

REPORTABLE

IN THE SUPREME COURT OF INDIA

CIVIL APPELLATE JURISDICTION

CIVIL APPEAL NOS. 6366-6368 OF 2003

TAPARIA TOOLS LIMITED

.....APPELLANT(S)

VERSUS

JOINT COMMISSIONER OF INCOME TAX
SPECIAL RANGE – I, NASIK

.....RESPONDENT(S)

WITH

CIVIL APPEAL NOS. 6946-6948 OF 2004

J U D G M E N T

A.K. SIKRI, J.

The appellant – Taparia Tools Limited (hereinafter referred to as the 'assessee') is before us, having lost in the courts below. In these six appeals, the issue involved is identical, that too between the same parties. Necessity of six appeals is because of the reason that the same dispute pertains to three assessment years, namely, assessment years 1996-97, 1997-98 and 1998-99. The assessee had claimed deduction of revenue expenditure on account of interest payment in the sum of ₹2,72,25,000 paid to

one M/s. Maliram Makharia Stock Brokers Pvt. Ltd. and ₹55,00,000 on account of interest payment given to M/s. Sharp Knife Company Pvt. Ltd. This was on account of upfront payments of interest given to the aforesaid two debenture holders in the assessment years 1996-97 and 1997-98 respectively. The Assessing Officer (for short, the 'AO'), however, treated it as the '*deferred revenue expenditure*', to be written off over a period of five years and, therefore, in these assessment years he allowed only 1/5th of the payment made, though the entire payment was made in the assessment year 1996-97.

- 2) The question of law, in the given circumstances, which has arisen for consideration is as to whether the liability of the assessee to pay the interest upfront to the debenture holder is allowable as a deduction in the first year itself or it is to be spread over a period of five years, being the life of the debentures? This substantial question of law has arisen in the following circumstances:
- 3) In the debenture issue of the assessee two options as regards payment of interest thereupon were given to the subscribers/debenture holders. They could either receive interest periodically, that is every half yearly @ 18% per annum over a period of five

years, or else, the debenture holders could opt for one time upfront payment of ₹55 per debenture. In the second alternative, ₹55 per debenture was to be immediately paid as upfront on account of interest. At the end of five years period, the debentures were to be redeemed at the face value of ₹100.

4) The debentures were allotted to the following parties as below:

S.No.	Party	Amount (in lacs)
1.	Maliram Makharia Stock Brokers Pvt. Ltd., dt. 29.03.1996	495.00
2.	Orient Corporation, dt. 19.06.1996	1.25
3.	Shree Suyog Agencies, dt. 19.06.1996	1.25
4.	Shree Kyamsap Enterprises, dt. 19.06.1996	1.25
5.	Shree Suraj Agencies, dt. 19.06.1996	1.25
6.	Sharp Knife Co. Pvt. Ltd, dt. 19.06.1996	100.00
	TOTAL	600.00

On February 14, 1996, M/s. Maliram Makharia Stock Brokers Pvt. Ltd. gave their letter of acceptance opting for upfront payment of interest. Likewise, vide letter of acceptance dated May 24, 1996, M/s. Sharp Knife Company Pvt. Ltd. exercised similar option.

As these parties, mentioned at S.Nos. 1 and 6, had opted for one time upfront payment towards interest, they were paid interest in the sum of ₹2,72,25,000 and ₹55,00,000 respectively.

- 5) The assessee follows mercantile system of accounting. Further, one time upfront interest of an amount mentioned above was actually paid as well in the Accounting Years 1995-96 and 1996-97 respectively. However, it so happened that the said upfront payment of interest on debentures were shown by the assessee as deferred revenue expenditure in the accounts to be written off over a period of five years. Notwithstanding this accounting treatment given to the payment *qua* interest, in the returns filed by the assessee for the assessment years 1996-97 and 1997-98, it claimed the entire upfront interest payment in the sum of ₹2,72,25,000 and ₹55,00,000 respectively as fully deductible expenditure. It may be clarified that insofar as the assessee's claim for deduction of premium payable on redemption is concerned, the same was claimed in the return on a spread over basis covering a period of five years.
- 6) In the assessment orders passed by the AO, the assessee's claim for deduction of upfront interest payment was denied. Instead, the AO chose to spread it over a period of five years thereby giving deduction only to the extent of 1/5th each in the respective assessment years. The order of the AO was challenged by the assessee in appeals preferred before the Commissioner of

Income Tax (Appeals). The Commissioner, however, dismissed the appeals thereby sustaining the orders passed by the AO. The assessee then approached the Income Tax Appellate Tribunal and thereafter the High Court of Bombay but was unsuccessful as the appeals preferred by him before the two fora have been dismissed maintaining the method of deduction adopted by the AO. To put it otherwise, instead of entire amount paid by the assessee in the particular assessment year, full deduction is not given and this deduction is spread over a period of five years. Thus, the question is as to whether deduction of the entire amount of interest paid should be allowed or the stance of Revenue needs to be affirmed.

