

In the High Court of Judicature at Madras

Dated : 01.10.2020

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The Honourable Mr.Justice T.S.SIVAGNAM

and

The Honourable Mrs.Justice V.BHAVANI SUBBAROYAN

Tax Case Appeal No.739 of 2019

M/s.The Karur Vysya Bank Ltd.,
Central Office, Karur-1

...Appellant

Vs

The Additional Commissioner of
Income Tax, Circle 1(1), Tiruchirapalli.

...Respondent

APPEAL under Section 260A of the Income Tax Act, 1961
against the order dated 27.4.2017 made in ITA.No.1340/Mds/2013 on
the file of the Income Tax Appellate Tribunal, Chennai 'B' Bench (Camp
: Madurai) for the assessment year 2003-04.

For Appellant : Mr.R.Parthasarathy

For Respondent : Mr.M.Swaminathan, SSC assisted by
Mrs.V.Pushpa, JSC

Judgment was delivered by T.S.SIVAGNANAM,J

This appeal, filed by the assessee under Section 260A of the Income Tax Act, 1961 (for short, the Act), is directed against the order dated 27.4.2017 made in ITA.No.1340/Mds/2013 on the file the Income Tax Appellate Tribunal, Chennai 'B' Bench (for brevity, the Tribunal) for the assessment year 2003-04.

2. The assessee filed this appeal by raising the following substantial question of law :

"Whether, on facts and in circumstances of the case, the Tribunal was right in holding that the income received in advance in the nature of interest income on discounting of bills against letter of credit is to be subjected to taxation on receipt basis and not on accrual basis ?"

3. We have heard Mr.R.Parthasarathy, learned counsel for the appellant – assessee and Mr.M.Swaminathan, learned Senior Standing Counsel assisted by Ms.V.Pushpa, learned Junior Standing Counsel appearing for the respondent – Revenue.

4. The assessee, which is a bank, filed its return of income for the assessment year under consideration namely AY 2003-04 on 27.11.2003 declaring a total income of Rs.1,51,41,88,620/-. An order

under Section 143(1) of the Act was passed by the Assessing Officer on 06.1.2004 determining a refund of Rs.10,01,58,647/-. The assessee's case was selected for scrutiny and a notice under Section 143(2) of the Act dated 29.6.2004 was issued. Thereafter, the assessee approached the Additional Commissioner of Income Tax concerned by filing an application under Section 144A of the Act, in which, the Assessing Officer was directed to complete the assessment by issuing certain guidelines. Subsequently, the assessment was completed by order dated 27.3.2006.

5. As against the said order dated 27.3.2006, the assessee filed an appeal before the Commissioner of Income Tax (Appeals), Tiruchirapalli [for brevity, the CIT(A)], who, by order dated 25.3.2013, dismissed the appeal filed by the assessee. Challenging the same, the assessee filed further appeal before the Tribunal and it was dismissed by the impugned order.

6. The only issue, which is the subject matter of this appeal, is with regard to the income received in advance.

7. The Assessing Officer, while dealing with the said issue, held that the assessee excluded the income received in advance from the taxable income claiming that the same was interest received in advance, which need not be assessed in the relevant year on account

of the fact that it was following mercantile system of accounting. The Assessing Officer, though accepted that the amount represented interest pertaining to a subsequent year, however, held that the same was received during the year under consideration. Therefore, the Assessing Officer referred to Section 5(1)(a) of the Act and held that the assessee received income during the year under consideration and that the same should be included in the total income of the year under consideration.

8. Aggrieved by the assessment order, the assessee preferred an appeal before the CIT(A) by contending that the Assessing Officer misinterpreted Section 5(1)(a) of the Act and failed to consider that the assessee was following mercantile system of accounting. The CIT(A) did not assign any independent reason while concurring with the decision taken by the Assessing Officer.

9. Before the Tribunal, the assessee reiterated the stand taken by them at the earliest point of time i.e. before the Assessing Officer by stating that as the interest income as shown under the head 'other liabilities' represented the interest received upfront on the bills purchased/discounted, the interest received beyond the account closing date was included under that head. It was further contended that the interest received upto the period of closing date was offered

to tax, that the interest related to the period beyond the closing date was debited from interest received account and that the interest received in advance account was credited. It was thus explained that this credit balance in interest received in advance was a liability as on 31st March and after 31st March, the balance in income received in advance account was transferred to the income account.

