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Chartered Accountants

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Interest earned on funds inextricably linked to asset acquisition not taxable as revenue receipt, to be adjusted from cost of asset[1]

Snapshot

The issue before the Hon'ble Delhi High Court was whether the interest earned on funds temporarily placed in short-term fixed deposits is a 'capital receipt' or a 'revenue receipt' chargeable to tax under the head 'Income from Other Sources' (IFOS).

In this case, the Taxpayer raised funds from its shareholders for the acquisition of a coal mine, which were temporarily kept in the short-term fixed deposit in the bank pending utilization. Since these funds were not surplus but specifically earmarked for acquisition of a coal mine overseas, the Hon'ble Delhi High court held that interest earned on borrowed funds, temporarily held in interest bearing deposit, forms part of the capital cost and must be credited to CWIP.

Facts of the case

The Taxpayer, a joint venture SPV formed by five public sector undertakings (SAIL, CIL, RINL, NMDC, and NTPC), was incorporated with the purpose of ensuring reliable coal supply for its promoter companies by acquiring resources, including an overseas coal mine.

In AY 2012-13, the Taxpayer earned interest income of Rs. 11.46 crores on funds received from its promoters for the acquisition of an overseas coal mine and paid Rs. 11.15 crores as interest to its promoters. The net amount was capitalized under 'Capital Work-in-Progress' (CWIP), and the income was declared as NIL. However, the Assessing Officer (AO), in the assessment order, made an addition of Rs. 31 lakhs, being the difference between the interest earned and paid, as 'Income from Other Sources' (IFOS).

On appeal, CIT(A) upheld the AO's decision categorizing the interest earned as 'revenue receipt' taxable under IFOS and not a 'capital receipt'. Additionally, the CIT(A) ruled that the interest paid to promoters amounting to Rs. 11.15 crores could not be deducted under section 57(iii) from the interest earned, as it was not incurred 'wholly and exclusively' for the purpose of earning interest income. Consequently, the CIT(A) determined the Taxpayer's income to be Rs. 11.58 crores.

On further appeal, the Hon'ble ITAT allowed the Taxpayer's appeal, thereby setting aside the orders of both the CIT(A) and the Assessing Officer (AO). Dissatisfied, the Revenue appealed before the Hon'ble Delhi High Court.

Taxpayer's Arguments

The Taxpayer contends that the interest income earned is not chargeable to tax under the head IFOS as it is directly linked to the acquisition of a coal mine, a capital asset. The Taxpayer argues that the interest payable on the funds borrowed for acquiring the asset should be capitalized and added to the total cost of the asset. Similarly, any interest earned on such funds, which were temporarily kept in an interest-bearing account pending

[1] *Pr. Commissioner of Income Tax – 4 vs. International Coal Ventures Pvt. Ltd. (ITA 1174/2018) (Delhi High Court) (TS-934-HC-2024(DEL))*

utilization, should be adjusted against the cost of the asset. The Taxpayer relied on the Delhi High Court's decision in *Indian Oil Panipat Power Consortium Limited [2009] 181 Taxman 249 (Delhi)* to support this view.

Revenue's Arguments

The Revenue argues that the ITAT failed to recognize that the funds invested by the Taxpayer in fixed deposits were surplus funds, and therefore, the interest earned on these funds should be taxable under the head 'Income from Other Sources'.

Decision of the Hon'ble Delhi High Court

The Hon'ble Delhi High Court observed that the Taxpayer received funds from promoters for acquiring an overseas coal mine, but the proposal was eventually aborted, and the funds were refunded. During this period, the funds were placed in fixed deposits, generating interest, and the Taxpayer paid interest on the amount to the promoters.

The Court emphasized that preoperative expenses incurred to establish a business should be capitalized as part of an asset's value. These costs should not be treated as revenue expenses, as they cannot be matched with revenue receipts. Costs related to asset construction or acquisition, especially when significant time is involved, must be included in the asset's cost. The court distinguished between the price of an asset and its cost, stating that amounts directly linked to its acquisition should reduce the capital cost, citing Accounting Standard AS-16 and India Accounting Standard (Ind AS) 23.

