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Hypothetical income is not chargeable to tax

The Karnataka High Court has rendered its decision that wheeling charges (not recognised due to uncertainty in its collection / recovery) are hypothetical income and not real income and thus, not chargeable to tax.

Background:

- The taxpayer[1] is a Karnataka state government undertaking engaged in the business of transmission of electricity.
- The Assessing Officer (AO) for the Financial Year (FY) 2000-01, corresponding to Assessment Year (AY) 2001-02, conducted revised audit proceedings under section 263 of the Income-tax Act, 1961 (ITA) based on the order of the Commissioner of Income-tax (CIT).

  As per Section 263 of the ITA, Commissioner of Income-tax (CIT) can request for revision of AO's order, if he is of the opinion that the AO's order is erroneous and prejudicial to the revenues' interest.
- The AO during the course of revised audit proceedings made an addition on account of wheeling charges (as the same was not offered to tax by the taxpayer in the relevant AY) on the following basis:
  - The wheeling charges became due to the taxpayer once electricity supply was made available to other state agencies;
  - The expenditure towards transportation / wheeling was debited to the books of accounts;
  - The taxpayer could not be permitted not to offer the wheeling charges to tax merely on the ground that the revenue was not realised in the relevant FY.
- In appeal proceedings, the matter reached the Karnataka High Court (HC).

Decision of the HC:

- The HC noted the following:
  - Notification dated 25 January 1996 issued by the government (in relation to the Accounting Standards to be followed by taxpayer following mercantile system of accounting), defined the expression 'accrual' to mean the revenue and cost accrued i.e. recognised as they were earned or incurred and recorded in the financial statements of the period to which they relate.

[1] CIT v. Karnataka Power Transmission Corporation limited (ITA no 196 of 2013) (Karnataka HC)

- Further, as per notification dated 29 September 2016 issued by Central Board of Direct Taxes (CBDT) to notify Income Computation and Disclosure Standards, (which applies to taxpayer following the mercantile system of accounting) accrual refers to the assumption that revenues and cost are accrued i.e. recognised as they were earned or incurred and recorded in the previous year, to which they relate.
- The Supreme Court in an earlier decision[2] had held that entry in a book which was made about a hypothetical income (which did not materialise) could not be subjected to tax as the entry reflected hypothetical income and only real income could be brought to tax.
- The Karnataka Electricity Board which owned transmission lines in Karnataka decided to recover wheeling charges from the relevant state electricity board. The taxpayer therefore, had not raised any demand on account of wheeling charges.

  Since, there was uncertainty with regard to recovery / collection of the outstanding amount for the AY in question, the taxpayer decided not to recognise revenue on account of wheeling charges for the relevant AY. The same was approved by the taxpayer's board;
- Subsequently during the meeting of the Southern Electricity Board, the cost-sharing arrangement of wheeling charges by the constituent states itself was scrapped and the said decision was in existence when the AO passed his order.

- In view of the above, the HC held that the income from wheeling charges never accrued to the taxpayer and was hypothetical income and not real income. Thus, the income could not have been subjected to tax and in view of AS 9 (relating to revenue recognition), the taxpayer had rightly decided not to recognise the wheeling charges for the relevant AY.

Accordingly, the HC dismissed the Revenue's appeal and upheld the ITAT's order.

Comment:

This ruling, based on facts, affirms the principle that hypothetical income is not chargeable to tax.

[2] CIT v. Bokaro Steel ltd [1999] 102 Taxman 94 (SC)