

A COMMISSIONER OF INCOME TAX, BIHAR-II, PATNA.

v.

BOKARO STEEL LTD. BOKARO

DECEMBER 18, 1998

B [SUJATA V. MANOHAR AND G.B. PATTANAIK, JJ.]

C *Income Tax Act, 1961—Assessee—Bokaro Steel Limited—During construction of factory and before commencement of business sums received by it as : (a) rent for housing workers and staff employed by contractors; (b) hire charges for plant and machinery given to the contractors for use in construction work of assessee; (c) interest from advances made to the contractors by assessee for purpose of facilitating work of construction—Held, these are receipts of capital nature and cannot be taxed as income—These receipts being inextricably linked with the setting up of the capital structure of the assessee-company, reduced cost of construction and could not be held to be income of assessee from any independent source.*

D *Capital Receipt—Royalty—Assessee—Company receiving certain amount by way of royalty charged from contractor for use of stones lying on assessee's land for construction work—Cost of the plant to the extent of such royalty received reduced for the assessee—Royalty received—Held to be a capital receipt.*

E *Income—Hypothetical income—Assessee making an entry in its books of accounts showing certain amount as income from interest received from another company for the eight locomotives supplied by the assessee-company to them—Entry reversed in the next year since the other company replaced the eight locomotives lent by the assessee company to it by new ones—Said entry reflecting only hypothetical income and the assessee not receiving any real income—View of the High Court that this entry did not reflect that real income of the assessee and hence not exigible to income-tax; upheld.*

F **The assessee-company, a corporation wholly owned by the Govt. of India was incorporated in January 1964 with the object to construct and own integral iron and steel works. During the assessment years under consideration, the work of construction of the company's factory and installation of the plant was in the process of completion. The company had not started any business during the assessment year in question. During**

this period, the assessee company received the following payments: (1) Payment for the quarters given to the contractors for the residence of their workmen engaged in the construction activity of the assessee's plant; (2) Interest for the advance made to the contractors to enable them to execute the large scale construction work smoothly; this interest was later adjusted against the dues of the contractors; (3) Income in the form of hire charges for the plant machinery given to the contractors on hire for the purpose of construction work; (4) Amount received by way of royalty charged from the contractor for use of stones excavated from the assessee's land for construction work; and (5) Interest from a certain sum said to have been accrued to the assessee during the assessment year 1971-72 from another company for eight locomotives supplied by the assessee-company to the other company. This entry was however reversed in the next year because eight new locomotives were supplied by the other company to the assessee and no interest income actually accrued to the assessee.

The Income-tax Appellate Tribunal held that all the amounts (under items 1 to 4) received by the assessee were in the nature of capital receipts which could be set off against the capital expenditure incurred by the assessee during the relevant assessment years. Hence, these amounts could not be taxed as income. Reference was made to the High Court by the Income-tax Appellate Tribunal. The reference was answered in favour of the assessee and against the appellant thereby upholding the view of the Tribunal. Hence, the present appeals.

Dismissing the appeals, this Court

**HELD. 1.1.** If the assessee receives any amounts which are inextricably linked with the process of setting up its plant and machinery, such receipts will go to reduce the cost of its assets. These are receipts of a capital nature and cannot be taxed as income. [691-A]

**1.2.** The activities of the assessee in connection with all these three receipts namely, (1) rent for housing workers and staff employed by contractors for the construction activity of the assessee's plant; (2) hire charge for plant and machinery given to the contractors for use in construction work of assessee; (3) interest from advances made to the contractors by assessee for purpose of facilitating work of construction, are directly connected with or are incidental to the work of construction of its plant undertaken by the assessee. To facilitate the work of the contractor, the assessee permitted the contractor to use the premises of the assessee for

A housing its staff and workers engaged in the construction activity of the assessee's plant. Had this facility not been provided by the assessee, the contractors would have had to make their own arrangements and this would have been reflected in the charges of the contractors for the construction work: The same is true of the hire charge for plant and machinery which was given by the assessee to the contractor for the assessee's construction work. The receipts in this connection also go to compensate the assessee for the wear and tear on the machinery. The advances which the assessee made to the contractor was as much to ensure that the work of the contractors proceeded without any financial hitches as to help the contractors. The arrangements which were made between the assessee-company and the contractors pertaining to these three receipts are arrangement which are intrinsically connected with the construction of its steel plant. The receipts have been adjusted against the charges payable to the contractors and have gone to reduce the cost of construction. They have, therefore, been rightly held as capital receipts and not income of the assessee from any independent source. [688-G-H; 689-A-E]

