Tax alert: Interest on FDs, made from funds received for setting up of power plant, not taxable as IFOS

8 August 2024

The Delhi High Court, based on facts, has rendered its decision that interest earned on fixed deposits made from funds received for setting up of power plant is to be treated as capital receipt and is not taxable as 'Income from Other Sources', since such funds are inextricably linked with setting up a power transmission system.

In a nutshell

For an income to be classified as income under the head 'profit and gains of business or profession' it would have to be an activity which is in some manner or form connected with business. The word 'business' is of wide import which would also include all such activities that coalesce into setting up of the business.

Interest earned on surplus funds would have to be treated as 'income from other source'. If there is any surplus money which is lying idle and it has been deposited in the bank for the purpose of earning interest, then it is liable to be taxed as income from other sources.

Whether the interest earned by the taxpayer from the investment made in FDs, out of the funds received for setting up a power plant, should be treated as 'capital receipt' or as 'income from other sources', is dependent on whether the invested funds were inextricably linked with setting up of the power plant.

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Background:

- The taxpayer[1] was incorporated as a joint venture undertaken by two companies i.e., A Co and B Co with the sole objective of setting up a power transmission system [‘Power Plant’].
- The construction of the Power Plant commenced in Financial Year (FY) 2007-08, which reached fruition in FY 2012-13. The estimated cost for setting up the Power Plant was say, INR 10,000, which was financed through both equity and debt. Out of this, say INR 3,000 was brought in by way of equity, while INR 7,000 was raised through borrowings.
- The borrowings were received by the taxpayer from a consortium of banks under Trust and Retention Account Agreement (‘TRA Agreement’) and a loan agreement.
- During the period of the project, the funds were received in tranches. In the period under consideration i.e. FY 2008-09, corresponding to Assessment Year (AY) 2009-10, the taxpayer used INR 2,500, out of which short-term Fixed Deposits (FDs) were created amounting of ~INR 55. On these FDs, the taxpayer earned interest say of INR 3 during the year under consideration, which was credited to an account titled as ‘Incidental Expenditure during construction Pending Allocation’.
- The taxpayer contended that the aforementioned interest amount received on FDs was capital receipt and hence, not taxable in India.
- During the course of audit proceedings, the Assessing Officer (AO) held that interest earned on funds invested in the FDs was taxable as income under the head ‘Income from other sources’.
- Aggrieved, the taxpayer filed an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)]. The CIT(A) upheld the order of the AO, which was then, on appeal, reversed by the Income-tax Appellate Tribunal (ITAT).
- Aggrieved, the Revenue filed an appeal before the Delhi High Court (HC).

Decision of the HC:

The HC acknowledged that the question for consideration was whether the interest earned by the taxpayer from the investment made in FDs, out of the funds received for setting up a power plant, should be treated as ‘capital receipt’ or ‘income from other sources’ and the same was dependent on whether the invested funds were inextricably linked with setting up of the power plant.

In this regard, the HC noted / observed as follows:

- In present case, the project was funded via two sources, i.e., equity and loans. Through equity capital, the taxpayer gathered say, INR 3,000 and through borrowing, the taxpayer secured say, INR 7,000 from the lenders.
- In the period under consideration, out of the borrowing received, it spent say INR 2,500. An amount of say, INR 55 was invested in FDs, which earned an interest of say, INR 3 during the period in issue.
- As per clause 15.1 of the Trust and Retention Account Agreement (TRA), amounts which were standing to the credit of any of the TRA accounts i.e., the sub-accounts, could only be invested in ‘permitted investments’, which had to have a scheduled maturity date which could not go beyond the anticipated cash withdrawal or transfer date.
- The fact that permitted investments had a linkage with the amounts that were credited to the TRA sub-accounts, and provided a security for liquidation of the debt, was evident upon the perusal of the TRA. The TRA indicated that:

[1] PCIT vs. Jaypee Powergrid Ltd [2024] 158 taxmann.com 86 (Delhi- HC)

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- — The title documents and other documentary evidence establishing ownership of the permitted investments made using the sub-accounts regulated by the TRA were to be held in custody for the benefit of the borrower/lender.
- — It cast an obligation that the maturity value of the permitted investments was related to the payment or transfer obligations under the TRA. The permitted investments had to be readily marketable.
- — The taxpayer had to ensure that the money which was realized through investments had to be immediately credited to the relevant account by the account bank or invested in another permitted investment, in accordance with the lender/borrower's instruction.
- — Any interest or other income paid qua permitted investments, would have to be paid to the relevant account as determined by the facility agent, which broadly meant to the benefit of the borrowers/lenders.

