

* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

DECIDED ON: 17.07.2012

+ **ITA-1238/2011**

NTPC SAIL POWER COMPANY PVT. LTD. Appellant

Through: Mr. R. Muralidhar with

Mr. K.N. Ahuja, Advocates.

versus

CIT Respondent

Through: Mr. Anupam Tripathi,

Sr. Standing Counsel with

Mr. Sumit Kumar, Advocate.

CORAM:

MR. JUSTICE S. RAVINDRA BHAT

MR. JUSTICE R.V. EASWAR

MR. JUSTICE S.RAVINDRA BHAT (OPEN COURT)

% The assessee is aggrieved by an order dated 25th April, 2012 of the Income Tax Appellate Tribunal (ITAT) in ITA Nos. 4668-73/Del/2010. The appeal is admitted. The following substantial question of law arises for consideration:

“Did the Tribunal fall into error in upholding the addition of interest of Rs.3,31,58,000/- earned on deposits and advances made for the new unit being established, instead of being set off/netted off against the interest on borrowed sums utilized for the new unit?”

With consent of counsel for parties, the appeal was heard finally for disposal.

2. The assessee was incorporated on 8.2.1999 with the paid up capital of Rs.1000/- consisting of 100 shares of Rs.10/- each. Of these, 98 shares were subscribed by M/s. Steel Authority of India Limited (hereinafter referred to as SAIL) and 1 share each by two individuals, both employees of SAIL. The SAIL owned and operated captive power plants at Durgapur and Rourkela which were necessary for the continuous operation of critical areas of plant. In tune with the policy of the Central Government, as SAIL's core activity is steel production, power plants were to be shifted to NTPC, another public sector undertaking power production. The captive power plants were transferred to the assessee, which became a joint venture company owned equally by SAIL and NTPC. Consequent to the approval by the Board of Directors of the assessee company, a shareholders' agreement was executed on 16.3.2001. The transfer of shares from SAIL to NTPC was completed on 22.3.2001 by Stock Holding Corporation of India Limited which is also a public sector undertaking.

3. The assessee company was in the process of expansion of its business by setting up new units at Bhilai for generation of power. Separate books of account and records were maintained for the new units being set up under expansion programme. For financing the expansion plans, the assessee company raised the additional capital of Rs.45,000 lakhs during the year. The outstanding of borrowed term loans as on 31.3.2007 was as under: -

Term loan – Union Bank of India	Rs.51,646 lakhs
Term loan – Central Bank of India	Rs. 1,500 lakhs
Term loan – Financial Institutions	Rs.21,500 lakhs
Total term loans	Rs.74,646 lakhs

The total interest/financial expenses incurred during the year was Rs.4,499.96 lakhs. Of this, Rs.3,148.27 lakhs were related to the borrowing utilized for expansion purposes. The assessee company earned total interest receipts of Rs.616.73 lakhs during the year. The interest was earned on temporary deposits made from surplus funds and on the deposits made with banks by way of margin or giving advances etc. for the purpose of expansion. Such interest earned was of Rs.331.58 lakhs. The balance or difference, of interest of Rs.285.15 lakhs, which had been admitted as a normal income, did not relate to expansion work. The interest earned on the surplus fund by way of margins or giving advances for the purpose of expansion was adjusted to the Incidental Expenses During Construction (IEDC for short). The interest was adjusted on account of the matching principle since the interest earned on deposits kept in relation to the expansion were credited to/reduced from the IEDC. The Assessing Officer treated this interest as “income from other sources”, relying on the judgment of the Supreme Court in *Tuticorin Alkalies Chemicals Fertilizers Ltd. vs. CIT* 227 ITR 172 (SC). The assessee’s appeal to the Commissioner (Appeals) was accepted. The revenue consequently approached the ITAT, which by the impugned order allowed it, and restored the order of the AO.

4. Learned counsel submitted that the Tribunal fell into serious error in holding that interest income earned out of borrowed funds, temporarily placed in fixed deposits was “income” and not capital receipt. It was urged that the decision of the Supreme Court in *Commissioner of Income Tax v. Bokaro Steel* 236 ITR 315, where the character of such receipts was held to be capital in nature as long as the borrowed funds (which constitute the principal) are inextricably connected with the construction activity. It was argued that the reasoning of the Tribunal that the change brought about by the amendment to the Income Tax Act with effect from 1-4-2004, by which interest paid on borrowed capital did not qualify for exemption, and in turn, *Bokaro Steel* did not consequently apply, was patently erroneous. In this context, it was submitted that by reason of the amended provision (section 36(1)(iii) inserted by the Finance Act, 2004) interest paid for capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized 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, cannot be allowed as deduction. However, the reasoning in *Bokaro* that the interest accrued or earned on borrowed capital which is linked with the construction activity is a capital receipt, has remained unaffected.