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1.3 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. The 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. [690-D-E]

F *Additional Commissioner of Income-Tax, New Delhi v. Indian Drugs & Pharmaceuticals Ltd.*, (1983) 141 ITR 134, affirmed.

*Challapalli Sugars Ltd. v. Commissioner of Income-Tax, A.P.*, (1975) 98 ITR 167, relied upon.

G *Tuticorin Alkali Chemicals & Fertilizers Ltd. v. Commissioner of Income Tax*, (1997) 227 ITR 172, referred to.

H 2. The land had been allowed to be utilised by the contractors for the purpose of excavating stones to be used in the construction work of assessee's steel plant. The cost of the plant to the extent of such royalty received, is reduced for the assessee. It is, therefore, rightly taken as a capital receipt. [691-B-C]

3. The entry in the books of accounts which was initially made as interest from a certain sum said to have been accrued to the assessee from another company for eight locomotives supplied by the assessee - company to the other company was reversed the next year because in fact the nature of the transaction was changed and the assessee did not receive any real income. The High Court has, therefore, rightly held this entry as not reflecting the real income of the assessee and hence not exigible to income-tax. The entry in the books which was made was about a hypothetical income which did not materialise and the entry was reversed in the next year. Since this entry reflected only hypothetical income, it could not be brought as income. Only real income can be brought to tax. [691-C-E; 692-C-D]

*Godhra Electricity Co. Ltd. v. Commissioner of Income-Tax, (1997) 225 ITR 746, followed.*

CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 2544-45 of 1998 Etc.

From the Judgment and Order dated 21.10.97 of the Patna High Court in T.C. Nos. 41 and 42 of 1978.

Ranbir Chandra, S. Rajappa, (K.N. Nagpal), for B.K. Prasad for the Appellant.

S. Ganesh K.J. John and Ms. Manju Mishra for the Respondents.

The Judgment of the Court was delivered by

**MRS. SUJATA V. MANOHAR, J.** Civil Appeal Nos. 2544-45 of 1988 pertain to assessment year 1972-73 while Civil Appeal Nos. 642-48 of 1989 pertain to assessment years 1965-66 to 1971-72. The Income-tax Appellate Tribunal had referred the following questions to the High Court for determination under Section 256(1) of the Income-tax Act, 1961:-

*At the instance of the Revenue:*

*Assessment year 1965-66:*

Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the hire charges of Rs. 56 received by the assessee-company for letting out the plant and machinery to the contractors were not taxable?

A *Assessment year 1966-67:*

(1) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the hire charges of Rs. 7,224 received by the assessee-company for letting out of the plant and machinery to the contractors were not taxable?

B (2) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in holding that the royalty of Rs. 8,530 received from the contractor was not taxable as it was of capital nature and not revenue?

C *Assessment year 1967-68:*

(1) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the hire charges of Rs. 12,195 received by the assessee-company for letting out of the plant and machinery to the contractors were not taxable?

D (2) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in holding that the royalty of Rs. 1,22,902 received from the contractors was not taxable as it was capital in nature and not revenue?

E *Assessment year 1968-69:*

(1) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the hire charges of Rs. 17,913 received by the assessee-company for letting out of the plant and machinery to the contractors were not taxable?

F (2) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in holding that the royalty of Rs. 65,799 received from the contractor was not taxable as it was of capital in nature and not revenue?

G *Assessment year 1969-70:*

(1) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the hire charges amounting to Rs. 46,342 received by the assessee-company for letting out of the plant and machinery to the contractors were not taxable?

