

Cit Vs. Syndicate Bank

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Court : Karnataka

Decided On : Dec-05-2002

Reported in : [2003]127TAXMAN287(Kar)

Appeal No. : ITRC No. 22 of 1997 5 December 2002

Appellant : Cit

Respondent : Syndicate Bank

Advocate for Pet/Ap. : E.R. Indra kumar, *for the Revenue* K.P. Kumar, *for the Assessee*

Judgement :
ORDER

Shylendra Kumar, J.

In this reference at the instance of the revenue for the assessment year 1987-88 the Tribunal has referred the following 3 questions for the opinion of this court :

'1. Whether on the facts and in the circumstances of the case, the Tribunal is right in law in holding that the assessee is correct in following cash system of accounting for interest receivable on sticky loans and mercantile system of accounting for other receipts ?

2. Whether on the facts and in the circumstances of the case, the Tribunal is right in law in holding that the interest on sticky loans should be assessed on cash basis and not on accrual basis ?

3. Whether, on the facts and in the circumstances of the case, the Tribunal is correct in holding that penal interest paid to Reserve Bank of India is not disallowable ?'

2. On a perusal of the statement of case as provided by the Tribunal it appeared that the revenue had initially sought for referring as many as 6 questions for the opinion of this court. However, the Tribunal finding that two of the questions being academic in nature, inasmuch as similar questions had been answered by this court earlier did not deem it fit to refer the same. In respect of the other 4 questions the Tribunal has thought it fit to refer as is now referred for our opinion.

3. The facts as emerge from the statement of facts by the Tribunal is that the respondent-assesses a nationalised bank carrying on the business of banking had been following the mercantile system of accounting for the purpose of computing its profits. The assessee had adhered to the mercantile system of accounting in respect of its transactions uniformly. However, it appears that in respect of certain categories of loans considered to be sticky loans which comprised of 3 types of transactions, viz.,

(1) suit filed accounts,

(2) claims lodged accounts, and

(3) accounts provided for bad and doubtful debts, the interest income on these loans was sought to be offered to tax on cash basis, in the sense that the interest income from these loans were actually reflected in the books of account on receipt basis and not on accrual basis.

In respect of the interest arising out of such sticky loans the assessee had put a claim that it was shifting over to the cash system of accounting wherein such accounts had been categorised as sticky loans and such transactions fell in one or other of the 3 classified types of transactions referred to above. Also it transpires

from the statement that the assessee bank did not give up its claim for interest in respect of such transactions in the nature of sticky loans, and on the other hand it appears that suits had been filed claiming repayment of the capital and the interest amount. Interest was being claimed pendente lite also. Nevertheless the assessee was not offering interest attributable to such transactions of sticky loans as part of the total income as and when they were categorized as such, and when they indicated that they are following the cash system of accounting in respect of the interest out of such sticky loans. It transpires that a sum of Rs. 24,21,43,522 was interest attributable for the accounting period relevant for the assessment year 1987-88 which the assessee has earned in respect of such sticky loan transactions. The assessee nevertheless did not offer this amount for tax on the premise that the assessee having chosen to follow the cash system of accounting in respect of these transactions, amount can be offered to tax as forming part of the total income only in the corresponding assessment year referable to the accounting year during which year the assessee actually receives the amount. The question as to whether such interest amount forms part of the total income of the assessee, liable to be taxed in the assessment year under consideration is the subject-matter of the first two questions referred to for our opinion. It appears that the assessing officer had disallowed the claim of the assessee that it is not assessable in the assessment year in question and had brought to tax the income in respect of such interest amount also in the assessment year on accrual basis. The assessee having carried the matter further by way of appeal before the Commissioner of Income Tax met with success as the Appellate Commissioner agreed with the stand of the assessee. The revenue appealed to the Appellate Tribunal, and the appeal having been dismissed by the Tribunal the revenue had sought for reference of these questions for our opinion.

4. The facts leading to the third question that has been referred to for our opinion that the assessee in the course of its banking activity is governed and regulated by the provisions of the Banking Regulation Act, 1949 and it is imperative that the assessee was required to comply with the provisions of section 24 of this Act in the course of its business activities and for having not complied with the same had been levied with the penal interest under the provisions of section 24(4)(a) of this Act which in all amounted to a sum of Rs. 10,37,035 during the accounting period

relevant for the assessment year in question. It is the case of the axis-bank that this amount paid by way of penal interest for certain infractions of the provisions of the Banking Regulation Act, 1949 being incidental and in the course of the business activities of the assessee and which was beyond the control of the assessee, should be allowed as a deductible expenditure under the provisions of section 37 of the Act. The assessing officer having disallowed this claim of the assessee also, the assessee questioned this action in the appeal before the Appellate Commissioner and the Appellate Commissioner had accepted the stand of the assessee following its similar decisions for earlier years and the appeal of the revenue on this aspect before the Tribunal also having met with the same fate as the other issues and the Tribunal holding that it had consistently allowed such penal interest as deductible expenditure in respect of assessments for the earlier years, it finds no reason to deviate from such view for the assessment in question. However, the Tribunal has thought it fit to refer the question of law on this aspect for our opinion rejecting the assessee's contention that as the revenue had not sought for referring such a question for the opinion of the High Court for the earlier years they cannot do so for the assessment year in question.

5. In this background these two aspects arise for our consideration and the questions are posed in that context for our opinion. Sri Indra kumar, learned senior standing counsel for the Income Tax Department appearing on behalf of the revenue has submitted that the assessing officer was perfectly justified in bringing to tax interest attributable to the so-called sticky loans as characterised by the assessee, having regard to the fact that the assessee has been following the mercantile system of accounting in respect of all other transactions of the assessee. It is the submission of the learned counsel that the mere fact that the assessee does not receive the interest amount from its customers or such transactions characterised as sticky loans or the possibilities of the assessee realising such interest amount being very remote are all not factors germane to the question of bringing to tax this interest amount by adding that to the total income of the assessee for the relevant period. It is the submission of the learned counsel that the concept of accrual and arisal is what was under consideration and apart from the provisions of section 2(24) read with section 5 of the Income Tax Act the decision of the Apex Court rendered in the case of State Bank of Travancore v.

CIT : [1986]158ITR102(SC) makes it very clear that the assessee bank is liable for payment of tax on this interest attributable to sticky loans also on accrual basis and as such the interest amount should be brought to tax without waiting for the receipt of such income. It is the submission of the learned counsel in this regard that the Apex Court had occasion to consider the concept of real income in the case of State Bank of Travancore (supra) and it has been very clearly pointed out by the Apex Court that the accrual or arisal of the income is not dependent on the volition of the parties or on the conduct of the parties such as making entries in the books of account or in the ledgers indicating the debits and credits to the customers account and to the banks interest account, etc., but happens because of the operation of the law, because of the provisions of the Act, namely, section 5 of the Act, and having regard to the transactions between the parties. It is submitted that in respect of an assessee following mercantile system of accounting the moment the assessee becomes entitled for receiving the income which happens even at the stage of accrual or arisal the income becomes taxable and it cannot be postponed to any further period. If this principle is to be applied to the facts of the present case it is very obvious that the interest attributable to the sticky loans having accrued to the axis-bank during the relevant accounting period it should be brought to tax in the corresponding assessment year and applying the ratio laid down by the Apex Court in the State Bank of Travancore's case (supra) interest income found on sticky loans should be assessed to tax. Sri Indra kumar elaborating his submissions has further submitted that the Appellate Commissioner as well as the Tribunal have misdirected themselves in not properly understanding the ratio laid down by the Apex Court in the case of State Bank of Travancore (supra) and at any rate are not justified in distinguishing the said decision as not applicable to the fact situation of the assessee.

6. We have perused the orders of the Appellate Commissioner and the order passed by the Tribunal in the appeal filed by the revenue. It is true that the reasonings which are given by the Appellate Commissioner or the Tribunal are not very cogent in the sense the Appellate Commissioner and the Tribunal have not really appreciated the stand taken by the assessee in this regard on an overall reading of the orders of the lower authorities and the stand taken by the assessee. It emerges that the assessee had been contending that it was not offering income

to the tax merely for the reason that it has switched over to the cash system of accounting in respect of the interest on sticky loans and as such the question of offering interest amount by way of income on accrual basis does not arise and if at all that income is to be assessed to tax that could only be on receipt basis in the accounting year that it is actually received and in the corresponding assessment year. If this is the stand of the assessee the question as to whether the income is real income or not or as to whether the income has accrued to the assessee or not, is not in dispute or not denied by the assessee. In fact accrual or arisal is a stage which is always anterior to the receipt and there is no denial that it is only an income which is accrued that is received at a later point of time. May be in certain situations the accrual and the receipt may be simultaneous but in most of the cases the accrual stage is earlier and the receipt stage is later.

7. It is the further case of the assessee that the assessee has been consistently following this hybrid system of accounting in respect of the interest on sticky loans for the past more than 35 years and that the department having not only permitted but also having recognised the hybrid system of accounting followed by the assessee whereby the assessee has adopted cash system, only in respect of interest on sticky loans and mercantile system of accounting in respect of all other transactions. On this basis, it is the contention for the assessee that there is no reason why the assessee should not be permitted to follow the same system in the accounting year relevant for the assessment year in question. On this aspect the assessee's stand is that the department having not taken any objection to the levy of tax on the method of accounting that is followed by the assessee for all these years the revenue is not entitled to deny that method of accounting for the assessment year in question alone and to compel the assessee to follow the mercantile system of accounting even in respect of the interest on sticky loans. It is the case of the assessee that the assessee having been permitted to follow this hybrid system of accounting and no action having been taken for long on such hybrid system of accounting it is not open to the department to bring to tax or add the amount of interest attributable to sticky loans to the total income for the period corresponding to the assessment year in question on the basis of accrual. It is the submission on behalf of the assessee that it virtually amounts to rejection of the method of accounting followed by the assessee by the department if that is

allowed to be done and revenue having not chosen to give any reason or not having pointed out any defect or incongruity in the method of accounting that is being followed by the assessee insofar as interest attributable to the sticky loans are concerned they can be brought to tax only in receipt basis and if this is the position in law the question of including the interest amount in the total income for the accounting period corresponding assessment year in question does not arise. On this aspect of the controversy the learned counsel for the revenue as well as Sri K.P. Kumar learned counsel appearing on behalf of the assessee have made very elaborate submissions and have relied upon a large number of authorities in support of their respective submissions. We will briefly refer to these decisions to the extent they are necessary for the purpose of expressing our opinion in this reference. However, at this juncture we deem it fit to notice another factor, viz., that the order passed by the Income Tax Tribunal out of which these 3 questions have been referred for our opinion was an order which had been passed in common along with two other appeals which had been preferred by the revenue involving two other banks, viz., M/s. Canara Bank and M/s. Vysya Bank. The Tribunal has passed a common order in respect of the 3 appeals involving the 3 banks. We are informed that in respect of the other two banks, viz., M/s. Canara Bank and M/s. Vysya Bank, questions on the taxability of the interest on sticky loans had been referred for the opinion of this court in earlier references, viz., in ITR C No. 21/1998 (in respect of Canara Bank for the assessment year 1981-82), ITR C Nos. 602 and 603 (in respect of Canara Bank for the assessment year 1986-87) and ITR C No. 929/98 (for the assessment year 1984-85), ITR C No. 298/90-98 (in respect of Vysya Bank for assessment year 1990-91) and ITR C Nos. 807/98 and 808/98 (for the assessment years 1987-88 and 1988-89 respectively). The Division Bench of this court had answered all these questions by the earlier decisions on different dates in favour of the assessee and against the revenue. In this view of the matter, though it would have been proper for us to simply follow the opinion expressed by the earlier Division Bench and dispose of this reference also but as the learned Standing counsel for the revenue brought to our attention the orders passed in those references and submitted that the Bench having not given adequate reasonings for not following the decision of the Apex Court which is relied upon in this reference also in support of its case and the

earlier Division Bench having proceeded on the premise that the decision of the Apex Court rendered in State Bank of Travancore's case (supra) having been subsequently noticed in the case of UCO Bank v. CIT : [1999]237ITR889(SC) though it was noticed the said earlier decision in State Bank of Travancore's case (supra) was explained and that was not followed having regard to the circulars that held the field at the relevant point of time it may be still necessary to look into these aspects of the matter for answering the question afresh and requested for a reasoned order on this aspect of the matter. It is in this context the learned counsel have been permitted to make detailed submissions.