- A holistic reading of the aforementioned clauses showed that there was indeed an inextricable link between the investment of the surplus funds and the setting up of the power transmission system. Therefore, clearly, the interest earned thereon could only be categorised as ‘capital receipt’. Reliance was placed on an earlier ruling[2] of the Delhi HC which had held that:
  - — The test was whether the activity which was taken up for setting up of the business and the funds which were garnered were inextricably connected to the setting up of the plant.
  - — For an income to be classified as income under the head ‘profit and gains of business or profession’ it would have to be an activity which was in some manner or form connected with business. The word ‘business’ is of wide import which would also include all such activities that coalesce into setting up of the business.
  - — The funds in the form of share capital were infused for a specific purpose of acquiring land and the development of infrastructure. Therefore, the interest earned on funds primarily brought for infusion in the business could not have been classified as income from other sources.
  - — In the earlier ruling[3] of the Supreme Court (SC) it was found that the funds available with the taxpayer were ‘surplus’ and therefore, the SC held that the interest earned on surplus funds had to be treated as ‘income from other source’. On the other hand, the SC in another ruling[4] where the taxpayer had earned interest on advance paid to contractors during pre-commencement period was found to be ‘inextricably linked’ to the setting up of the plant of the taxpayer and hence, was held to be a capital receipt which was permitted to be set-off against pre-operative expenses.

  The aforementioned principle was followed in other rulings[5].

- The Revenue had relied upon a recent ruling[6] of the SC, which supported the view taken above. The issue that came up for consideration before the SC in the said matter was whether interest accrued on account of deposit of share application money in FD would be taxable in the hands of the taxpayer. The SC applied the test of inextricable linkage and went on to rule that the taxpayer could set off the interest earned against the expenses incurred on public issue. The key observation of the SC was that the common rationale followed in all the earlier judgement was that if there was any surplus money which was lying idle and it had been deposited in the bank for the purpose of earning interest, then it was liable to be taxed as income from other sources. But if

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[2] Indian Oil Panipat Power Consortium Ltd. v. ITO [2009] 315 ITR 255 (Delhi HC)

[3] Tuticorin Alkali Chemicals & Fertilizers Ltd. v. CIT [1997] 93 Taxman 502/227 ITR 172 (SC)

[4] CIT v. Bokaro Steel Ltd. [1999] 102 Taxman 94/236 ITR 315 (SC)

[5] Pr. CIT v. Brahma Centre Development (P.) Ltd. [2021] 437 ITR 285; CIT v. NTPC Tamil Nadu ER Co. Ltd. [IT Appeal No. 66 of 2015, dated 6-2-2015]; Pr. CIT v. Triumph Realty (P.) Ltd. [2023] 148 taxmann.com 196 (Delhi); NTPC Sail Power Co. (P.) Ltd. v. CIT [2012] 25 taxmann.com 401 (Delhi); Pr. CIT v. Facor Power Ltd. [2016] 66 taxmann.com 178 (Delhi); CIT v. Sasan Power Ltd. [2012] 18 taxmann.com 182 (Delhi) and Pr. CIT v. Road Infrastructure Development Corp. of India [2018] 96 taxmann.com 155 208 (Raj.)

[6] CIT v. Shree Rama Multi Tech Ltd. [2018] 403 ITR 426 (SC)

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the income accrued was merely incidental and not the prime purpose of doing the act in question which resulted into the accrual of some additional income, then the income was not liable to be assessed and was eligible to be claimed as deduction.

In view of the above, the HC upheld the decision of the ITAT that, interest earned by the taxpayer from the investment made in FDs, out of the funds received for setting up a power plant, would not be taxable under the head 'Income from other sources'.

Comments:

Whether a particular income earned from interest of FDs in relation to funds received for a particular project is business income or taxable as 'Income from other sources' has been a subject of litigation.

The HC in this ruling, based on facts of the case has observed the following / upheld the following principles:

- For an income to be classified as income under the head 'profit and gains of business or profession' it would have to be an activity which is in some manner or form connected with business. The word 'business' is of wide import which would also include all such activities that coalesce into setting up of the business.
- Interest earned on surplus funds would have to be treated as 'income from other source'. If there is any surplus money which is lying idle and it has been deposited in the bank for the purpose of earning interest, then it is liable to be taxed as income from other sources.
- Whether the interest earned by the taxpayer from the investment made in FDs, out of the funds received for setting up a power plant, should be treated as 'capital receipt' or 'income from other sources', is dependent on whether the invested funds were inextricably linked with setting up of the power plant.
- There is indeed an inextricable link between the investment of the surplus funds and the setting up of the power transmission system. Therefore, clearly, the interest earned thereon can only be categorised as 'capital receipt'.

Taxpayers with similar facts may want to evaluate the impact of this ruling to the specific facts of their cases.

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