H (2) Whether, on the facts and in the circumstances of the case, the

Tribunal was justified in law in holding that the royalty of Rs. 25,928 received from the contractors was not taxable as it was of capital nature and not revenue? **A**

*Assessment year 1970-71:*

(1) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the interest received by the assessee-company on the amount of Rs.7,50,502 advanced to the contractors was not taxable? **B**

(2) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the hire charges of Rs. 182 received by the assessee-company for letting out the plant and machinery to the contractors were not taxable? **C**

(3) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in holding that the royalty of Rs.13,052 received from contractors is not taxable as it is of capital nature and not revenue? **D**

(4) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding miscellaneous receipt of Rs. 49 as not taxable? **E**

*Assessment year 1971-72:*

(1) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the interest received by the assessee-company on the amount of Rs. 14,98,993 advanced to the contractor was not taxable? **F**

(2) Whether, on the facts and in the circumstances of the case, the tribunal was justified in law in holding that the hire charges of Rs.3,68,442 received by the assessee-company for letting out the plant and machinery to the contractors were not taxable? **G**

(3) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in holding that the royalty of Rs. 6,504 received from the contractors is not taxable as it is capital in nature and not revenue? **G**

(4) Whether, on the facts and in the circumstances of the case, the **H**

A Tribunal was justified in law in holding that the interest received amounting to Rs.7,39,332 by the assessee-company on the amount advanced to M/s. Hindustan Steel Ltd. is not taxable?"

For the assessment year 1972-73 a consolidated reference was made at the instance of the revenue as well as the assessee and the following questions were referred:-

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“(1) Whether on the facts and in the circumstances of the case, the receipts arising from the letting out of the quarters to the outsiders, such as employees of the contractors engaged in the construction of the plant can be treated as the income of the assessee and/or, in any event, should be adjusted against the cost of construction so as to reduce such cost?

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“(2) Whether on the facts and in the circumstances of the case, the receipts from the letting out of the properties to outsiders, such as the employees of the contractors engaged in the construction of the plant are to be assessed as income from property under section 22 of the Income-tax Act, 1961, or the said income should be assessed under section 28 of the Income-tax Act, 1961, as business income or in any event, under section 56 of the Income-tax Act, 1961, as income from other sources?

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“(3) Whether on the facts and in the circumstances of the case, the receipts arising from the letting out of the quarters to the outsiders, such as employees of the contractors engaged in the construction of the plant can be treated as the income of the assessee and/or, in any event, should be adjusted against the cost of construction so as to reduce such cost?

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“(4) Whether on the facts and in the circumstances of the case, the interest received from the bank on short-term deposits is liable to be assessed as the income of the assessee or such interest should reduce the cost of construction of the assessee and, therefore, would not constitute the income of the assessee?

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The assessee is a corporation wholly owned by the Government of India. It was assessed in the status of a company.

H The assessee-company, M/s Bokaro Steel Ltd., was incorporated in January 1964. Its object was to construct and own an integral iron and steel works.

During the assessment years under consideration, the work of construction of the company's factory and installation of the plant was in the process of completion. The company had not started any business during the assessment years in question. A

(1) During this period the company had given to the contractors quarters for the residence of the staff and workers employed by the contractors who had been engaged by the assessee-respondent for carrying out the work of construction. The assessee charged the contractors for the use of the quarters so given to the contractors for the residence of his workmen who were engaged in the construction activity of the assessee's plant. B C

(2) Secondly, during the assessment years in question the assessee had entered into supplementary agreements with its contractors under which the assessee had made certain advances to the contractors to enable them to execute the large scale construction work smoothly. The assessee had agreed to advance these advances to the contractors on payment of interest. The contractors thus did not have to raise funds from outside agencies. For the assessee-company, this arrangement primarily meant payment in advance of the amounts of the contractors' bills for which the assessee-company had charged interest. This interest was later adjusted against the dues of the contractors. D E

(3) For the purpose of the construction work the assessee had given on hire certain plant and machinery to the contractors. Against the letting of plant and machinery the assessee received from the contractors income in the form of hire charges. It was not the business of the assessee-company to let out plant and machinery to others. The assessee-company permitted its use only to its own contractors for the construction work done by the contractors for the assessee-company. The Tribunal has found that the assessee-company charged hire charges for such use of plant and machinery in order to cover the maintenance and wear and tear of the plant and machinery belonging to the assessee. F G

(4) The assessee-company allowed the contractors to use the stones lying on the assessee's land for construction work. The stones lying on the assessee's company's land were the capital assets of the assessee-company. The assessee charged the contractor a certain H

A amount by way of royalty for excavation and use of these stones for construction work.