8. In this regard it is the stand of the revenue that the subsequent decision of the Supreme Court in UCO Banks case (supra) has in no way touched upon the principles that had been laid down as noticed in the case of State Bank of Travancore (supra) particularly on the aspect of accrual of the income and the concept of real income and if those principles are applied as enunciated in the decision of the Apex Court which according to the learned standing counsel for the revenue, does not in any way detract from any principles laid down in the State Bank of Travancore's case (supra), the question posed for the opinion of this court may still have some significance before this court and may be necessary for discussion. It is for this reason that the learned counsel has sought for the detailed order notwithstanding the earlier reference having been answered in favour of the assessee and against the revenue.

9. Shri K.P. Kumar, learned counsel appearing on behalf of the assessee has submitted that the authorities below have clearly distinguished the facts of the present case and have clearly held that the ratio laid down in State Bank of Travancore's case (supra) is not attracted and to this extent the earlier reference answered by the Division Bench of this court is perfectly correct and there is no scope for taking a different view from the one expressed by the earlier Division Bench. In view of the rival submissions we gave our anxious thought to the controversy at issue and we thought it fit that we can have a look at the matter afresh particularly in view of the elaborate submissions that had been made at the Bar and reach a conclusion and if such conclusion is in any way different or other than the view that has already been expressed then alone further action may be

required in this regard and it is for this purpose only we have examined the submissions addressed in the course of this reference though similar references arising out of the common order of the Tribunal have already been answered against the revenue by this court in the earlier cases. Sri E.R. Indra kumar learned senior standing counsel for the revenue has cited and placed reliance on the following decisions in support of his submission that the interest income on sticky loans also should be included in the accounting year corresponding to the assessment year in question on accrual basis, the income being real in nature and the assessee having become entitled to receive this income and not having given up its right to receive the same at any time before the income became due to the assessee. The decisions are :

1. ED. Sassoon & Co. Ltd. v. CIT : [1954]26ITR27(SC)
2. CIT v. A. Gajapathi Naidu : [1964]53ITR114(SC) .
3. CIT v. Swadeshi Cotton & Flour Mills (P) Ltd. : [1964]53ITR134(SC) .
4. CIT v. A. Krishnaswami Mudaliar : [1964]53ITR122(SC)
5. CIT v. British Paints Ltd. : [1991]188ITR44(SC) .
6. Morvi Industries Ltd. v. CIT : [1971]82ITR835(SC)
7. CIT v. V Sampangiramaiah : [1968]69ITR159(KAR)
8. CIT v. ABV Gowda : [1986]157ITR697(KAR) .
9. State Bank of Travancore's case (supra);
10. UCO Banks case (supra);
11. K.R.M.T.T. Thiagaraja Chetty & Co. v. CIT : [1953]24ITR535(SC)
12. State Bank of India v. CIT : [1986]157ITR67(SC)
13. CIT v. Confinance Ltd. : [1973]89ITR292(Bom) .

On the other hand Sri K.P. Kumar, learned counsel appearing on behalf of the assessee has placed reliance upon the following decisions in support of the submission that the assessee having been permitted to follow the hybrid system of accounting, i.e., the mercantile system of accounting in respect of its entire business transactions except insofar as the interest attributable to what it had classified as interest on sticky loans in respect of which the assessee had been permitted to follow the cash system of accounting and the assessee having followed this hybrid method of accounting for the past over 30 years and the department also having accepted this and having not found fault with such method of accounting followed by the assessee it is not liable to tax on the interest attributable to the sticky loans though it might have accrued or arisen in the accounting year corresponding to the assessment year in question but can be brought to tax only on receipt basis as and when such interest is brought to tax only on receipt basis as and when such interest if at all is received, on the basis of cash system of accounting and the revenue having not rejected the method of accounting that is being followed by the assessee for the past 30 years and also during the relevant year and the revenue not having indicated or assigned any cogent or convincing reasons to reject the method of accounting followed by the assessee particularly in respect of interest on sticky loans it is not open to the revenue to bring to tax such interest attributable to sticky loans during the accounting year either on accrual or arisal basis. The said decisions are :

1. CIT v. City Bank N.A. : [1994]208ITR930(Bom) .2. CIT v. ICICI Ltd. : [1991]189ITR126(Bom)

3. CIT v. North Arcot Distt. Co-operative Spg. Mills : [1984]148ITR406(Mad)

4. CIT v. M.P. Financial Corpn. : [1997]227ITR888(MP)

5. CIT v. Rajasthan Financial Corpn. (No.

1)

6. CIT v. Rajasthan Financial Corpn. (No.

2)

7. CIT v. A.P. Industrial Infrastructure Corpn. : [1999]236ITR648(AP) .Sri. K.P. Kumar has also placed reliance on an unreported decision of the Division Bench of this court rendered in the case of CIT v. Vysya Bank Ltd. (ITRC Nos. 807 and 808 of 1998 dated 24-1-2000).¹⁰. Before we take up discussion on the case law cited and relied upon by the learned counsel in support of their respective submissions we think it will be profitable to mention as to what is the real controversy in issue and what issues are required to be addressed by this court to answer the reference. In this regard unfortunately the learned counsel has not zeroed in on the real controversy that is required to be resolved as it arises in the context of the facts of the present case but have proceeded to support their respective submissions without so much as addressing as to point out either the fallacy or the irrelevance of the number of decisions relied upon by their counter part. To appreciate the real controversy it is necessary to understand the basic scheme of the Income Tax Act.¹¹. Under the Act the total income of an assessee earned during the period of 12 months known as the previous year is brought to tax in the following or subsequent year known as the assessment year applying the rate/rates of Income Tax Act as provided by the Finance Act of each year corresponding to an assessment year. The charging section is the section 4 of the Act and the scope of total income which is the subject-matter of charge is to be determined on a proper understanding of section 2(25) which defines total income and section 5 which indicates the scope of such total income. Under section 5 of the Act it is indicated that the income can be brought to tax either on receipt basis on the one hand or on accrual basis or arrival basis on the other hand. When it is on the receipt basis the income is obvious and its physical form is experienced. When the income is brought to tax on accrual or arrival basis it is based on the right to receive such income and accrues or arises at that point of time when the right to receive become tangible and enforceable and crystallises into a definite sum. In either situations either on receipt basis or on accrual or arrival basis the income is real and either has reached the assessee or has given rise to a right to the assessee to receive or enforce the same.¹². Profit and gains of business or profession is one among the heads of income under the Income Tax and in computing the income attributable to such business or profession and while determining the same an assessee is given the choice to choose the method of

accounting for computing such profits or gains as provided under section 145 of the Act. In the manner of following the method of accounting for computing the profits an assessee is given considerable latitude and the only real restriction that is sought to be placed as can be culled out from settled legal principles is that the method of accounting followed should be such as to bring out or to ascertain the true and correct profits of the assessee for the accounting year in question. An assessee is also given the option to change its method of accounting from one system to another system and the assessee is also given the further option to adopt different methods of accounting in respect of different sources of income.¹³ Under the scheme of the Act it is enjoined upon the authorities in implementing and enforcing the provisions of the Act, to scrupulously follow the provisions of the Act, bring to tax income of the previous year only in the corresponding assessment year and in no other year subject to the exceptions provided in the Act itself. In the matter of determining as to in which assessment year the income of the assessee is to be subjected to tax not much choice is given either to the revenue or to the assessee but it is dependent on the application of the provisions of the Act. It is this background that the learned counsel for the revenue is canvassing the submissions that even the interest attributable to the sticky loans having accrued or arisen to the assessee during the previous year relevant to the assessment year in question and such an income being also real in nature and the assessee having not either renounced or given up the right to receive such income before such accrual or arisal and on the other hand the assessee having consciously indicated that it is entitled for such interest even on sticky loans which the borrowers from the bank were not in a position to pay the same, the assessing authority is duty bound to include this income as part of the total income of the assessee computed for the previous year in question and the mere fact that it was not being so included in the earlier years would not make any difference to the legal position and as such the assessment for the year by which the interest on sticky loans has been included in the total income of the assessee should be upheld and sustained. On the other hand, Sri K.P. Kumar learned counsel for the assessee has submitted that the axis-bank does not dispute the liability if the said interest income on sticky loans is to be brought to tax either on accrual or arisal basis but has sought to contend that the assessee having been permitted to follow

its own method of accounting as provided under section 145 of the Act and such method of accounting having been permitted and not objected to by the department hitherto and if the cash system of accounting followed by the assessee in respect of interest attributable to sticky loans is to be accepted the effect of it is only to postpone the assessment of income attributable to interest on sticky loans to a later year when the amount is actually received and at any rate the income attributable to interest on sticky loans cannot be included as part of the total income of the previous year in question and as such the assessee is not liable.¹⁴ The submissions made on behalf of the revenue by Sri Indra kumar, learned senior standing counsel though appear to be perfectly valid and well supported by the legal principles enunciated by the various decisions cited and relied upon by the learned counsel, it unfortunately does not help to resolve the controversy in hand inasmuch as it does not address the real issue in dispute. Here the dispute is not so much with reference to the real nature of income and infact it is not a dispute at all inasmuch as the assessee is not disputing the real nature of income, but the dispute is as to at what point of time and during which accounting period and which corresponding assessment year such income is to be assessed and brought to tax. If this aspect is borne in mind it becomes clear that the reliance placed by the learned counsel for the revenue on the various decisions cited by him does not further to demolish the case of the assessee. In the instant case the assessee is not at all disputing that interest could have accrued or arisen during the previous year relevant for the assessment year in question. There is no controversy either on the real nature of income. The controversy is only with regard to the point of time when such income is to be assessed. This is determined by the method of accounting that is being followed by the assessee in the instant case and when once there is no infirmity or illegality or any contravention of any of the provisions of the Act by the assessee in following the method of accounting which it has been doing, then there is no scope for compelling the assessee to offer such income to tax for the accounting period other than the one in which the assessee has to offer the incomes to tax as per the method of accounting followed by the assessee. In this situation we will briefly refer to the various decisions cited by the learned counsel and indicate our conclusions on the same.¹⁵ In *ED. Sassoon & Co. Ltd.s* case (*supra*), the