10. Thus, the assessee contended that there was no escapement of income, that the assessee was following mercantile system of accounting as specified under the Companies Act and that the income was assessable in the year of receipt only when cash basis was followed.

11. The Tribunal proceeded solely on the basis that the receipt of income/interest on purchase and discount may not be required to be repaid by the assessee at any point of time and that in other words, there was no liability for the assessee for payment in the subsequent year or at any point of time. Further, going by the contentions raised by the Department, the Tribunal held that the assessee physically received the amount towards income in advance and there was no liability for repayment. The Tribunal was of the opinion that the same had to be treated as income of the assessee and that the matter would stand differently in case there was liability for repayment of money

received in advance.

12. In our considered view, the observation made by the Tribunal that the interest received on purchase and discount may not be required to be repaid by the assessee at any point of time is a finding, which is not borne out by facts. As argued before us by Mr.R.Parthasarathy, learned counsel for the assessee, if the bills are discounted, normally the period of repayment is 90 days and in the event the bill gets honoured within a period of 90 days, it goes without saying that for the differential period, proportionate interest has to be refunded. Thus, the Tribunal is not justified in coming to the conclusion that the interest on purchase and discount of bills may not be required to be repaid by the assessee at any point of time.

13. On going through the orders passed by the Assessing Officer, the CIT(A) and the Tribunal, what is conspicuously absent is the matter pertaining to the accounting system followed by the assessee bank. This, in our considered view, would be very relevant because the assessee was following mercantile system of accounting.

14. In terms of Section 145 of the Act, which deals with '**method of accounting**', Sub-Section (1) states that "**income chargeable under the head 'Profits and gains of business or profession' or 'Income from other sources' shall, subject to the**

provisions of Sub-Section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee”.

15. Therefore, to bring the receipt of interest by the assessee to be profit as mentioned in Sub-Section 2(24) of the Act, it is necessary that it should be computed in accordance with the method of accounting regularly employed by the assessee and in the instant case, it is mercantile system of accounting.

16. In the decision of the Mumbai Tribunal, which is placed before us for consideration by Mr.R.Parthasarathy, learned counsel for the assessee in the case of **Siam Commercial Bank PCL Vs. DDIT, International Taxation [reported in (2011) 15 Taxmann.com 353]**, the assessee was also a bank, which was following the mercantile system of accounting. The Tribunal explained the mercantile system of accounting and how the deduction for expenses was allowed when the liability to pay arose irrespective of the fact whether such an amount had been paid or remained unpaid at the end of the year in the following lines :

“The assessee bank is admittedly following mercantile system of accounting. Under such a method, deduction for expenses

is allowed when the liability to pay arises irrespective of the fact whether such an amount has been paid or remained unpaid at the end of the year. In the like manner, income, under such a method of accounting is recognized on accrual basis. In other words, when the assessee finally acquires the right to receive such income, it is charged to tax. Actual receipt of such amount, whether before or after accrual, is of no consequence. The material thing is the time of its accrual. Once an income has accrued it is liable to be taxed, notwithstanding the fact that it was not received during the year. In the same manner, if some amount has been received, which does not represent the income accrued for the year, it shall not be charged to tax and will assume the character of liability till the time of its accrual. Only when such amount accrues as income, the hitherto liability will get converted into income. Till that time, it will continue as liability despite the fact that it was received. Thus what is relevant to magnetize tax under the mercantile system of accounting is the fact of accrual of income during the year and not the receipt of any amount or non receipt of income. It shows that receipt or non receipt of

an amount during the year is an irrelevant consideration in determining whether the income has accrued or not.”

17. In the same order, the Tribunal also explained about **'matching concept'** on the following lines :

“At this juncture, it is relevant to note that the 'matching concept' goes hand in hand with the 'mercantile system of accounting'. Matching concept underlines the idea of matching revenues with the corresponding costs. It recognizes income with the incurring of simultaneous expenditure. When a lender, in the money lending business, advances money on interest, it receives income and it also pays interest on the monies borrowed by it for the purpose of his business. It is the difference between the interest incurred and interest earned, which constitutes his income. Going with the above example, when the lender, who had borrowed Rs.100 in his normal course of business on interest at the rate of 8%, advances it on interest at the rate of 10%, he will earn income of the differential interest. His liability to pay interest (expenditure in his hands) shall arise for that part of the year for which he used the borrowed funds or remained deprived of such

funds. When he borrowed Rs.100 on 1.1.2011 and advanced it on the same date, his interest expenditure for the year ending 31.3.2011 shall be to the tune of Rs.2 (8% on Rs.100 for a period of three months from 1.1.2011 to 31.3.2011). When the interest expenditure for a period of three months is deductible, naturally going by the matching concept, the interest of only Rs.3 (10% interest income on Rs.100 for a period of three months from 1.1.2011 to 31.3.2011) can be recognized as income."