(5) The assessee had, during the assessment year 1971-72 shown in its accounts as income from interest a certain sum said to have been accrued to the assessee from M/s Hindustan Steel Limited for eight locomotives supplied by the assessee-company to M/s Hindustan Steel Limited. The assessee-company, however, reversed this entry in the next year because eight new locomotives were supplied by M/s Hindustan Steel Limited to the assessee and no interest income actually accrued to the assessee.

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C We have to consider whether the amounts received by the assessee under these five heads can be treated as income of the assessee for the relevant assessment years. The Tribunal has held that all these amounts (under items 1 to 4) received by the assessee have gone to reduce the cost of construction. These are in the nature of capital receipts which can be set off against the capital expenditure incurred by the assessee during the relevant assessment years. This view has been upheld by the High Court and hence the department has come by way of the present appeals.

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During these assessment years, the respondent-assessee had invested the amounts borrowed by it for the construction work which were not immediately required, in short-term deposits and earned interest. It has been held in these proceedings that the receipt of interest amounts to income of the assessee from other sources. The assessee has not filed any appeal from this finding which is given against it. In any case, this question is now concluded by a decision of this Court in *Tuticorin Alkali Chemicals and Fertilizers Ltd. v. Commissioner of Income-tax*, (1997) 227 ITR 172. Hence, we are not called upon to examine that issue.

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F We will take the first three heads under which the assessee has received certain amounts. These are, the rent charged by the assessee to its contractors for housing workers and staff employed by the contractor for the construction work of the assessee including certain amenities granted to the staff by the assessee. Secondly, hire charges for plant and machinery which was given to the contractors by the assessee for use into the construction work of the assessee and thirdly, interest from advances made to the contractors by the assessee for the purpose of facilitating the work of construction. The activities of the assessee in connection with all these three receipts are directly connected with or are incidental to the work of construction of its plant undertaken by

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the assessee. Broadly speaking, these pertain to the arrangements made by the assessee with its contractors pertaining to the work of construction. To facilitate the work of the contractor, the assessee permitted the contractor to use the premises of the assessee for housing its staff and workers engaged in the construction activity of the assessee's plant. This was clearly to facilitate the work of construction. Had this facility not been provided by the assessee, the contractors would have had to make their own arrangements and this would have been reflected in the charges of the contractors for the construction work. Instead, the assessee had provided these facilities. The same is true of the hire charges for plant and machinery which was given by the assessee to the contractor for the assessee's construction work. The receipts in this connection also go to compensate the assessee for the wear and tear on the machinery. The advances which the assessee made to the contractor to facilitate the construction activity of putting together a very large project was as much to ensure that the work of the contractors proceeded without any financial hitches as to help the contractors. The arrangements which were made between the assessee-company and the contractors pertaining to these three receipts are arrangements which are intrinsically connected with the construction of its steel plant. The receipts have been adjusted against the charges payable to the contractors and have gone to reduce the cost of construction. They have, therefore, been rightly held as capital receipts and not income of the assessee from any independent source.

In the case of *Addl. Commissioner of Income-tax, New Delhi v. Indian Drugs and Pharmaceuticals Ltd.*, (1983) 141 ITR 134, the Delhi High Court considered a case where the work of construction of the factory of the assessee was in progress and production had not commenced. Receipts from sale of tender forms and supply of water and electricity to the contractors engaged in construction as also receipts on account of sale of stones, boulders, grass and trees were held to be receipts not from independent sources but were considered as inextricably linked with the process of setting up of business. These were directly related to the capital structure of business and were held to be capital in nature. We agree with this view taken by the Delhi High Court.