Supreme Court was concerned with the liability of an assessee who had sold away its rights to receive certain income in the nature of commission paid at a percentage of the profits earned by the principle company payable to its managing agent which in turn had been assigned in favour of the two other Companies by the assessee. The question was whether in respect of the assessment year 1944-45 the assessee was liable to pay tax on accrual basis in respect of the proportionate income attributable to the part of the year prior to the assignment affected by the assessee. Under the managing agency terms the assessee was entitled to receive commission at about 10 per cent of the total profits of its principal which profits were being determined on the 31st of March each year and the assessee's commission fixed on determination of such profits. However, during the year in question the assessee had on 1-12-1943 under an agreement assigned its office as managing agent and all rights and benefits under the Managing Agency agreement in consideration of a receipt of a fixed sum which he transported to its capital reserve account and assigned all such rights in favour of the transferee companies. In view of such facts the question was as to in respect of the assessment year 1944-45 whether the entire income attributable to the managing agency commission determined as on 31-3-1944 and which was received by the transferees was liable to be taxed in its entirety in the hands of the transferees or was to be apportioned between the assessee and its transferees proportionate to the length of the period during which the assessee and the transferees had worked, namely, commission attributable upto 1-12-1943 in the hands of assessee company and commission attributable to the subsequent period in the hands of the transferee companies. While M/s. E.D. Sassoon & Co. Ltd., the transferor assessee contended that no portion of the managing agency commission was taxable and for the year in question the transferees contended that they will be liable only to such portion of the commission earned subsequent to 1-12-1943 and the earlier commission should be taxed as income in the hands of the transferor; On a reference by the Income Tax Tribunal the Bombay High Court having answered the reference in favour of the transferees and against the revenue and M/s. E.D. Sassoon & Co. Ltd. the revenue appealed to the Supreme Court. The Supreme Court allowing the appeal held that no income accrued or arisen or arose in the hands of the transferor company and the question of

apportioning the commission does not arise inasmuch as the commission amount to be paid by the principal company itself was being determined only on the 31st March of the year when the profits of the principal company was being made up and ascertained and then only the actual amount of commission payable under the principal company and the managing agent was being ascertained for the first time and in such view of the matter no income accrued in the hands of the transferor company and the transferees also having received the entire commission then only will be liable in respect of such income attributable under the entire commission and were liable to tax. We are afraid that the principal laid down by the Supreme Court in this case and the ratio of the case does not in any way further the case of the revenue in the instant case. We fail to understand or appreciate the relevance of this decision to the facts of the present case particularly in the context of the question that has been referred for our opinion.¹⁶

A. Gajapathi Naidu's case (*supra*) is the next case referred to and relied upon by the learned counsel for the revenue. In this case the question for consideration was as to what point of time income accrues or arises. It was held that if in reality income accrued or arose in a subsequent year it cannot be relegated or brought to tax as income of an earlier year on the basis that it is attributable to the transaction effected in the earlier year. The facts that the assessee was a contractor supplying bread to Government Hospitals had, under one such contract supplied bread to the Government Hospital as per the agreed price during the period 1-4-1942 to 31-3-1949 and had received the contractual payments. However, on the representation of the assessee that in view of several adverse developments the assessee had incurred losses by supplying bread at the stipulated rates, made to the government the government directed a sum of Rs. 12,447 over and above the stipulated rate by way of compensation for the losses sustained by the assessee in supplying bread at the stipulated rates and this amount was received by the assessee during the accounting year 1950-51 and assessment year being 1951-52 was again reversing the decision of the Madras High Court which had held that the amount of Rs. 12,447 was also to be included in the income of the assessee for the assessment year 1949-50 as it was attributable to a transaction of period relevant for the assessment year. The Supreme Court allowing the appeal held that the amount of Rs. 12,447 which was received later by the assessee from the

government had neither accrued nor arisen to the assessee during the period relevant for the assessment year 1949-50, that it was a payment over and above the contractual terms and known as compensatory and systematic measure to enable the assessee to tide over the losses incurred by the assessee by adhering to the rates stipulated under the contract and as such the income can be earned only for the assessment year 1951-52 and not for an earlier assessment year. Sri E.R. Indra Kumar learned counsel contended that if it can be shown that income had accrued or arisen during any period relevant to the assessment year it should be brought to tax in that assessment year and no other year and on such premise the learned counsel submits that the interest payable on sticky loans having accrued or arisen during the period relevant for the assessment year in question the authorities are bound to bring such income to tax in this assessment year and not in any other subsequent year.¹⁷ Unfortunately here again the dispute is not as to when the income accrues or arises but when such income is to be brought to tax based on the method of accounting that is being followed by the assessee. Accordingly we are of the view that this decision also does not further the case of the revenue on the questions referred for the opinion.¹⁸ In *Swadeshi Cotton & Flour Mills (P) Ltd.*s case (supra) the Supreme Court was concerned with the question as to when actually the liability is incurred by the assessee for claiming the expenditure as a deduction. The assessee was following the mercantile system of accounting and in terms of an award made on 13-1-1949 the assessee was liable to pay a sum of Rs. 1,08,325. 9 Annas 3 Paise. By way of profit bonus to its employees. The assessee debited the amount for the current year 1947 corresponding to the assessment year 1948-49. It was held that the liability for payment of profit bonus was determined only under the award dated 13-1-1949 and it was also in fact paid during this calendar year and the question of debiting this amount to the profit and loss accounts made up during the current year 1949 by reopening such accounts does not arise at all even assuming that the assessee is following the mercantile system of accounting, inasmuch as this was a liability which arose for the first time under the award and the scheme of Income Tax Act is not provided for. Reopening of accounts for an assessment period on the basis of determination of liability subsequently though relatable to the earlier period, just as in the case of an income accruing or arising for the first time in a subsequent

year not added to the income of the earlier year on the basis of the income being attributable to the transaction of that earlier year and the Supreme Court following the ratio laid down in *A. Gajapathi Naidus* case (supra) dismissed the appeal of revenue confirming the view taken by the trial court that the assessee was entitled to claim deduction in respect of such bonus relating to the current year 1947, paid to the employees during January 1949 under the award relevant for the assessment year 1950-51 and as such as an allowable deduction in computing the income of the assessee for the assessment year 1950-51.¹⁹ Here again we fail to see any advantage the revenue can derive for the purpose of present case by relying upon this decision and the ratio laid down in the same.²⁰ The next case cited and relied upon by the learned counsel for the revenue is *A. Krishnaswamy Mudaliyars* case (supra). This was a case which arose in the context of provisions of sections 10 and 13 of the Income Tax Act, 1922 which were the corresponding provisions to the present section 145 of the Income Tax Act, 1961. In this case the return filed by the assessee as following the cash system of accounting for determining its profits and for determining the income was not accepted by the assessing officer and the assessing officer while rejecting the return which had indicated a net profit of Rs. 28,643 assessed the firm on the net profit of Rs. 93,642 by including a sum of Rs. 65,000 attributable to the value of the rights in the film over which firm had acquired leasehold rights and for the balance of the leasehold period. The assessing officer had indicated that the method of accounting followed by the assessee did not disclose the true profits of the assessee and as such had while rejecting the profits as declared by the assessee had assessed the income on the basis referred to above. The Supreme Court though found that the High Court had not properly applied itself or appreciated the questions involved in the case in calling for a statement to be made by the Tribunal and for referring the stated questions to its opinion and in answering them in favour of the assessee, nevertheless having regard to the larger issue of interpretation of the scope and meaning of proviso to section 13 involved in the case proceeded to examine the appeal before it at the instance of the revenue and concluded that the High Court was in error in holding that the assessee having maintained its accounts in cash system it was not open to the Income Tax Officer to add to the receipts from the business the value of the stock-in-trade at the end

of the year in determining the profits of business for the year in question and accordingly allowed the appeal holding that the assessing officer was entitled to ascertain the true profits and income of the assessee under proviso to section 13 of the Act and as such the assessee was liable on the income computed as per the assessment order. This is a case wherein the return filed by the assessee computing the profits of business had been specifically rejected by the assessing officer who was of the view that the method of accounting followed by the assessee did not disclose or help in determining the true profits of the assessee. It is no doubt true even under the provisions of section 145 proviso to section 145(1) of the Act does confer such a power on the assessing officer but unfortunately the inclusion of interest attributable to sticky loans is not because of the rejection of the returns filed by the assessee on the basis of method of accounting regularly followed by it being not able to project the true profits of the assessee but because of an estimation on the part of the assessing officer that such interest on sticky loans was not being offered as part of its income as it had neither arisen nor accrued to the assessee bank. The Income Tax Officer also relied upon the decision of the Supreme Court in State Bank of Travancore's case (supra) to hold that even the interest on sticky loans is includible in the total income though the assessee bank had neither debited such interest to the borrowers accounts nor had carried the same and credited it in its interest account. In view of this controversy we specifically called upon the learned counsel appearing for the revenue to place before us a copy of the Memorandum of Appeal preferred by the assessee in its appeal before the Commissioner (Appeals). The assessee had clearly taken up the stand in its appeal that having regard to the method of accounting that is being followed by the assessee which had been consistently followed by the past over 30 years and the assessee having been allowed to change over to the cash system of accounting in respect of interest on sticky loans the question of including such interest on sticky loans in the accounting period corresponding to the assessment year in question does not arise on the basis of either accrual or arisal. Though the Appellate Commissioner did not address this issue in such a manner nevertheless has allowed the appeal of the assessee on this aspect and granted relief.²¹ Having regard to the case of the assessee that it had been following the cash system of accounting only in respect of transactions