5. Counsel for the revenue argued that the reasoning of the Tribunal is unexceptionable and does not call for interference. It was submitted that the Tribunal’s reasoning distinguishing the

decision in *Bokaro* was based on the change in law brought about by amendment to section 36 (1) with effect from 1.4.2004. It was also submitted that interest earned on fixed deposit has to be assessed as “income from other sources” in view of the Supreme Court judgment in *Tuticorin Alkalies Chemicals Fertilizers Ltd. vs. CIT* 227 ITR 172 (SC). The learned counsel contended that in terms of the amended provision [in section 36(1) (iii)], interest paid on capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized 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. That amount was correctly directed to be taxed as “income from other sources” in view of the decision of the Supreme Court in *Tuticorin Alkalies*. . It was contended that the principle of netting of interest is inapplicable to the facts of the case and the impugned order should not be interfered with.

6. The Tribunal’s reasoning in support of its decision is extracted below:

“Prior to the inserting of proviso to section 36(1)(iii), the interest paid on capital borrowed for the purpose of extension of existing business or profession was being allowed as deduction u/s 36(1)(iii) of the Income-tax Act as revenue expenditure. By inserting proviso to this section w.e.f. 1.4.2004 by the Finance Act, 2004, the amount of 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. The assessee company was running two power plants. Thereafter a new power plant was to be set up at Bhilai for generation of power. Company raised term loan for setting up this new plant. The separate books of account were maintained for this new unit. The assessee has worked out the amount of interest payable or paid relating to the borrowings utilized for expansion purposes. Similarly, the assessee also worked the earning of interest on the FDRs of surplus fund and interest on margins/advances made for the purpose of expansion. The assessee has adjusted the interest income towards the IEDC (incidental expenses during construction) by adopting the matching principle in respect of the interest earned on the FDRs of surplus fund and margins and advances made for the purpose of expansion. Admittedly, these incidental expenses were incurred during construction period of setting up new unit at Bhilai and whatever not related to this expansion work was claimed as revenue expenditure in the books which had been allowed. The CIT (A) granted the relief by following the judgement of Hon'ble Supreme Court in the case of Bongaigaon Refinery & Petrochemicals Ltd. vs. CIT 251 ITR 329 where the decision of Tuticorin Alkalies Chemicals & Fertilisers Ltd. vs. CIT 227 ITR 172 was also referred. We would like to state that in the decision of Bongaigaon Refinery & Petrochemicals Limited, Hon'ble Supreme Court has held as under :-

“The High Court has already held that the interest income derived by the assessee during its formative period was taxable. What remains for consideration is the income which the assessee derived from house property, its guest house, charges for equipment and recoveries from the contractors on account of water and electricity supply. These items are covered by the decision in Bokaro Steel Ltd.'s case [1999] 236 ITR 315 (SC). To the extent that it relates to these items,

i.e., items excluding interest, the question must be answered in the affirmative and in favour of the assessee. The order under challenge will stand modified to that extent.”

Hon'ble Apex Court has not deliberated on interest income but the interest income during the formative state was held to be taxable. The issues on which Apex Court deliberated were related only to the income derived from house properties, guest house, charges for equipment and recoveries from the contractor on account of water and electricity supply. Therefore, the ratio decided by Hon'ble Supreme Court does not cover the interest income. In the decision of CIT vs. Bokaro Steel Limited 236 ITR 315 (SC), the Hon'ble Supreme Court has held that the interest earned was inextricably linked with the process of setting up its plant and machinery, such receipts will go to reduce the cost of assets and these are receipts of capital nature. However, the decision of Hon'ble Supreme Court in the case of CIT vs. Bokaro Steel Limited was delivered in December, 1998, and thereafter a proviso has been added to section 36(1)(iii) of Income-tax Act w.e.f. 1.4.2004. By inserting this proviso to section 36(1)(iii), the interest paid on capital borrowed for acquisition of an asset for extension of existing business or profession 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. The assessee has claimed the adjustment of interest against the incidental expenses during construction on the basis of matching principle is also not as per law. As we have stated above, the interest earned on FDRs made from surplus fund and interest earned on margins and advances made for expansion work shall be assessed under the head 'income from other sources'. The set off claimed against the incidental expenses during the construction of new

plant of which main component of this expense is interest paid on borrowed capital. The netting of interest in the case of CIT vs. Shri Ram Honda Power Equip 289 ITR 475 (Delhi) was allowed only for the purpose of deduction u/s 80HHC in view of provisions of Section 80HHC (3)(baa). In the decision also, the Hon'ble Delhi High Court has clearly held that surplus funds parked with the bank and interest is earned thereon can only be categorized as income from other sources and such receipts merits separate treatment under section 56 of the Income-tax Act. Therefore, the principle of netting cannot be adopted in the assessee's case.