- 7) As pointed out above, the assessee maintains its accounts on mercantile basis. Further, the entire amount for which deduction was claimed was, in fact, actually paid to the debenture holder as upfront interest payment. It is also a matter of record that this amount became payable to the debenture holder in accordance with the terms and conditions of the non-convertible debenture issue floated by the assessee, on the exercise of option by the aforesaid debenture holders, which occurred in the respective assessment years in which deduction of this expenditure was

claimed.

- 8) Section 36 of the Income Tax Act, 1961 (hereinafter referred to as the 'Act') is a residual section in respect of certain deductions which are to be made from the income of the assessee while arriving at the taxable income. It is nomenclatured as '*other deductions*', as some of the preceding sections provide for certain deductions of specific nature, with which we are not concerned in the present case. One of the deductions, apart from many other kinds of deductions stipulated in the section, relates to the amount of interest paid in respect of capital borrowed for the purpose of business or profession. This is provided in clause (iii) of sub-section (1) of Section 36 and reads as under:

“S.36. (1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28 –

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(iii) the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession:

[*Provided* that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalised in the books of account or not); for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as

deduction.]

Explanation. - Recurring subscriptions paid periodically by shareholders or subscribers in Mutual Benefit Societies which fulfil such conditions as may be prescribed, shall be deemed to be capital borrowed within the meaning of this clause;

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- 9) Ignoring the proviso and the explanation in clause (iii) above, with which we are admittedly not concerned in this case, it is clear that as per the aforesaid provision any amount on account of interest paid becomes an admissible deduction under Section 36 if the interest was paid on the capital borrowed by the assessee and this borrowing was for the purpose of business or profession. There is no quarrel, in the present case, that the money raised on account of issuance of the debentures would be capital borrowed and the debentures were issued for the purpose of the business of the assessee. In such a scenario when the interest was actually incurred by the assessee, which follows the mercantile system of accounting, on the application of this statutory provision, on incurring of such interest, the assessee would be entitled to deduction of full amount in the assessment year in which it is paid. While examining the allowability of deduction of this nature, the AO is to consider the genuineness of business borrowing and that the borrowing was for the purpose of business

and not an illusory and colourable transaction. Once the genuineness is proved and the interest is paid on the borrowing, it is not within the powers of the AO to disallow the deduction either on the ground that rate of interest is unreasonably high or that the assessee had himself charged a lower rate of interest on the monies which he lent. In the instant case, the AO did not dispute that the non-convertible debentures were issued and money raised for business purposes. The AO did not even dispute the genuineness of clause relating to upfront payment of interest in the first year itself as per the option to be exercised by the debenture holder. In nutshell, the AO did not dispute that the expenditure on account of interest was genuinely incurred. Therefore, there is no dispute that interest has, in fact, been '*paid*' during the year of accounting. Definition of '*paid*' is contained in Section 43(ii) of the Act to mean actually paid or incurred according to the method of accounting. To be precise, this definition is couched in the following language:

“S.43 In sections 28 to 41 and in this section, unless the context otherwise requires –

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(2) “paid” means actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under the head “Profits and gains of business or profession”;

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As per the aforesaid definition, even if the amount is not actually paid but '*incurred*', according to the method of accounting, the same would be treated as '*paid*'. Since the assessee was following mercantile system of accounting, the amount of interest could be claimed as deduction even if it was not actually paid but simply '*incurred*'. However, in the instant case, it is not in dispute that the amount of interest was actually paid as well in the assessment year in which it was claimed.

- 10) The only reason which persuaded the AO to stagger and spread the interest over a period of five years was that the term of debentures was five years and that the assessee had itself given this very treatment in the books of accounts, viz, spreading it over a period of five years in its final accounts by not debiting the entire amount in the first year to the Profit and Loss account and it has, in fact, debited 1/5th of the interest paid to the Profit and Loss account from the second year onwards. The High Court, in its impugned judgment, has based its reasoning on the second aspect and applied the principle of '*Matching Concept*' to support this conclusion.