which have been categorised as sticky loans and this method of accounting followed by the assessee having not been either rejected or found fault with by the revenue and on the other hand the revenue having accepted the returns and computation of income based on such method of accounting for the past over 30 years the case cited by the learned counsel for the revenue does not lend support to the submission canvassed on behalf of the revenue to include the interest on sticky loans also while computing the profits of the accounting year relevant for the assessment year and ascertaining income for this year. Existence of power is one thing but exercise of that power in the manner and for the purpose for which it is meant for is another thing. The revenue is not able to demonstrate as to in what manner and for what reasons the assessing officer has exercised the power under section 145(1) to reject the returns of the assessee. In the absence of this basic foundation we are afraid that the decision relied upon by the learned counsel for the revenue does not help the revenue to answer the reference in its favour.²². The next decision relied upon by the learned counsel for the revenue is British Paints Ltd.'s case (supra). In this case the Supreme Court rejected the plea of the assessee that as the assessee had been following a particular system of valuing its stock-in-trade for a long number of years and had made that the basis for determining the profits and on the other hand reversing the decision of the High Court held that the assessing officer was duty bound under the provisions of section 145 of the Income Tax Act as to whether the system of accounting adopted by the assessee though had been followed regularly over a period of time was one which enables to arrive at the correct profits and gains and the assessing officer was of the opinion that it did not do so the assessing officer was duty bound to reject the method of accounting followed by the assessee and to adopt a course which could reflect true profits and gains. The principle enunciated in this case could have been of considerable help to the revenue if only had the case of the revenue could have been one for rejection of the method of accounting followed by the assessee for any justifiable reasons given by the assessing officer. Unfortunately the method of accounting followed by the assessee is not even frowned by the assessing officer is not one disclosing the profits of the axis-bank nor the assessing officer has categorically rejected the method of accounting followed by the assessee. Accordingly we are of the view that this case also does

not advance the case of the revenue.²³ Morvi Industries Ltd.s case (supra) is the next decision cited and relied upon by the learned counsel for the revenue. In this case the assessee which was acting as a managing agent of its subsidiary Company was following the mercantile system of accounting. Under the terms of agreement between the managed company and the assessee, the assessee was entitled to commission of certain percentage on the net profits of the managing company and under the terms of agreement such commission was due for the assessee on 4-4-1955 and 6-10-1956 in respect of the two assessment years which were in issue. By resolution of the Board of Directors of the assessee-company held on 24-11-1955 and 21-7-1956 respectively the Board resolved the assessee-company to relinquish the portion of its commission and other allowances payable to it by the managed company in view of the heavy losses that the managed company had suffered during the years in question but these resolutions had been passed subsequent to the two general body meetings of the managed company held 24-11-1955 and 21-7-1956 wherein the annual accounts of the managed company had been passed which included the commission payable to the assessee.²⁴ The Supreme Court affirming the view taken by the High Court held that the commission amount due to the assessee company having accrued on 31-12-1954 and 31-12-1955 and actual payment having been deferred till the passing of the annual accounts by the managed company the subsequent relinquishment of this right by resolutions of its Board by the assessee company had been in any way divert or reduce this income which already accrued to the assessee and as such the assessee was liable to pay tax on the income attributable to such commission also.²⁵ This was a case where subsequent to the accrual of income the assessee sought to purge itself of the same by its own resolution. This was not approved by the Supreme Court holding that the income which accrues or arises under the provisions of the Act and as per the law cannot be whisked away by the voluntary act of an assessee. It was pointed out that if the income never reaches the assessee then alone it will be a different proposition. However, this decision is also of not much avail to the revenue inasmuch as the assessee is not seeking to divest the income but is only contending that within the method of accounting followed and permitted the interest income attributable on sticky loans can be brought to tax as and when received under the cash system

and not on accrual or arisal basis.²⁶ The next case relied upon by Sri Indra kumar, learned senior standing counsel is of V. Sampangiramaiah's case (supra). In this case the attempt of the revenue to tax the entire interest income which was paid to the assessee, whose lands had been acquired by the state under the Land Acquisition Act and was paid during the accounting period relevant for the assessment year 1962-63 which had worked out to a sum of Rs. 87,265 was thwarted at the Appellate Tribunal stage holding that the interest attributable for a number of years, i.e., from the date of acquisition till the date of enhanced compensation to which the assessee became entitled to on the compensation amount being enhanced that the High Court would not be assessed as a revenue receipt for one assessment year in question but only the proportionate income attributable to the accounting year alone can be assessed to tax for the assessment year 1962-63. This view was affirmed by the High Court on the reasoning that the mere pendency of the appeal before the Supreme Court at the instance of the state against the enhanced amount did not and cannot arrest the accrual of interest on such enhanced compensation accruing from year to year and such interest income having accrued cannot be postponed to be taxed in one year when it was actually paid. The High Court rejected the contention of the revenue that unless the Land Acquisition Officer actually worked out the interest amount payable to the assessee, subsequent to the dismissal of the appeal of the revenue by the Supreme Court and as such could be brought to tax only during the assessment year in question and not for earlier years. The court also rejected the stand of the revenue that the assessee himself had not indicated the accrual of interest income in the earlier years and as such it was assessable to tax only during the accounting year relevant for the assessment year 1962-63. In this regard the court distinguished the decision of the Supreme Court in A. Gajapathi Naidus case (supra) by approving the reliance placed by the Tribunal on the ratio of the decision of the Supreme Court rendered in ED. Sassoon & Co. Ltd.s case (supra) and holding that the law as declared in ED. Sassoon & Co. Ltd.s case (supra) continues to hold the field and was in no way eclipsed by the subsequent decision of the Supreme Court rendered in A. Gajapathi Naidu's case (supra). In this view of the matter, the High Court did not find any reason to interfere with the view taken by the Tribunal and rejected the contention of the revenue. Sri. E.R.

Indra kumar, learned counsel appearing for the revenue placing reliance on this decision of the court submits that if interest income has accrued during the accounting period relevant for the assessment year in view of such legal position it is not open to the assessing officer to accept the stand of the assessee that it may be offered to income in the later year and as such cannot be brought to tax during the accounting year relevant for the assessment year. Again there are two distinguishing features. The first is in the case on hand we are concerned with interest income relevant for one accounting year assessable in the assessment year. This is not a case of income which had accrued over a period of time being brought to tax in one assessment year. Secondly there is no dispute on the accrual of the interest income during the accounting period in question. What is contended on behalf of the assessee is having regard to the fact that the assessee had been permitted to change to the cash system of accounting in respect of such interest the accrued income can be assessed to tax on receipt basis during the accounting period relevant for the assessment year during which the interest amount is received. We would not like to express any view on the correctness or otherwise of the decision of this court in V. Sampangiramaiahs case (supra) as we have our own reservations. However what is relevant for the purpose of the present case is that this decision also does not further the case of the revenue in the context of the controversy as it arises for our consideration.²⁷ The next case relied upon on behalf of the revenue is K.R.M.T.T. Thiagaraja Chetty & Co.s case (supra). We are afraid this decision and the ratio laid down in the decision also is not of much help in furthering the case of the revenue inasmuch as in K.R.M.T.T. Thiagaraja Chetty & Co.s case (supra) the Supreme Court had occasion to hold that the conduct of the managed company in postponing the commission payable to its managing agent and keeping the amount so due in suspense account, till the proposal to write off such payment was approved by the general body of shareholders, did not in any way detract from the fact that the assessee-company had become entitled to receive the said commission and the amount became due to it. The subsequent resolution to be passed by the shareholders of the principal did not in any way affect accrual of income to the assessee and as such the managing agent commission was assessable in the hands of the assessee-company. In the instant case it is not so much as to what entries the axis-bank had

made in its books of account that is determinative of the question whether the disputed interest income is assessable to tax in the assessment year or not. The liability is not made contingent or dependent on the entries so made by the assessee bank, though in the first instance the assessing officer appears to have discussed on this aspect to hold that the assessee had contended that the income is not real and no entries had been made by the bank to credit the interest amount to the interest account of the bank. This theory does not appear to have been canvassed by the assessee at all stages. The assessee stands on the other hand is only on the basis of the method of accounting that it has been following, which had been permitted and which it has followed for the accounting year corresponding to the assessment year in question also. If that is the controversy these decisions do not bear upon the controversy in issue and does not advance the case of the revenue.²⁸ Sri Indra kumar, learned senior counsel has placed strong reliance on the decision of the Supreme Court in the case of State Bank of Travancore (supra). In this case, the Supreme Court had occasion to consider as to the concept of 'real income' and once the income is 'real' and the income which is required to be brought to tax on approval basis accrues or arises to an assessee, there is no escape from bringing to tax such income in the corresponding assessment year. The Supreme Court also approved in this context, the observations made by the learned author Kanga in his 'Commentary on the Income Tax Act, 1969' 5th Edition occurring at page 665 which was quoted and approved by the Supreme Court. The particular sentences on which stress is laid by the learned senior standing counsel for the Income Tax Department is ' . . . having adopted a regular method of accounting, the assessee cannot be allowed to change it or depart from it for a particular year or for part of the year or in respect of particular transactions'. Relying upon such observation, learned counsel for the revenue submits that the assessee having adopted mercantile system for the purpose of offering his income to tax, income attributable to interest on sticky loans are doubtful loans being part of the income of the assessee and interest being charged to the account of the assessee periodically, accrues to the assessee as and when such interest becomes due to the bank and the income being 'real', the assessee is required to operate for tax in the corresponding assessment year and the question of postponing or relegating the income to the

assessed tax in a later assessment year, is not permissible in law and as such, the view of the Tribunal that the assessee can be permitted to offer that income on actual receipt basis as and when received and in a corresponding assessment year is clearly in the teeth of the decision of the Supreme Court in the case of State Bank of Travancore (supra). The learned counsel for the revenue has also further drawn the attention of the court to the further discussion of the Supreme Court in State Bank of Travancore's case (supra) of the said decision. It reads as under :

'An acceptable formula of co-relating the notion of real income in conjunction with (the method of accounting for the purpose of the computation of income for the purpose of taxation is difficult to evolve. Besides, any strait-jacket formula is bound to create problems in its application to every situation. It must depend upon the facts and circumstances of each case. When and how does an income accrue and what are the consequences that follow from accrual of income are well-settled. The accrual must be real taking into account the actuality of the situation. Whether an accrual has taken place or not must, in appropriate cases, be judged on the principles of real income theory. After accrual, non-charging of tax on the same because of certain conduct based on the ipse dixit of a particular assessee cannot be accepted. In determining the question whether it is hypothetical income or whether real income has materialised or not, various factors will have to be taken into account. It would be difficult and improper to extend the concept of real income to all cases depending upon the ipse dixit of the assessee which would then become a value judgment only. What has really accrued to the assessee has to be found out and what has accrued must be considered from the point of view of real income taking the probability or improbability of realisation in a realistic manner and dovetailing of these factors together but once the accrual takes place, on the conduct of the parties subsequent to the year of closing an income which has accrued cannot be made no income.

The extension of such a value judgment to such a field is pregnant with the possibility of misuse and should be treated with caution; otherwise one would be on sticky grounds. One should proceed cautiously and not fall a prey to the shifting sands of time.

As a result of the aforesaid discussion, the following propositions emerge :

(1) It is the income which has really accrued or arisen to the assessee that is taxable. Whether the income has really accrued or arisen to the assessee must be judged in the light of the reality of the situation. (2) The concept of real income would apply where there has been a surrender of income which in theory may have accrued but in the reality of the situation, no income had resulted because the income did not really accrue. (3) Where a debt has become bad, deduction in compliance with the provisions of the Act should be claimed and allowed. (4) Where the Act applies, the concept of real income should not be so read as to defeat the provisions of the Act. (5) If there is any diversion of income at source under any statute or by overriding title, then there is no income to the assessee. (6) The conduct of the parties in treating the income in a particular manner is material evidence of the fact whether income has accrued or not. (7) Mere improbability of recovery, where the conduct of the assessee is unequivocal, cannot be treated as evidence of the fact that income has not resulted or accrued to the assessee. After debiting the debtors account and not reversing that entry-but taking the interest merely in suspense account cannot be such evidence to show that no real income has accrued to the assessee or been treated as such by the assessee. (8) The concept of real income is certainly applicable in judging whether there has been income or not but, in every case, it must be applied with care and within well-recognized limits.