.....

The nexus between obtaining the loan and paying interest thereon (laying out the expenditure by way of interest) for the purpose of earning the interest on the fixed deposit, to draw an analogy from section 37, will require to be shown by the assessee for application of the netting principle. The interest earned on surplus fund parked into FDRs and on margin/advances made for expense on work can be categorized only as 'income from other sources'. Further, as per the proviso to section 36(iii), the whole of interest as the borrowed capital have to be capitalised for the period till the asset first put to use. Admittedly, the assets were not put to the use in the financial year relevant to assessment year under consideration. Hence, it has to be capitalised. Further, the deduction of interest or other expenditure under section 57 can be allowed only when it has been borrowed for the purpose of earning of such income. Here the loan was taken for expansion. Deduction u/s 57(iii) of the Income-tax Act is allowable when any expenditure not being in the nature of capital expenditure laid out or expanded wholly and exclusively for the purpose of making or earning such income. Thus, the expenditure to be

deductible u/s 57(iii) must be laid out or expended wholly or exclusively for the purpose of making or earning such income. Unless the expenditure sought to be deducted resulted in making or earning income it could not be said to be laid out or expended for the purpose of making such income.

*.....
Admittedly, the dominant purpose for the loan taken was for the extension of the existing business by way of setting up a new power generation plant at Bhilai. Since assessee had been denied the benefit by inserting a specific proviso to section 36(1)(iii), therefore, matching principle shall help assessee. Whatever cannot be achieved directly, it can also not be achieved indirectly.”*

7. The amended section 36 of the Income Tax Act reads as follows:

“36. Other deductions.—(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—

- | | | | |
|--|-----|-----|-----|
| (i) | XXX | XXX | XXX |
| (ii) | XXX | XXX | XXX |
| (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;”

8. In *Tuticorin Alkali Chemicals and Fertilizers Ltd.*(supra) the Supreme Court held as follows:

"if the company, even before it commences business, invests the surplus funds in its hands 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..... The company may also, as in that case, keep the surplus funds in short-term deposits in order to earn interest. Such interest will be chargeable under section 56 of the Income-tax Act".

The Supreme Court, subsequently, in *Bokaro Steel Ltd.* (supra) held that:

“However, while interest earned by investing borrowed capital in short-term deposits is an independent source of income not connected with the construction activities or business activities of the assessee, the same cannot be said in the present case where the utilisation of various assets of the company and the payments received for such utilisation are directly linked with the activity of setting up the steel plant of the assessee. These receipts are inextricably linked with the setting up of the capital structure of the assessee-

company. They must, therefore, be viewed as capital receipts going to reduce the cost of construction.”

9. This Court, in *Indian Oil Panipat Power Consortium Ltd Vs. ITO* (2009) 315 ITR 255 (Del.) held that where interest on money received as share capital is temporarily placed in fixed deposit awaiting acquisition of land, a claim that such interest is a capital receipt entitled to be set off against pre-operative expenses, is admissible, as the funds received by the assessee company by the joint venture partners are “inextricably linked” with the setting up of the plant and such interest earned cannot be treated as income from other sources. The reasoning in *Indian Oil* is in line with *Bokaro Steel Ltd.* Similarly, the Supreme Court in *CIT vs. Karnataka Power Corporation*, 247 I.T.R. 268 (SC) and *Bongaigaon v Refinery and Petro Chemical Co. Ltd. vs. Commissioner Income Tax* 251 I.T.R. 329(SC) held that such receipts are not income.

10. It is no doubt correct that the proviso to section 36(1)(iii) of the Income Tax Act enacts that any amount of the interest paid towards (“*in respect of*”) capital borrowed for acquisition of an asset or for extension of existing business regardless of its capitalization in the books or otherwise, “*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*” would not qualify as deduction. However, in all these cases, when the interest was *received* by the assessee towards interest paid for fixed deposits when the borrowed funds could not be immediately

put to use for the purpose for which they were taken, this Court, and indeed the Supreme Court held that if the receipt is “inextricably linked” to the setting up of the project, it would be capital receipt not liable to tax but ultimately be used to reduce the cost of the project. By the same logic, in this case too, the funds invested by the assessee company and the interest earned were inextricably linked with the setting up of the power plant. It may be added that the Tribunal has not found that the deposits made as margin monies were not limited to the construction activity connected to the expansion of the business by way of setting up of a new power generation plant.

11. As a result of the above discussion, it is held that the Tribunal and the lower authorities fell into error in holding that the interest earned on fixed deposit of amounts borrowed, which is the subject matter of the present appeal, would have to be treated as revenue receipt. The answer is given in favour of the assessee; the appeal is consequently allowed.

**S. RAVINDRA BHAT
(JUDGE)**

**R.V. EASWAR
(JUDGE)**

JULY 17, 2012