount of the borrowed money expended on that line to be Æ0,000, that being the company's estimate? The money is borrowed for that particular purpose - the Æ0,000. They have to pay interest on that Æ0,000 during the period that construction is taking place. In my opinion that asset which they are so constructing costs them not only the Æ0,000 but the Æ0,000 plus the amount of interest during the period of construction; and that is what they are out of pocket during the construction of that mile of line. Now, it seems to me that the company are entitled -I do not say that they are bound to do it - if they think fit to charge in their accounts as the cost of that mile of line not only Æ0,000, but the Æ0,000 and the interest on it during the period of construction."

In other words, it was held that cost of construction will be the amount actually spent and also the interest payable on the amount borrowed during the period of construction.

The judgment in Challapalli's case goes to show that the Court was not in any way departing from legal principles because of any opinion expressed by the Institute of Chartered Accountants. The phrase 'actual cost' was not defined in the Act. Therefore, it had to be understood in the commercial parlance. To find that out the normal rule of accountancy prevalent in commercial and industrial circles was noted. According to the Institute of Chartered Accountants, actual cost will also include interest paid on borrowed money for the purchase of the assets. Khanna, J. however, did not stop there. He pointed out that the principle of capitalising interest was to be found in Section 208 of the Companies Act itself and was also consistent with the view of the English Courts.

But this is an entirely different case. Whether a particular receipt is of the nature of income and falls within the charge of Section 4 of the Income-Tax Act is a question of law which has to be decided by the Court on the basis of the provisions of the Act and the interpretation of the term 'income' given in a large number of decisions of the High Courts, the privy Council and also this Court. It is well-settled that income attracts tax as soon as it accrues. The application or destination of the income has nothing to do with its accrual or taxability. It is also well-settled that interest income is always of a revenue nature unless it is received by way of damages or compensation.

In the premises, we are of the view that the Madras High Court came to a correct decision in the case of Commissioner of Income-Tax v. Seshasayee Paper And Boards Ltd., (156 ITR 543). The contrary views expressed in the cases of CIT v. Nagarjuna Steels Ltd., Commissioner of Income-Tax v. Electrochem Orissa Ltd. and Commissioner of Income- Tax v. Maharashtra Electrosmelt Ltd. are erroneous.

We are of the view that the Tribunal has come to a correct decision. The question referred by the Tribunal is in two parts. The first part of the question is answered in the affirmative and in favour of the revenue. The second part of the question is answered in the negative and in favour of the revenue.

The References are-disposed of accordingly. There will be no order as to costs.