We were invited to abandon legal fundamentalism. With a problem like the present one, it is better to adhere to the basic fundamentals of the law with clarity and consistency than to be carried away by common cliches. The concept of real income certainly is a well-accepted one and must be applied in appropriate cases but with circumspection and must not be called in aid to defeat the fundamental principles of the law of income-tax as developed.' (p. 154)

Ultimately the Supreme Court held that the concept of 'real income' is a concept which is well-accepted and defined and that when one income has accrued, the mere possibility that it may not be possible for the assessee to realise that income does not in any way detract from the approval of the income and as such while the

assessee is bound to offer that income to tax, non-realization could be made a ground for claiming appropriate relief as per the Income Tax Act and on satisfying the conditions prescribed under the Act, the Supreme Court held that the appellant-bank was bound to offer to tax the interest income on accrual/arisal basis though not included in the income.

29. The learned counsel for the revenue draws our attention to a decision in UCO Banks case (supra) and submits that insofar as this decision did not really in any way alter or dilute the law laid down by the Supreme Court in State Bank of Travancores case (supra) and the concept of real income and income being brought to tax on accrual basis, continues to be as enunciated and clarified by the Supreme Court in the case of State Bank of Travancore (supra). Accordingly he submitted that in the instant case, there is no escape for the assessee from offering the interest on so-called sticky loans. In the assessment year corresponding to the accounting period, when such income accrued and the assessee not offering the same to tax in such assessment year, but contending that the interest if and when realised will be offered to tax in the corresponding assessment year, cannot be accepted and the Tribunal is in error in permitting the assessee to do so.

30. There is no difficulty in understanding the concept of 'real income' nor in holding that an interest which is required to be offered to tax on accrual or arisal basis, has to be offered to tax in the corresponding assessment year based on the time of accrual or arisal and cannot be postponed beyond the point of time of accrual or arisal. Though Sri Indra kumar, learned counsel for the revenue has relied upon another decision in Confinance Ltd.s case (supra), the real question in the instant case is not on the dispute as to whether the interest income on sticky loans has arisen or accrued to the assessee, in fact, as is submitted by Sri K.P. Kumar, learned advocate appearing on behalf of the assessee, the assessee does not even dispute this proposition. Learned counsel for the assessee, on the other hand submits that the assessee had been permitted to change to the cash system of accounting in respect of income which is termed as 'income by way of interest on sticky loans' and the assessee having followed the hybrid system of accounting for several years and with the permission of the Income Tax Department, and the

revenue having accepted this hybrid method of accounting by the assessee for the past several years and the assessee having not deviated from such method of accounting for the year in question also, there was something wrong in the assessee not offering the interest on sticky loans as income of the assessment year. It is on accrual or arisal basis. It is submitted that the Income Tax Department having permitted the assessee to follow cash system of accounting in respect of this particular income, namely, the interest on sticky loans, the assessee will be required to offer to tax as and when such income is received and the assessee has been doing so, for the past several years. The learned counsel for the assessee, by drawing our attention to section 43D of the Act, submits that in fact the method that is being followed by the axis-bank has even received statutory recognition and the Reserve Bank of India having issued suitable circulars in this regard to the public financial institutions, there was nothing wrong in the assessee bank having followed such hybrid system of accounting while offering its income on accounting basis for determination of its income insofar as the income attributable to the interest of sticky loan was being offered on cash system of accounting and as has been permitted by the department. Sri K.P. Kumar, learned counsel for the assessee has also drawn our attention to the earlier decisions of this court rendered in ITR C 298/98 dated 30-9-1999, ITR C 602 and 603 of 1998 dated 1-10-1999, ITR C 807 and 808/98 dated 24-1-2000 and also ITR C 21/98 dated 8-12-1999 in this context. Learned counsel for the assessee has also drawn our attention to the provisions of section 145 of the Act which provides for method of accounting that could be followed by the assessee in the context of income chargeable under the head 'Profit and gains of business or profession'. He submits that the assessee had been permitted to follow the hybrid system of accounting way back in the year 1953 and the department not only permitted the assessee for such change over to cash system of accounting in respect of interest on sticky loans, but has also accepted the returns filed by the assessee for all subsequent years offering its income to tax determined on such hybrid system of accounting. In support of such submission, Mr. K.P. Kumar, learned counsel has placed reliance on a decision of the Bombay High Court in Citibank N.A.s case (supra). It has been held in this case that it is open to a bank to follow the hybrid system of accounting under which mercantile system of

accounting may be adopted for most of its transactions while in respect of income attributable to interest on problem loans which the assessee credits to its account only on an actual receipt of cash system. The learned Judges of the Bombay High Court had occasion to refer to the decision of the Supreme Court in State Bank of Travancores case (supra), which was relied upon on behalf of the revenue and sought to be contended that the decision of the Supreme Court would cover the issue in that case by distinguishing the said decision pointing out the distinction that whereas in the case of State Bank of Travancore (supra), while the bank actually debited the customers account the interest amount but carried it to a separate suspense account and as such did not offer the same to income, in the case on hand no corresponding debit entries had been made to the customers account. Ultimately it was held that having regard to the fact that the assessee had been permitted to follow a particular system of accounting and the income having been offered to tax based on the computation as per the accounting system maintained by the assessee, the assessee was not liable to include in his total income, the interest on doubtful loans on accrual basis, but can offer the same to tax on actual receipt basis.

31. Insofar as the question as to whether an assessee can be permitted to follow such a hybrid system of accounting, particularly following a different method of accounting in respect of some of the transactions or a part of its income or even a portion for the accounting period, there appears to be divergence of judicial opinion as a contrary view, appears to have been taken in the following decisions by the Calcutta High Court and the Madras High Court. These decisions are :

(1) Reform Flour Mills (P) Ltd. v. CIT : [1981]132ITR184(Cal) .

This decision was followed in Nawn Estates (P) Ltd. v. CIT : [1982]137ITR557(Cal) .

(2) G. Padmanabha Chettiar & Sons v. CIT : [1990]182ITR1(Mad) .

But the question before the court is not in the context of what method of accounting can be permitted to be followed by the assessee and as to whether such method of accounting is correct or otherwise. In the instant case, admittedly

the assessee has been allowed to follow such hybrid method of accounting for the last about 20 years or more and assessee's income offered to tax on the basis of such hybrid method of accounting. Though Sri K.P. Kumar, learned counsel for the revenue has placed reliance on a few more decisions as indicated and discussed below, namely,

(1) ICICI Ltd.'s case (supra).

(2) North Arcot Distt. Co-op. Spg. Mills case (supra).

(3) M.P. Financial Corpn.'s case (supra).

(4) Rajashthan Financial Corpn.'s case (supra).

(5) Andhra Pradesh Industrial Infrastructure Corpn.'s case (supra).

These are all decisions essentially touching upon the question as to what system of accounting can be permitted to be followed by an assessee; as to whether the assessee can follow the dual system of accounting namely when the assessee is permitted to follow hybrid system of accounting and what are the consequences in permitting an assessee to follow cash system of accounting in respect of a portion of its income while mercantile system of accounting is followed in general. As already indicated, we are not required to consider the question as to whether the assessee is right in following the particular system of accounting, as to whether the assessee can be permitted to follow the cash system of accounting only in respect of income referable to sticky loans while can follow the mercantile system of accounting in respect of the rest of its income or as to whether the assessee is entitled in law to follow such a system of accounting. The questions referred for the opinion of this court do not force us for providing answer to such questions though the first question is termed as under :

'Whether, on the facts and in the circumstances of the case, the ITAT is right in law in holding the assessee is correct in following cash system of accounting for interest receivable on sticky loans and mercantile system of accounting for other receipts ?'

32. On facts it is noticed that the assessee had categorized three types of accounts coming within the purview of 'sticky loans' namely :

- (1) Suit filed accounts;
- (2) Claims lodged accounts; and
- (3) Accounts provided for bad and doubtful debts.

The assessee had not offered to tax, interest which in fact had accrued to the account of the bank in the accounting year corresponding to the assessment year 1987-88 which totalled a sum of Rs. 24,21,43,522. The assessing officer sought to include this interest amount to the income of the assessee purporting to follow the decision of the Supreme Court in the case of State Bank of Travancore (supra). On appeal by the assessee to the Commissioner of Appeals, the Commissioner allowed the appeal, held that the assessee having been permitted to offer this income only on receipt basis, it cannot be brought to tax on accrual basis by such permitted deletion of this income. The Tribunal upheld the view of the Commissioner of Appeals. What emerges is that the Tribunal and the Commissioner of Appeals had only directed deletion of this income for the assessment year in question on the basis of the method of accounting that had been permitted to be followed by the assessee for the accounting period corresponding to the assessment year as had been done for the past 20 to 25 years. The question as to whether the assessee is correct in following the cash system of accounting for interest receivable on sticky loans and mercantile system of accounting for other receipts, was not really raised or arose for consideration either before the Commissioner of Appeals or before the Appellate Tribunal. In fact, this is a question which can arise in the context of permitting an assessee to follow a particular method of accounting as provided under the provisions of section 145 of the Act. This controversy did not arise before the authorities below inasmuch as the revenue itself had permitted the assessee to follow such hybrid system of accounting and had continued to permit the assessee including the accounting period corresponding to the assessment year 1987-88. When once the revenue itself had permitted offering the income to tax only as a sequel to the method of accounting that is followed and on the determination of income based

on such method of accounting, the Appellate Commissioner as well as the Tribunal have obviously concluded that the assessee was justified in not offering to income attributable to the interest on sticky loans as in respect of other income assessee had been permitted to follow cash system of accounting which enabled an income to be brought to tax on 'actual receipt basis' and the assessee having not actually received such income. The correctness or otherwise of the method of accounting that was being followed by the assessee was not challenged nor was the assessee permitted to change such method of accounting not had the revenue rejected the method of accounting that was being followed by the assessee. The assessing officer simply sought to bring to tax the income attributable to the income on sticky loans based on the legal position said to have been clarified in the case of State Bank of Travancore (supra). The controversy as to whether the amount of Rs. 24,21,43,522 referable to the interest on sticky loans had accrued or not and was real income or not, was never the issue in the instant case. Under such circumstances, there was no occasion to call in aid the principle enunciated by the Supreme Court in the case of State Bank of Travancore (supra) to be applied to the facts of the present case, as was sought to be done. In fact, the method of accounting that was followed by the assessee, it appears, was the subject-matter of reference in ITRC 82 of 1982 and the Appellate Commissioner has referred to this appellate order and has noticed that the method of accounting that had been followed by the assessee ever since the year 1953 had been approved by the High Court while answering this reference as per its judgment dated 24-1-1989. In the circumstances, this is a question which is already against the revenue insofar as the correctness of the method of accounting is concerned. When the method of accounting followed by the assessee is not questioned and is accepted, the first question referred for our opinion becomes academic and an answer one way or the other to this question will not have a bearing on the decision of the Tribunal in the context of assessing the income of the assessee for the assessment year 1987-88. However, the learned counsel for the assessee has brought to our notice that such questions have already been answered in favour of the assessee and against the revenue in the earlier reference which we have quoted. In this view of the matter, we are constrained to answer question Nos. 1 and 2 in the affirmative and against the revenue.