The appellant, however, relied upon the decision of this Court in *Tuticorin Alkali Chemicals and Fertilizers Ltd. v. Commissioner of Income-tax* (supra). That case dealt with the question whether investment of borrowed funds prior to commencement of business, resulting in earning of interest by the assessee would amount to the assessee earning any income. This Court

- A held that if a person borrows money for business purposes, 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. Merely because he utilised it to re-pay the interest on the loan taken, will not make the interest income as a capital receipt. The department relied upon the observations made in that judgment (at page 179) to the effect that
- B it the company, even before it commences business, invests 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 rented house and gets rent, such rent will be assessable to tax under Section 22 as income from house property.
- C Likewise, the 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. This Court also emphasised the fact that the company was not bound to utilise the interest so earned to adjust it against the interest paid on borrowed capital. The company was free to use this income in any manner
- D it liked. 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
- E 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. In the case of *Challapalli Sugars Ltd. v. Commissioner of Income-tax, A.P.*, (1975) 98 ITR 167, this Court examined the question whether interest paid before the commencement of production by a
- F company on amounts borrowed for the acquisition and installation of plant and machinery would form a part of the actual cost of the asset to the assessee within the meaning of that expression in Section 10(5) of the Indian Income-tax Act, 1922 and whether the assessee will be entitled to depreciation allowances and development rebate with reference to such interest also. The
- G Court held that 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 of such borrowed money can be capitalised and added to the cost of the fixed
- H assets created as a result of such expenditure. By the same reasoning if the

assessee receives any amounts which are inextricably linked with the process of setting up its plant and machinery, such receipts will go to reduce the cost of its assets. These are receipts of a capital nature and cannot be taxed as income. A.

The same reasoning would apply to royalty received by the assessee company for stone etc. excavated from the assessee company's land. The land had been allowed to be utilised by the contractors for the purpose of excavating stones to be used in the construction work of assessee's steel plant. The cost of the plant to the extent of such royalty received, is reduced for the assessee. It is therefore, rightly taken as a capital receipt. B

In the assessment year 1971-72, the assessee had shown in its books of accounts a sum of Rs.7,39,232 as income from interest received from Hindustan Steel Ltd. for the eight locomotives supplied by the assessee-company to them. The entry in this regard was reversed in the next year since M/s. Hindustan Steel Ltd.. had replaced the eight locomotives lent by the assessee-company to it by new ones. The entire nature of the transaction was changed between the parties. There was a resolution of the assessee-company in this regard and the income from interest did not result at all as the original agreement ceased to be operative ab initio. The entry in the books which was made was about a hypothetical income which did not materialise and the entry was reversed in the next year. Both the Tribunal as well as the High Court have held that since this entry reflected only hypothetical income, it could not be brought to tax as income. Only real income can be brought to tax. C D E

In support of this finding, the assessee has drawn our attention to a decision of this Court in *Godhra Electricity Co. Ltd. v. Commissioner of Income-tax*, (1997) 225 ITR 746 where the Court, inter alia, examined the case system and the mercantile system of accounting in the context of hypothetical income. The computation of income is made in accordance with the method of accounting regularly employed by the assessee. It may be either the case system where entries are made on the basis of actual receipts and actual outgoing or disbursements; or it may be the mercantile system where entries are made on accrual basis, that is to say, accrual of the right to receive payment and the accrual of the liability to disburse or pay. However, in both cases unless there is real income, there cannot be any income-tax. Considering the facts before it, the Court said that although the assessee-company was following the mercantile system of accounting and had made entries in the books regarding enhanced charges for the supply of electricity made to its F G H

A consumers, no real income had accrued to the assessee-company in respect of those enhanced charges in view of the fact that soon after the assessee-company decided to enhance the rate, representative suits were filed by the consumers which were decreed by the court and ultimately, after various proceedings which took place, the assessee-company was not able to realise the enhanced charges. The Court held that no real income had accrued to assessee-company and hence the entries in respect of enhanced charges did not reflect the real income of the assessee and could not be brought to tax by the Income-tax Officer.

C In the present case also the entry which was initially made as interest was reversed the next year because in fact the nature of the transaction was changed and the assessee did not receive any real income. The High Court has, therefore, rightly held this entry as not reflecting the real income of the assessee and hence not exigible to income-tax. In the premises, the appeals are dismissed. There will, however, be no order as to costs.

D M.P.

Appeals dismissed.