11) Insofar as the first reason, namely, non-convertible debentures were issued for a period of five years is concerned, that is clearly not tenable. While taking this view, the AO clearly erred as he ignored by ignoring the terms on which debentures were issued. As noted above, there were two methods of payment of interest stipulated in the debenture issued. Debenture holder was entitled to receive periodical interest after every half year @ 18% per annum for five years, or else, the debenture holder could opt for upfront payment of ₹55 per debenture towards interest as one time payment. By allowing only 1/5th of the upfront payment actually incurred, though the entire amount of interest is actually incurred in the very first year, the AO, in fact, treated both the methods of payment at par, which was clearly unsustainable. By doing so, the AO, in fact, tampered with the terms of issue, which was beyond his domain. It is obvious that on exercise of the option of upfront payment of interest by the subscriber in the very first year, the assessee paid that amount in terms of the debenture issue and by doing so he was simply discharging the interest liability in that year thereby saving the recurring liability of interest for the remaining life of the debentures because for the remaining period the assessee was not required to pay interest on

the borrowed amount.

- 12) The next question which arises for consideration is as to whether the assessee was estopped from claiming deduction for the entire interest paid in the year in which it was paid merely because it had spread over this interest in its books of account over a period of five years. Here, the submission of learned counsel for the assessee was that there is no such estoppel, inasmuch as, the treatment of a particular entry (or for that matter interest entered in the instant case) in the books of accounts is entirely different from the treatment which is to be given to such entry/expenditure under the Act. His contention was that assessment was to be made in accordance with the provisions of the Act and not on the basis of entries in the books of accounts. His further argument was that had the assessee not claimed the payment of entire interest amount as tax in the income tax returns and had claimed deduction over a period of five years treating it as deferred interest payment, perhaps the AO would have been right in accepting the same in consonance with the accounting treatment which was given. However, learned counsel pointed out that in the instant case the assessee had filed the income tax return claiming the entire deduction which was allowable to it under the

provisions of Section 36(1)(iii) of the Act as all the conditions thereof were fulfilled and, thus, it was exercising the statutory right which could not be denied.

- 13) We find that the High Court has taken into consideration the provisions of Section 36(1)(iii) of the Act and the conditions which are to be fulfilled for allowing the deduction on this account in the following words:

“...The term “interest” has been defined under Section 2(28A) of the Act. Briefly, interest payment is an expense under Section 36(1)(iii). Interest on monies borrowed for business purposes is an expenditure in a business [see 35 ITR 339 – Madras]. For claiming deduction under Section 36(1)(iii), the following conditions are required to be satisfied viz. the capital must have been borrowed; it must have been borrowed for business purpose and the interest must be paid. The word “Paid” is defined in Section 43(2). It means payment in accordance with the method followed by the assessee. In the present case, therefore, the word “Paid” in Section 36(1)(iii) should be construed to mean paid in accordance with the method of accounting followed by the assessee i.e. Mercantile System of accounting...”

Notwithstanding the aforesaid, the High Court chose to decline the whole deduction in the year of payment, thereby affirming the orders of the authorities below, by invoking the '*Matching Concept*'. It is observed by the High Court that under the mercantile system of accounting, book profits are liable to be

taxed and in order to determine the net income of an Accounting Year, the revenue and other incomes are to be matched with the cost of resources consumed (expenses). For this reason, in the opinion of the High Court, this matching concept is required to be done on accrual basis. As per the High Court, in this case, payment of ₹55 per debenture towards interest was made, which pertained to five years, and, thus, this interest of five years was paid in the first year. We are of the opinion that it is here the High Court has gone wrong and this approach resulted in wrong application of *Matching Concept*. It is emphasized once again that as per the terms of issue, the interest could be paid in two modes. As per one mode, interest was payable every year and in that case it was to be paid on six monthly basis @ 18% per annum. In such cases, the interest as paid was claimed on yearly basis over a period of five years and allowed as well and there is no dispute about the same. However, in the second mode of payment of interest, which was at the option of the debenture holder, interest was payable upfront, which means insofar as interest liability is concerned, that was discharged in the first year of the issue itself. By this, the assessee had benefited by making payment of lesser amount of interest in comparison with the interest which was payable under the first mode over a period of

five years. We are, therefore, of the opinion that in order to be entitled to have deduction of this amount, the only aspect which needed examination was as to whether provisions of Section 36(1)(iii) read with Section 43(ii) of the Act were satisfied or not. Once these are satisfied, there is no question of denying the benefit of entire deduction in the year in which such an amount was actually paid or incurred.