The Hon'ble Delhi High Court relied on the SC judgment in *Challapalli Sugar Limited v. CIT (1975) 98 ITR 167*, which held that interest incurred on borrowings used for constructing assets before production starts can be capitalized as part of the asset's cost. This principle applies to both borrowed funds and share capital raised for construction.

The court distinguished the case from *Tuticorin Alkali Chemicals and Fertilizers Limited v. CIT (1997) 227 ITR 172*, noting that in the latter, the funds were surplus and unrelated to the creation of a capital asset, making the interest taxable as revenue. In the present case, the funds were earmarked specifically for the coal mine acquisition.

The court held that the interest earned on such funds was inextricably linked to the acquisition of the coal mine, a capital asset. Therefore, the interest was considered a capital receipt and required to be capitalized as part of the CWIP. This decision was consistent with earlier rulings, including *Bokaro Steel Ltd. (1999) 236 ITR 325 and Indian Oil Panipat Power Consortium Ltd. [2009] 181 Taxman 249 (Delhi)*, which held that income directly linked to the creation of a capital asset should be treated as part of the capital cost and is required to be credited to CWIP.

KCM Comments

This judgment offers valuable clarity on the tax treatment of interest income earned from funds earmarked for specific capital projects. By classifying such income as a capital receipt and linking it directly to the acquisition of a capital asset, the Court aligns with established accounting principles under AS-16 and Ind AS-23. These standards mandate that preoperative costs associated with asset acquisition be capitalized as part of the asset's cost, ensuring a coherent treatment of such expenses and income.

It is noteworthy, however, that the introduction of Income Computation and Disclosure Standards (ICDS) by the Tax Department, effective from AY 2017-18, adds a layer of complexity. Specifically, ICDS IX on Borrowing Costs mandates capitalization of actual borrowing costs for funds raised for asset acquisition, construction, or production. Unlike AS-16 and Ind AS-23, ICDS IX does not explicitly allow for the adjustment of income earned on temporary investments made with such funds. This divergence increases the likelihood of litigation, particularly in cases where temporary interest income is in question post - ICDS implementation.

Additionally, the ruling effectively distinguishes the present case from earlier precedents such as *Tuticorin Alkali Chemicals*, where surplus funds unrelated to capital asset creation were rightly treated as revenue receipts. By adhering to the principle that interest earned on funds specifically raised for capital expenditure forms part of the capital cost, the Court not only ensures consistency with judicial precedent but also provides businesses with greater certainty on tax implications for long-term capital projects.

While this judgment reinforces key principles of tax treatment for capital projects, businesses must remain vigilant regarding evolving regulatory standards like ICDS. Ensuring compliance while preparing for potential litigation under these frameworks is crucial for effective tax planning and financial reporting.

For further analysis and discussion, you may please reach out to us.

Locations

Ahmedabad
Arpit Jain
Level 11, Tower B,
Ratnaakar Nine Square,
Vastrapur,
Ahmedabad - 380 015
Phone: + 91 79 4910 2200
arpit.jain@kcmehta.com

Bengaluru
Dhaval Trivedi
4/1, Rudra Chambers, First Floor, 4th Main, B/W 8th & 9th Cross Road, Malleshwaram,
Bengaluru - 560 003
Phone: +91 80 2356 1880
dhaval.trivedi@kcmehta.com

Mumbai
Bhadresh Vyas
315, The Summit Business Bay,
Nr. WEH Metro Station,
Gundavali, Andheri East,
Mumbai – 400 069
Phone: +91 22 2612 5834
bhadresh.vyas@kcmehta.com

Vadodara
Milin Mehta
Meghdhanush,
Race Course,
Vadodara - 390 007
Phone: +91 265 2440 400
milin.mehta@kcmehta.com