18. It cannot be disputed that discounting of bills is being done in one of the modes of finance and the Assessing Officer accepted that the assessee received the amount of interest, which represented interest pertaining to a subsequent year. In such cases, if the assessee is not permitted to debit interest related to the period beyond the closing date from the interest received account and credited in the advance account, then it would fall foul of the mercantile system of accounting. This concept has been clearly brought out in the decision of the Mumbai Tribunal in the case of **Siam Commercial Bank PCL, which we quote with approval.**

19. In fact, in the said decision, the Revenue placed reliance on the decision of the Special Bench of the Mumbai Tribunal in the case of ***DCIT, International Taxation Vs. Bank of Bahrain & Kuwait [reported in (2010) 41 SOT 290]***, which pertained to a case of guarantee commission and as to how it had to be taxed. The Tribunal rightly distinguished that decision and held in paragraph 12 as follows:

“...But when it comes to the discounting charges, the period of the bill is relevant as it requires the divesting of funds by the lender for such period entailing the incurring of the interest expenditure for such period. The quantum of discounting charges has direct nexus with the due date of the bill, which, in turn, determines the period for which the bank is deprived of its funds in discounting the bill. If the due date of bill crosses the date of closure of the financial year, the bank discounting the bill will incur matching interest cost on its funds in the current year and also the later year. As the interest cost for the subsequent year shall not become deductible in the current year, naturally the corresponding income in the form of discounting charges for the next year shall also not accrue as income in the current year.”

20. A similar issue arose for consideration before the Mumbai Tribunal in the case of **DCIT Vs. Jetu J.T.Lalwani [reported in (2007) 15 SOT 322]**. In this case also, the assessee was following the mercantile system of accounting and engaged in bill discounting transaction, which used to be a period of 90 to 180 days and the income, in respect of the entire bill discounting period, was accounted in the beginning itself when the transaction was entered into without really considering as to what was the income accrued or became due and which related to the year. The Tribunal held as follows :

"As regards the second grievance raised by the revenue, i.e., set out in Ground Nos. 3 and 4, it pertains to the question as to whether the entire bill discounting income is to be taxed in this previous year or only such income can be taxed in this previous year which pertains to the period within the previous year. In other words, we are required to adjudicate whether or not interest received from the period falling outside this previous year could be taxed in this previous year itself. While dealing with the Ground Nos. 1 and 2 in preceding paras, we have dealt at length with the concept of interest income and the basis on which it is to be allocated over the different

accounting period. A bill discounting receipt is also the interest income in nature. In the sense that by way of bill discounting, the borrower is allowed the use of money from the date of bill discounting till the date when bill is actually paid. When such usage of money is spread over more than one accounting period and particularly when the assessee is following mercantile method of accounting, only such income from bill discounting can be brought to tax as pertains to that accounting period. In the case before us the bills are discounted at the fag end of the relevant previous year. With the result that a portion of time for which the money is allowed to be used by the borrower falls outside the relevant accounting year. Following the discussions in the preceding paras dealing with Ground Nos. 1 and 2 the interest income for that period as falls outside the accounting year is to be taxed in the accounting year to which it pertains. Therefore, only such bill discounting can be taxed in this year as pertains to the period of usage of money within this previous year. The learned Commissioner (Appeals) is quite justified in remitting the matter to the file of the assessing officer for redeciding the issue in

this light. We see no infirmity in the same and we uphold and approve order of the learned Commissioner (Appeals) on this issue. .”

21. Furthermore, our attention has been drawn to the Foreign Exchange Association of India Rules and in particular, Rule 2.2.(c), which reads as follows :

*“2.2. Application of Interest
a)....
b)....
c) In case of early realization, interest for the unexpired period shall be refunded to the customer. The bank shall also pay or recover notional swap cost as in the case of early delivery under a forward contract. Interest on outlay/inflow of funds for such SWAPS shall also be recovered/ paid as per Rule 6 para 6.6.”*

22. In terms of the above Rule, in case of early realization, interest for the unexpired period should be refunded to the customer.