33. This leads us to question No. 3 namely the correctness of the Tribunals view insofar as it relates to allowing the penal interest paid to the assessee by the Reserve Bank of India as 'liable extent'. Elaborate submissions have been made by the learned counsel for the revenue and the learned counsel for the assessee on this aspect of the matter also. The assessee being a banking company, is required to observe the statutory conditions and requirements to be followed under the Banking Regulation Act, 1949. Section 24 of this Act compels a Banking company to maintain unencumbered approved security of a value of not less than 20 per cent of the total of its demands and time liabilities at the close of business on any given date. This obligation is on all banking companies once two years period has elapsed from the commencement of the Act.

34. Section 24(2A) of the Act imposes further additional obligations in respect of a banking company which is a scheduled bank and requirement of filing monthly returns, furnishing the particulars of assets maintained by it for the purpose of compliance with the requirements of statutory minimum. Section 24(4) of the Act provides for levy of penalties in the form of penal interest at 3 per cent above the bank rate in respect of shortfall at the end of every alternate Friday. The bone of contention is as to whether the penal interest that the assessee bank was required to pay of the noncompliance of the provisions of section 24 of the Banking Regulation Act, 1949, during the accounting period corresponding the assessment year which was at a sum of Rs. 10,37,035 can be allowed as a deductible expenditure for the purpose of arriving at the income of the assessee. The assessing officer disallowed this as a permissible item of business expenditure being of the view that the amount paid being in the nature of a penalty for contravention of a statutory provision, it cannot be permitted as a deduction towards business expenses. The Appellate Commissioner reversed this view accepting the version on behalf of the assessee that the amount is not actually penalty but only penal interest and if so, following the decision of the Supreme Court *Mahalakshmi Sugar Mills Co. v. CIT* : [1980]123ITR429(SC) , and as had been done earlier in the assessment years, the amount was required to be allowed as a deduction. The Appellate Tribunal has confirmed this view and it is in these circumstances the revenue has sought for reference of this question for the opinion of this court. The learned counsel appearing for the revenue as well as the

assessee have made elaborate submissions on this aspect of the legal position and have also placed reliance on a good number of decided cases to support their view point. The question basically is one as to whether the amount paid by the assessee is one in the nature of a penalty for infraction of any law or in the nature of a mere compensatory payment though characterised as a penal interest which is incidental in the carrying on of the business of the assessee and as such can be allowed as a deductible item of business expenditure. In our view, the difference can be compared to the difference between an 'illegality' and irregularity'. If the payment is in the nature of a penalty for violation of statutory provision, i.e., for illegal act, the question relating to the amount paid towards such deeds then, penalty being allowed as a deductible item of expenditure does not arise at all, but if it is merely for permitting an 'irregularity' and the payment being in the nature of a compensatory payment for non-compliance with the statutory stipulations partaking the character of a penal interest and as to whether such payment can be considered as one arising in the course of business and incidental to the business which may perhaps be allowed as an item of deductible expenditure. A deductible expenditure of this nature necessarily should come within the scope of section 37 of the Income Tax Act. Sri Indra kumar, learned counsel for the revenue, while drawing attention to section 24 of the Banking Regulation Act, submits that non-compliance with the requirement therein amounts to infraction of the statutory provision and an express penalty has been provided for such an infraction under section 24(4)(a) and 24(4)(b) of the Banking Regulation Act. Learned counsel submits that the provisions of section 24 have a specific purpose to be served and it is a provision which is enacted keeping in view larger public interest and is a safety device. It is not left to the volition of the Banking Companies like the assessee, to comply or not to comply, but there is a compulsion and non-compliance attracts the penalty. It is submitted that under such circumstances, the amount paid for non-compliance with such a statutory requirement can never be characterised as compensatory in nature though the measure of penalty is with reference to the shortfall and at a fixed rate of 3 to 5 per cent per annum above the bank rate and the fact that the axis-bank did suffer this penalty notwithstanding the provision in the statute itself for not enforcing such penal interest by the Reserve Bank on the Reserve Bank being satisfied by an application by defaulting bank

that the Banking Company had sufficient cause for its failure to comply with the statutory requirement which is provided in section 24(8) of the Act itself. Sri Indra kumar, learned counsel for the revenue submits that in the light of such enabling provision, notwithstanding the assessee having tried to explain the default and having failed in that effort and the penalty having been demanded and paid, it cannot be described as a compensatory payment which in turn can be treated as an item of deductible business expenditure qualifying for deduction in computing the business profits of the assessee. In the light of such submissions, the learned counsel for the revenue submits that the Tribunal is in error in construing that the payment towards penal interest can be allowed as a deductible item of business expenditure.

35. Mr. Indra kumar, learned senior standing counsel for the revenue has relied upon the following decisions in support of his submission that the penal interest levied upon under section 24(4A) and 24(4B) of the Act is in the nature of penalty and not a payment which is compensatory payment entitled for reduction as deductible business expenditure. The decisions are :

(1) Commissioner of Inland Revenue v. E.C Warnes & Co. Ltd. 12 TC 227 (KB).

(2) Spot forth & Prince v. Golder 26 TC 310 (KB).

(3) Haji Aziz & Abdul Shakoor Bros. v. CIT : 1983ECR1942D(SC) .

(4) Prakash Cotton Mills (P) Ltd. v. CIT : [1993]201ITR684(SC) .

36. The question that arose in the case of E C. Warnes & Co. Ltd. (supra) was as to whether the sum of 2000 pounds and litigation costs amounting to 560 and odd pounds was to be permitted as a business, loss incidental to the trade the company was carrying on and in the context of the Income Tax Act, 1842 as existing in England at the relevant time and in the light of the relevant rules. The assessee company which was carrying on business in oil and exporting the same had shipped a consignment to Norway. On the receipt of information that the said export was in contravention of the provisions of the Customs (War Powers) Act, 1915 and the relevant instructions issued by the Board of Customs and Excise, the

Attorney General sued the company for penalty. This action was settled by consent on the agreement of the company to pay a mitigated penalty of 2000 pounds and on such payment, imputations against the company was withdrawn and the company was absolved of its culpability. The assessee company in fact had incurred 560 and odd pounds of expenditure in defending the proceedings. This amount was sought to be claimed as a loss which the company had incurred and incidental to its business and as such is deductible expenditure. While the Commissioners for Inland Revenue had allowed the same as a deduction, in appeal, the High Court reversed the same holding that the item of expenditure paid as mitigated penalty and towards costs of the litigation cannot at all be characterised as loss to the company connected with or arising out of the trade carried on by the company. Rowlatt, J, speaking for the Bench, held that the payment of such a nature which is essentially in the nature of a penalty can never be termed as a business loss and accordingly allowed the appeal of the revenue. In the instant case, the amount is not claimed as a business loss and item of deductible expenditure incidental to the carrying on of the business.

37. Spot forth & Princes case (supra) is an interesting case where the partner of a firm of Chartered Accountants was charged with conspiracy for tempting a person to evade income-tax. The partner was criminally prosecuted. The charge was successfully defended. The cost incurred for such defence was claimed as a deductible expenditure by the firm which was keen on protecting its fair name and reputation. It was held that the expenditure incurred for defending the action as against the partner would be charged in personal capacity and cannot be held to be an item of expenditure incidental to the carrying on of the trade or profession and as such the costs incurred was disallowed to a deductible expenditure at the hands of the firm.

38. The Supreme Court had occasion to distinguish these two English decisions apart from the decision in the case of Haji Aziz and Abdul Shakoor Bros. (supra). In this case, the assessee who was carrying on business of importing dates, had imported a certain quantity of dates partly by a steamer and partly by a country boat at the time when import by steamer was prohibited. The customs authorities confiscated the dates imported by the steamer under the provisions of section 167

of the Sea Customs Act. However, the assessee was given the option to redeem the same by paying a fine and the importer exercised the option, paid the fine and got the dates released. The amount paid for such redemption was sought to be claimed as a business expenditure as it had been laid out, for the purpose of redeeming the dates which had been confiscated by the customs authorities in which goods the assessee was carrying on trade. The Supreme Court, affirming the view taken by the Bombay High Court, held that no item of expenditure which was paid by way of penalty for the breach of law that had been incidental to the carrying on of the business and not involving any personal liability, still, cannot be allowed as an amount wholly and exclusively laid for the business of the assessee within the meaning of section 10(2)(xv) of the Income Tax Act, 1961. The Supreme Court laid emphasis that an amount paid by way of penalty and for an infraction of law can never be accepted to be an amount laid out as an item of expenditure for the purpose of carrying on of a lawful business of the assessee. The court also held that it must have been a commercial loss in the normal course of the trade and business and not when the amount paid by way of penalty for a breach of law which may be in the course of carrying on of the trade and business of the assessee. The court also held that infraction of law is not a normal incident of business though it is a matter of normal routine traders may keep infracting laws.

39. In Prakash Cotton Mills (P) Ltd.s case (supra) the Supreme Court had occasion to consider the question as to whether the interest paid by an assessee for delayed payment under the Bombay Sales Tax Act, as also the damages paid by the assessee for delayed payment of contribution under the Employees State Insurance Act was allowable as revenue expenditure under section 37(1) of the Income Tax Act, 1961. Further, the court, while holding that the assessing authority is required to examine the scheme of the provisions of the relevant statute providing for payment of impost notwithstanding the nomenclature of the impost whether called as a penalty or damage may not be conclusive, but the particular requirement in the context of the statute in which it occurs and to decide as to whether it was really compensatory or penal in nature and it was only when it was found that the payment was in the nature of a compensatory payment it could be allowed as a deductible item of expenditure under section 37(1) and if it was a compensatory one, it was only the compensatory part of the composite payment

which can be allowed as an expenditure of deductible one which was required to be bifurcated by the authorities concerned with the question and if it was penal in nature, no deduction was permissible. However, the Supreme Court, while laying down this principle following its earlier decision in the case of Mahalakshmi Sugar Mills Co. (supra) nevertheless remanded the matter to the authorities for consideration of these aspects which had not been done in that case.

40. The position that emerges is that if a payment is really in the nature of a compensatory payment, it may qualify for deduction whereas if it is a penalty a penalty for refraction of law, it may not qualify for deduction. This is an aspect which has to be gathered with reference to the context in which the provision was made having regard to the scheme of a particular enactment. The statutory provision which we consider in section 24 of the Banking Regulation Act, 1949 which reads as under :

'Maintenance of a percentage of assets.(1) After the expiry of two years from the commencement of this Act, every banking company shall maintain in India in cash, gold or unencumbered approved securities, valued at a price not exceeding the current market price, an amount which shall not at the close of business on any day be less than twenty per cent of the total of its demand and time liabilities in India.