- 14) The High Court has also observed that it was a case of deferred interest option. Here again, we do not agree with the High Court. It has been explained in various judgments that there is no concept of deferred revenue expenditure in the Act except under specified sections, i.e. where amortization is specifically provided, such as Section 35-D of the Act.
- 15) What is to be borne in mind is that the moment second option was exercised by the debenture holder to receive the payment upfront, liability of the assessee to make the payment in that very year, on exercising of this option, has arisen and this liability was to pay the interest @ ₹55 per debenture. In ***Bharat Earth Movers v. Commissioner of Income Tax***¹, this Court had categorically held that if a business liability has arisen in the

¹ (2000) 6 SCC 645

accounting year, the deduction should be allowed even if such a liability may have to be quantified and discharged at a future date.

Following passage from the aforesaid judgment is worth a quote:

“The law is settled: if a business liability has definitely arisen in the accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date. What should be certain is the incurring of the liability. It should also be capable of being estimated with reasonable certainty though the actual quantification may not be possible. If these requirements are satisfied the liability is not a contingent one. The liability is *in praesenti* though it will be discharged at a future date. It does not make any difference if the future date on which the liability shall have to be discharged is not certain.”

The present case is even on a stronger footing inasmuch as not only the liability had arisen in the assessment year in question, it was even quantified and discharged as well in that very accounting year.

- 16) Judgment in ***Madras Industrial Investment Corporation Limited v. Commissioner of Income Tax***² was cited by the learned counsel for the Revenue to justify the decision taken by the courts below. We find that the Court categorically held even in that case that the general principle is that ordinarily revenue expenditure incurred wholly and exclusively for the purpose of

² (1997) 4 SCC 666

**Civil Appeal Nos. 6366-6368 of 2003 and
Civil Appeal Nos. 6946-6948 of 2004**

business is to be allowed in the year in which it is incurred. However, some exceptional cases can justify spreading the expenditure and claiming it over a period of ensuing years. It is important to note that in that judgment, it was the assessee who wanted spreading the expenditure over a period of time and had justified the same. It was a case of issuing debentures at discount; whereas the assessee had actually incurred the liability to pay the discount in the year of issue of debentures itself. The Court found that the assessee could still be allowed to spread the said expenditure over the entire period of five years, at the end of which the debentures were to be redeemed. By raising the money collected under the said debentures, the assessee could utilise the said amount and secure the benefit over number of years. This is discernible from the following passage in that judgment on which reliance was placed by the learned counsel for the Revenue herself:

“15.. The Tribunal, however, held that since the entire liability to pay the discount had been incurred in the accounting year in question, the assessee was entitled to deduct the entire amount of Rs.3,00,000 in that accounting year. This conclusion does not appear to be justified looking to the nature of the liability. It is true that the liability has been incurred in the accounting year. But the liability is a continuing liability which stretches over a period of 12 years. It is, therefore, a liability spread over a period of 12 years. Ordinarily, revenue expenditure which is incurred

wholly and exclusively for the purpose of business must be allowed in its entirety in the year in which it is incurred. It cannot be spread over a number of years even if the assessee has written it off in his books over a period of years. However, the facts may justify an assessee who has incurred expenditure in a particular year to spread and claim it over a period of ensuing years. In fact, allowing the entire expenditure in one year might give a very distorted picture of the profits of a particular year. Thus in the case of *Hindustan Aluminium Corporation Ltd. vs. CIT*, (1982) 30 CTR (Cal) 363: (1983) 144 ITR 474 (Cal) the Calcutta High Court upheld the claim of the assessee to spread out a lump sum payment to secure technical assistance and training over a number of years and allowed a proportionate deduction in the accounting year in question.

16. Issuing debentures at a discount is another such instance where, although the assessee has incurred the liability to pay the discount in the year of issue of debentures, the payment is to secure a benefit over a number of years. There is a continuing benefit to the business of the company over the entire period. The liability should, therefore, be spread over the period of the debentures.”