23. A reference was also made to the Master Direction – Export of Goods and Services issued by the Reserve Bank of India in Master Direction No.17/2016-17 dated 01.1.2016, updated on 04.2.2016 and in paragraph C.2, the direction deals with interest of import bills and in Clause (ii), it has been stated as follows :

“In case of pre-payment of usance import bills, remittances may be made only after reducing the proportionate interest for the unexpired portion of usance at the rate at which interest has been claimed or LIBOR of the currency in which the goods have been invoiced, whichever is applicable. Where interest is not separately claimed or expressly indicated, remittances may be allowed after deducting the proportionate interest for the unexpired portion of usance at the prevailing LIBOR of the currency of invoice.”

24. The above direction states that in case of pre-payment of usance import bills, remittances may be made only after reducing the proportionate interest for the unexpired portion of usance at the rate at which interest has been claimed and in cases where interest is not separately claimed or expressly indicated, remittances may be allowed after deducting the proportionate interest for the unexpired portion of usance at the prevailing LIBOR of the currency of invoice. The above directions issued by the RBI would also come to the aid and assistance of the assessee.

25. For all the above reasons, we hold that the Assessing Officer, the CIT(A) and the Tribunal fell in error while considering the issue framed before us as a substantial question of law.

26. In the result, the above tax case appeal filed by the assessee is allowed and the substantial question of law raised is answered in favour of the assessee. No costs.

01.10.2020

Speaking Order

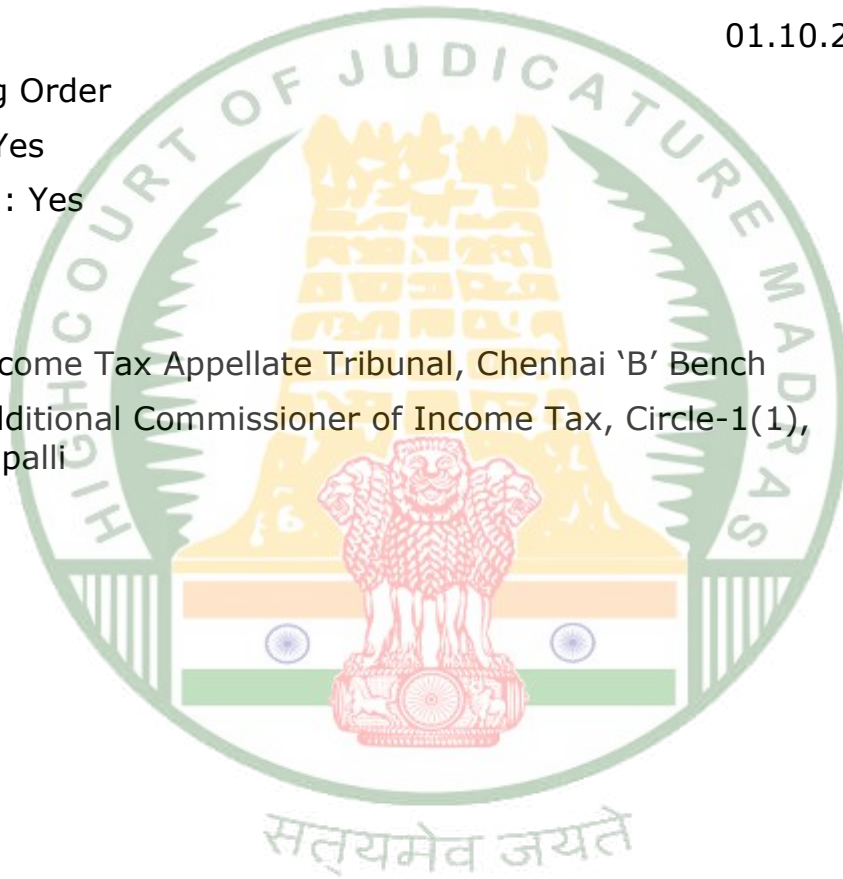
Index : Yes

Internet : Yes

To

- 1.The Income Tax Appellate Tribunal, Chennai 'B' Bench
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