Explanation.For the purposes of this section, unencumbered approved securities of a banking company shall include its approved securities lodged with another institution for an advance or any other credit arrangement to the extent to which such securities have not been drawn against or availed of.

(2) In computing the amount for the purposes of sub-section (1), the deposit required under sub-section (2) of section 11 to be made with the Reserve Bank by a banking company incorporated outside India and any balances maintained in India by a banking company in current account with the Reserve Bank or the State Bank of India or with any other bank which may be notified in this behalf by the Central Government including in the case of a scheduled bank the balance required under section 42 of the Reserve Bank of India Act, 1934 (2 of 1934), to be so maintained shall be deemed to be cash maintained in India;

(2A)(a) Notwithstanding anything contained in sub-section (1) or in subsection (2), after the expiry of two years from the commencement of the Banking Companies (Amendment) Act, 1962 (36 of 1962) :

(i) a scheduled bank, in addition to the average daily balance which it is, or may be, required to maintain under section 42 of the Reserve Bank of India Act, 1934 (2 of 1934), and

(ii) every other banking company, in addition to the cash reserve which it is required to maintain under section 18, shall maintain in India,

(A) in cash, or

(B) in gold valued at a price not exceeding the current market price or in unencumbered approved securities valued at a price determined in accordance with such one or more of, or combination of, the following methods of valuation, namely, valuation with reference to cost price, market price, book value or face value, as may be specified by the Reserve Bank from time to time,

an amount which shall not, at the close of business on any day, be less than twenty-five per cent or such other percentage not exceeding forty per cent as the Reserve Bank may, from time to time, by notification in the Official Gazette, specify, of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight;

(b) in computing the amount for the purpose of clause (a),

(i) the deposit required under sub-section (2) of section 11 to be made with the Reserve Bank by a banking company incorporated outside India;

(ii) any cash or balances maintained in India by a banking company other than a scheduled bank with itself or with the Reserve Bank or by way of net balance in current account in excess of the aggregate of the cash of balance or net balance required to be maintained under section 18;

(iii) any balances maintained by a scheduled bank with the Reserve Bank in excess of the balance required to be maintained by it under section 42 of the

Reserve Bank of India Act, 1934 (2 of 1934);

- (iv) the net balances in current accounts maintained in India by a scheduled bank;
- (v) any balances maintained by a Regional Rural Bank in call or fixed deposit its Sponsor Bank,

shall be deemed to be cash maintained in India.

Explanation. For the purpose of clause (a) of this sub-section the market price of an approved security shall be the price as on the date of the issue of the notification or as on any earlier or latter date as may be notified from time to time by the Reserve Bank in respect of any class or classes of securities.

(2B) The Reserve Bank may, by notification in the Official Gazette, vary the percentage referred to in sub-section (2A) in respect of a Regional Rural Bank.

(3) For the purpose of ensuring compliance with the provisions of this section, every banking company shall, not later than twenty days after the end of the month to which it relates, furnish to the Reserve Bank in the prescribed form and manner a monthly return showing particulars of its assets maintained in accordance with this section, and its demand and time liabilities in India at the close of business on each alternate Friday during the month, or if any such Friday is a public holiday, at the close of business on the preceding working day :

Provided that every Regional Rural Bank shall also furnish a copy of the said return to the National Bank.

(4)(a) If on any alternate Friday or, if such Friday is a public holiday, on the preceding working day, the amount maintained by a banking company at the close of business on that day falls below the minimum prescribed by or under clause (a) of sub-section (2A), such banking company shall be liable to pay to the Reserve Bank in respect of that day's default, penal interest for that day at the rate of three per cent per annum above the bank rate on the amount by which the amount actually maintained falls short of the prescribed minimum on that day; and

(b) if the default occurs again on the next succeeding alternate Friday, or, if such Friday is a public holiday, on the preceding working day, and continues on succeeding alternate Friday or preceding working day, as the case may be, the rate of penal interest shall be increased to a rate of five per cent per annum above the bank rate on each such shortfall in respect of that alternate Friday and each succeeding alternate Friday or preceding working day, if such Friday is a public holiday, on which the default continues.

(5)(a) Without prejudice to the provisions of sub-section (3), the Reserve Bank may require a banking company to furnish to it a return in the form and manner specified by it showing particulars of its assets maintained in accordance with this section and its demand and time liabilities in India, as at the close of business on each day of a month; and

(b) without prejudice to the provisions of sub-section (4), on the failure of a banking company to maintain as on any day the amount so required to be maintained by or under clause (a) of sub-section (2A) the Reserve Bank may in respect of such default, require the banking company to pay penal interest for that day as provided in clause (a) of sub-section (4) and if the default continues on the next succeeding working day, the penal interest may be increased as provided in clause (b) of sub-section (4) for the concerned days.

(6)(a) The penalty payable under sub-section (4) and sub-section (5) shall be paid within a period of 14 days from the date on which a notice issued by the Reserve Bank demanding payment of the same is served on the banking company and in the event of failure of the banking company to pay the same within such period, the penalty may be levied by a direction of the principal civil court having jurisdiction in the area where an office of the defaulting banking company is situated, such direction to be made only upon an application made by the Reserve Bank in this behalf to the court; and

(b) when the court makes a direction under clause (a), it shall issue a certificate specifying the sum payable by the banking company and every such certificate shall be enforceable in the same manner as if it were a decree made by the court in a suit.

(7) When under the provisions of clause (b) of sub-section (4) penal interest at the increased rate of five per cent, above the bank rate has become payable by a banking company, if thereafter the amount required to be maintained on the next succeeding alternate Friday, or if such Friday is a public holiday, the next preceding working day, is still below the prescribed minimum, every director, manager or secretary of the banking company, who is knowingly and wilfully a party to the default shall be punishable with fine which may extend to five hundred rupees and with a further fine which may extend to five hundred rupees for each subsequent alternate Friday or the preceding working day, as the case may be, on which the default continues.

(8) Notwithstanding anything contained in this section, if the Reserve Bank is satisfied, on an application in writing by the defaulting banking company, that the banking company had sufficient cause of its failure to comply with the provisions of clause (a) of sub-section (2A), the Reserve Bank may not demand the payment of the penal interest.

Explanation. In this section, the expression public holiday means a day which is a public holiday under the Negotiable Instruments Act, 1881 (26 of 1881).'

41. Sri. K.P. Kumar, learned counsel appearing for the assessee, on the other hand, counters the submissions made on behalf of the revenue by drawing our attention to the history of legislation of the Banking Regulation Act, 1949. Learned counsel by drawing our attention to section 24(2A) of the Act submits that the penal interest payable either under section 24(4)(a) or under section 24(4)(b) for non-compliance with the requirement of section 24(2A) which mandates the Banking Company to maintain certain percentage in cash or in gold, of total of its demand and time liabilities in India and for such shortfall, being liable to pay penal interest for the day at 3 per cent per annum above the bank rate and the shortfall at the end of the day, is essentially in the nature of a compensatory payment and as such, though called by the name penal interest should be allowed as if a deductible item of expenditure. Learned counsel further submits that in the very nature of things, maintenance of balance of the requisite percentage in cash or in gold at the end of each day, they are in the nature of 'not practically feasible' as at

the relevant time communication was not as advanced as of now and in the absence of accurate data/information, there could have been several infractions as the assessee was carrying on the banking activities and in fact the short fall was being realised and complied only at a later point of time if at all there was such shortfall. Such being the situation, there was never any intention on the part of the assessee to infract any statutory provisions nor could it be said there was any deliberate non-compliance on the part of the assessee. Learned counsel submits that the whole object of providing for a collection of penal interest at 3 per cent over and above the normal banking rates is for compensating the depletion of such reserves, which would have enured to the benefit of the Government and such a loss is sought to be compensated by the levy of additional 3 per cent to 5 per cent over and above the normal banking rates. As regards levy of penal interest, the very fact that the rate of interest is kept at a reasonable level is in itself, an indication that it is compensatory in nature and not penal. Sri K.P. Kumar submits that the infraction is not in the nature of committing an act which is forbidden in law and if at all, it can, at the best be, characterised as an irregularity and never an illegality. An assessee carrying on such business has only acted in a legally permitted manner. When, while so carrying on its business, if there are certain technical or statutory infractions, the same cannot be characterised as an illegal activity and as such an item expenditure incurred cannot be disallowed by applying the principles as have been laid down by the Supreme Court in Prakash Cotton Mills (P) Ltd.s case (supra) and Mahalakshmi Sugar Mills Co.'s case (supra). The learned counsel seeks to make a distinction in the present set of facts and has drawn our attention to the following decisions in support of such submissions.

42. CIT v. Pannalal Narottamdas & Co. : [1968]67ITR667(Bom) . In this case, the assessee, an importer, had imported certain items which at the time of clearance was found to be irregular by the customs authorities. The Customs authorities confiscated the goods and permitted redemption on the same on payment of fine. The assessee paid the fine and got the goods released. Bombay High Court took the view that in the peculiar circumstances of the case, the fine paid by the assessee should be held to be as forming part of the price paid for the goods itself and if so, being part of the price at which the goods were purchased, can be

allowed as deductible item of expenditure. In the first instance, we are afraid that this decision does not advance the case of the assessee in the present case. We say this for two reasons. The learned Judges of the Bombay High Court took the view that the business of the assessee itself being a legal one, the redemption fine being paid for the purpose of redeeming the goods and carrying on of the business permitted in law, it could be allowed as an item of deductible expenditure. With great respect, we are unable to share this view of the learned Judges. We also notice that this decision directly conflicts with the view taken by the Supreme Court in Haji Aziz & Abdul Shakoor Bros. case (supra). The decision of the Supreme Court was not noticed in the case of Pannalal Narottamdas & Co. (supra). Sri K.P. Kumar, learned counsel has also brought to our notice a decision of our High Court in CIT v. Mandya National Paper Mills Ltd. : [1984]150ITR26(KAR) , wherein it has been held that the penalty payable under section 13(2) of the Karnataka Sales Tax Act is in the nature of compensatory payment and as such the same could be taken as an item of deductible expenditure. The same is the effect in another case cited by the learned counsel Sri K.P. Kumar in CIT v. Mysore Electrical Industries Ltd. : [1992]196ITR884(KAR) , wherein the interest paid under section 7 of the Employees State Insurance Act has been held to be compensatory in nature and could as such be claimed as an item of deductible expenditure. Sri K.P. Kumar, learned counsel, has also referred to the decision in Prakash Cotton Mills (P) Ltd.s case (supra) to which we have made a reference earlier.