- 17) Thus, the first thing which is to be noticed is that though the entire expenditure was incurred in that year, it was the assessee who wanted the spread over. The Court was conscious of the principle that normally revenue expenditure is to be allowed in the same year in which it is incurred, but at the instance of the assessee, who wanted spreading over, the Court agreed to allow the assessee that benefit when it was found that there was a continuing benefit to the business of the company over the entire

period.

- 18) What follows from the above is that normally the ordinary rule is to be applied, namely, revenue expenditure incurred in a particular year is to be allowed in that year. Thus, if the assessee claims that expenditure in that year, the IT Department cannot deny the same. However, in those cases where the assessee himself wants to spread the expenditure over a period of ensuing years, it can be allowed only if the principle of '*Matching Concept*' is satisfied, which upto now has been restricted to the cases of debentures.
- 19) In the instant case, as noticed above, the assessee did not want spread over of this expenditure over a period of five years as in the return filed by it, it had claimed the entire interest paid upfront as deductible expenditure in the same year. In such a situation, when this course of action was permissible in law to the assessee as it was in consonance with the provisions of the Act which permit the assessee to claim the expenditure in the year in which it was incurred, merely because a different treatment was given in the books of accounts cannot be a factor which would deprive the assessee from claiming the entire expenditure as a deduction. It

has been held repeatedly by this Court that entries in the books of accounts are not determinative or conclusive and the matter is to be examined on the touchstone of provisions contained in the Act [See – ***Kedarnath Jute Manufacturing Co. Ltd. v. Commissioner of Income Tax (Central), Calcutta***³; ***Tuticorin Alkali Chemicals & Fertilizers Ltd., Madras v. Commissioner of Income Tax, Madras***⁴; ***Sutlej Cotton Mills Ltd. v. Commissioner of Income Tax, Calcutta***⁵; and ***United Commercial Bank, Calcutta v. Commissioner of Income Tax, WB-III, Calcutta***⁶].

- 20) At the most, an inference can be drawn that by showing this expenditure in a spread over manner in the books of accounts, the assessee had initially intended to make such an option. However, it abandoned the same before reaching the crucial stage, inasmuch as, in the income tax return filed by the assessee, it chose to claim the entire expenditure in the year in which it was spent/paid by invoking the provisions of Section 36(1)(iii) of the Act. Once a return in that manner was filed, the AO was bound to carry out the assessment by applying the

3 (1972) 3 SCC 252

4 (1997) 6 SCC 117

5 (1978) 4 SCC 358

6 (1999) 8 SCC 338

provisions of that Act and not to go beyond the said return. There is no estoppel against the Statute and the Act enables and entitles the assessee to claim the entire expenditure in the manner it is claimed.

- 21) In view of the aforesaid discussion, we are of the opinion that the judgment and the orders of the High Court and the authorities below do not lay down correct position in law. The assessee would be entitled to deduction of the entire expenditure of ₹2,72,25,000 and ₹55,00,000 respectively in the year in which the amount was actually paid. The appeals are allowed in the aforesaid terms with no orders as to costs.

.....J.
(A.K. SIKRI)

.....J.
(ROHINTON FALI NARIMAN)

**NEW DELHI;
MARCH 23, 2015.**

ITEM NO.1A
(For Jt.)

COURT NO.13

SECTION IIIA

S U P R E M E C O U R T O F I N D I A
R E C O R D O F P R O C E E D I N G S

Civil Appeal No(s). 6366-6368/2003

TAPARIA TOOLS LTD.

Appellant(s)

VERSUS

JOINT COMMNR. OF INCOME TAX, NASIK

Respondent(s)

WITH

C.A. No. 6946-6948/2004

Date : 23/03/2015 These appeals were called on for judgment today.

CORAM :

HON'BLE MR. JUSTICE A.K. SIKRI

HON'BLE MR. JUSTICE ROHINTON FALI NARIMAN

For Appellant(s)

Mr. Rustom B. Hathikhanawala, Adv.

Mr. B. V. Balaram Das, Adv.

For Respondent(s)

Rr-ex-parte, Adv.

Hon'ble Mr. Justice A.K.Sikri pronounced the judgment of the Court comprising of His Lordship and Hon'ble Mr. Justice Rohinton Fali Nariman.

The appeals are allowed in terms of the signed Reportable judgment with no orders as to costs.

(SUMAN WADHWA)
AR-cum-PS

(SUMAN JAIN)
COURT MASTER

(SIGNED REPORTABLE JUDGMENT IS PLACED ON THE FILE)