43. These aspects apart, the learned counsel appearing on behalf of the assessee also submits that liquidated damages which are paid for breaches of provisions of any contract are allowed as an item of deductible expenditure as a matter of course and as a permitted item of expenditure under section 37 of the Act. Learned counsel submits that there are such liquidated damages which are provided for in a contract between the parties can be allowed as an item of deductible expenditure under section 3 and the penal interest in the instant case, which according to the learned counsel, is also in the nature of a compensatory payment as has been provided for in the statute itself and as such on the same analogy the amounts paid by the assessee under the provisions of section 24(4)(a) and 24(4)(b) could be allowed as an item of expenditure and urges that

the question should be answered against the revenue and in favour of the plaintiff.

Sri K.P. Kumar, learned counsel for the assessee has also drawn our attention to an earlier decision of the Appellate Tribunal in the case of the very assessee and for the assessment year 1981-82 rendered in I.T.A. 750 (Bang) 1985. In this appeal, the Tribunal, following its earlier decision and the view taken in the case of Corporation Bank, held that interest payable by the assessee to the Reserve Bank under section 42(3) of the Reserve Bank of India Act, is in the nature of an admissible business expenditure and as such the assessee can claim deduction on the same in computing its business profits. The submission of Sri K.P. Kumar, learned counsel for the assessee in the context of this decision of the income Tax Appellate Tribunal is that the revenue having accepted this position as it emerges from the decision of the Appellate Tribunal cannot be permitted to raise the same question subsequently as such legal position had been accepted by the department in respect of an earlier assessment year. In support of this proposition, the learned counsel has placed reliance on two decisions of the Supreme Court namely CIT v. Narendra Doshi (2002) 254 ITR 607 (SC) and Union of India v. Kaumudini Narayan Dalal : [2001]249ITR219(SC) . In the first case, on facts it was found that the department having allowed a decision of the Deputy Commissioner in appeal holding that interest was payable on interest and such view having been affirmed by the Appellate Tribunal and having been carried to the High Court by the revenue, the revenue having failed, on the same question the revenue cannot be permitted to take a different stand in respect of a different assessee. The Supreme Court said that having regard to this position in law, the question referred for the opinion of High Court having been answered against the revenue, is the correct position of law. In the latter case, the Supreme Court noticed that the order in challenge before the court was following an earlier judgment of the same High Court and the revenue having not questioned the correctness of the earlier decision nor having pursued the same to its logical conclusion, revenue cannot be permitted to challenge such decision in the case of another assessee and as such the Supreme Court declined to go into the correctness of the decision in appeal before it. Sri K.P. Kumar, learned counsel for the assessee has also relied upon yet another decision of the Supreme Court in Union of India v. Satish Panalal Shah (2001) 249 ITR 321 (SC). In this decision also the Supreme Court held that it

was not open to the revenue to accept the ruling of the High Court on a particular aspect in the case of some assessees and challenge the correctness of the same in the case of other assessees without there being just cause in the case of such assessees.

In the instant case, the question that had arisen for consideration is as to the nature of payment under section 24(4)(a) and 24(4)(b) of the Banking Regulation Act, 1949. This is a question which is required to be answered in the context of the provisions of this enactment and having regard to the importance and objectives of this Act. Even assuming that the Tribunal had taken a view one way or the other, unless the view has been affirmed by the High Court on examination in that particular context, the view taken by the Tribunal cannot be said to have attained finality. At any rate, the view taken by the Tribunal in the context of interpretation of the provisions of section 42(3) of the Reserve Bank of India Act and though to some extent these provisions may be analogous to the provisions of section 24(4)(a) and 24(4)(b) of the Act, cannot be a stumbling block in the way of our examining the scope and nature of the provisions of sections 24(4)(a) and 24(4)(b) of the Act. The learned counsel for the assessee has not placed before us any earlier view of our High Court or the Supreme Court in the context of these provisions. Such being the position, the decisions relied upon by the learned counsel for the assessee does not come in the way of our examining question No. 3 referred to us for our opinion which we are required to examine and answer.

44. The real point in issue in the light of the submissions and the given case laws is as to the nature of payment under the provisions of section 24(4)(a) and 24(4)(b) of the Banking Regulation Act, 1949. The object of the Act, as the very name suggests, is to provide for regulation of the banking activities, particularly, is the object of safeguarding the interest of the depositors. It may be noticed that the Banking Regulation Act, 1949 is in fact supplementary to the Reserve Bank of India Act, 1934 which in fact seeks to regulate several aspects of banking. In fact, the statement of objects and reasons to the bill whereby the Amending Act 36 of 1962 was incorporated to the Act is very illuminative in this regard which is as under :

'Act 36 of 1962 The provisions in the Banking Companies Act relating to the minimum paid-up capital and reserves of the commercial banks and the amounts which such banks are required to maintain in the form of cash or bank balances or in the form of liquid assets which can be readily utilised for meeting any current obligations are somewhat out of date. In view of the changes which have taken place since March 1949, when the provisions relating to the minimum paid-up capital were brought into force, and the very great increase in the deposits and working funds of the commercial banking system in recent years, it is considered desirable that the paid-up capital and reserves, the cash and bank balances, and the overall liquid assets of the commercial banks should be increased. The Bill seeks to amend the relevant provisions of the Act in a suitable manner for these purposes and is intended to strengthen the financial position of the commercial banks generally and to increase the protection which is available to the depositors.

The opportunity provided by the amendment of the Act for these purposes has also been utilised to make a few clarificatory changes in some of the other provisions of the Act.

The scope and object of the amendments proposed are explained in detail in the notes on the various clauses of the Bill-Gaz. of Ind., 24-8-1962, Pt. II, S.2, Expt. p. 712.'

45. Section 24 of the Act which provides for such maintenance of percentage of assets of a banking company in the manner provided therein is a self-contained provision which not only enjoins such a duty on the banking company, but also provides for penalties for non-compliance. The provision which provides for levy of penalty, though it is termed as penal interest under section 24(4)(a) and 24(4)(b) of the Act, is for noncompliance with such requirement stipulated under section 24(2A) of the Act. The requirement of section 24(2A) of the Act is in addition to requirement of section 24(1) which also stipulates a similar compliance. Sub-section (6) of section 24 clearly indicates that the penal interest payable under sub-sections (4) and (5) is a 'penalty' and if the penalty amount is not paid it could be enforced as a decree made by a civil court. The Reserve Bank has been given the discretion not to demand payment of panel interest on being satisfied by an

application made by the defaulting banking company, i.e., that the banking company had sufficient cause for its non-compliance with the requirements of section 24(2A)(a) as provided for in sub-section (8) of section 24. This is an important provision which throws light that the amount in question is not compensatory in nature, but definitely penal and an opportunity is also provided to the defaulting banking company to satisfactorily explain the non-compliance and to avoid the penalty. Notwithstanding such an enabling provision, if a banking company has suffered the penalty under section 24(4)(a) and 24(4)(b) of the Act and has also paid on demand the only inevitable inference is that the amount is paid by way of penalty and such an amount cannot be characterised as a compensatory payment. One normal characteristic feature of a compensatory payment is that such compensatory payments are levied as a matter of course and with reference to time stipulations. In the instant case, the levy is not with reference to the time stipulation, but the non-adherence to the maintenance of requisite deposit,

46. There is also a larger principle involved in the matter of considering as to whether an amount may be permitted as an item of deductible expenditure or not. To permit any expenditure as an item of deductible expenditure under section 37 of the Income Tax Act it should be an expenditure which is laid out in the normal carrying on of the business activity of the assessee and incidental to the business and more importantly an item of expenditure which is permitted in law in the sense that the expenditure should be a legitimate one. An amount payable for incurring an infraction of law can be considered only when it is an item of legitimate expenditure incurred and as incidental to the carrying on the business of the assessee. It may be that while an assessee is carrying on his business activity occasions may arise knowingly or unknowingly infractions take place. When the law frowns upon such infractions and in fact with an intention to discourage such commissions and omissions provides for payment of penalty as in the present case, it can never be said that the act of infraction is one which is permitted in law. The amount paid by way of penalty or even called as penal interest cannot be treated as a legitimate item of expenditure. If such interpretation is to be accepted then it will obviously defeat the purpose of levying penalty under section 24(4)(a) and 24(4)(b) of the Act. If such penal interest or penalty paid by an assessee is to

be treated as part of deductible expenditure laid out by an assessee for carrying on his business and is to be permitted as an item of deductible expenditure under section 37 of the Income Tax Act it only amounts to placing a premium on such infraction rather than frowning upon the same. The whole significance of permitting an amount as an item of deductible expenditure is that the total taxable income of the assessee gets reduced to this extent with the consequential deduction in the tax liability, which is an incentive for claiming it as an item of deductible expenditure. It will be rather ironic that while under the provisions of the Banking Regulation Act, when the very same Act attracts a penalty it should also be recognised as an act which can also be recognised as a legitimate act under the provisions of the Income Tax Act which Act entails the assessee to claim the expenditure paid by way of penalty, as an item of expenditure incurred for the carrying on the business. We do not think that we can permit such an incongruous situation to arise by accepting the submissions made on behalf of the assessee.

47. The activity of banking carried on by the assessee is an activity permitted in law. While carrying on an activity in the nature of business within the limits of law and while so doing if the assessee commits an infraction of the provisions of law it cannot be accepted that the infraction is also part of the carrying on of the business activities of the assessee. The mere possibility that while carrying on its business activity in a lawful manner it is inevitable that there can be some infraction having regard to the nature of the business activity of the assessee cannot by itself change the fact that it was an infraction or an act not permitted under the law. The assessee is expected to carry on its business activities without infraction of any of the provisions of law and neither the assessee can be permitted nor can be condoned if the acts of the assessee is otherwise under the provisions of the very statute which makes that act an infraction of particular statutory provisions.

In the instant case as indicated earlier the assessee has paid the penalty which it could have avoided by putting forth plausible explanation before the concerned authority; but the assessee obviously has suffered the penalty for want of a plausible explanation. If that is the factual situation, consequences cannot be avoided. We are of the clear view that permitting penalty paid for the nature of

violations referred to above as an item of deductible expenditure under section 37 of the Income Tax Act will only amount to placing a premium on the commission of infraction of the assessee. It will be clearly against the public policy to place such an interpretation either on the provisions of section 37 or on the provisions of section 24 of the Banking Regulation Act, 1949. In any view of the matter we are not in a position to accept the submissions made on behalf of the assessee and for holding that the penalty payable under section 24(4)(a) and 24(4)(b) of the Banking Regulation Act, 1949 can be treated as an item of deductible expenditure for the purpose of section 37 of the Income Tax Act. We may usefully quote in this regard the decision of the Supreme Court in *Maddi Venkataraman & Co. (P) Ltd. v. CIT* (1998) 96 (SC) as under :

'An assessee carrying on a lawful business cannot claim deductions in respect of expenses incurred for meeting unlawful activities though an assessee who is carrying on an illegal business may be permitted such deduction.'

48. In the result, we answer question No. 3 referred to for our opinion in the negative and against the assessee. Under such circumstances we are of the clear view that the deduction in question has to be held to be penal in character on applying law as it has emerged from our discussion above and based on the decisions referred to supra.

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