

IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 05.03.2019

CORAM

THE HON'BLE DR.JUSTICE VINEET KOTHARI  
AND  
THE HON'BLE MR.JUSTICE C.V.KARTHIKEYAN

Tax Case Appeal No. 158 of 2009

M/s. Sundaram Finance Limited.,  
21, Patullos Road  
Chennai - 600 002.

Appellant / Appellant

Vs.

The Assistant Commissioner of Income Tax  
Company Circle VI(4)  
Chennai.

Respondent/Respondent

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Tax Case Appeal filed under Section 260A of the Income Tax Act, 1961 against the order of the Income Tax Appellate Tribunal, Madras 'C' Bench, Chennai, dated 17.04.2008 made in ITA No.1002/Mds/2006 against the order passed by the commissioner of Income Tax (appeals)-V, Chennai. 34. dated 31.01.2006 made in ITA.NO.232/2005-06 and against the order passed by the Assisatant Commissioner of Income Tax company Circle VI(4), Chennai. Dated 28.03.2005 made in SV-048/AAACS4944A for the Assessment Year 2002-2003.

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For Appellant : Mr.R.Vijayaraghavan

For Respondent : Mr. T.R.Ravikumar  
Senior Standing Counsel

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J U D G M E N T

(Delivered by DR.VINEET KOTHARI, J)

The present Appeal was admitted by the Co-ordinate Bench of this Court on 16.03.2009 with the following questions of law:-

"(i) Whether, on the facts  
and in the circumstances of the  
case, the Tribunal was right in

law in holding that the Internal Rate Return (IRR) method is the appropriate method of income recognition in hire purchase transaction as against the Equated Sum (ESM) method regularly followed by the Appellant?;

(ii) Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that the interest income on hire purchase transactions accrued only under the Internal Rate Return (IRR) method and form part of the mercantile system of accounting?;

(iii) Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that the appellant is not entitled to maintain its Book on the Internal Rate Return (IRR) method while offering the income on Equated Sum (ESM) method for tax purpose."

2. Both the learned counsels fairly agreed that the said questions are covered by a decision of this Court in the case of Commissioner of Income Tax Vs. Ashok Leyland Finance Ltd. [(2013) 213 Taxman 0204], wherein it was held as under:

"18. In the light of the said finding of fact, one has to look at the reasoning of the Tribunal referring to the order of the Special Bench of the Hyderabad Tribunal and the assessee's own case in respect of the previous assessment year. Referring to the earlier orders of the Tribunal, which came on reference before this Court and which in turn was also rejected by this Court under judgment dated 12.3.1998, the Tribunal held that the consistency of returning the income for the purpose of income was only on EMI method. This was so, ever since the assessee started its business in this field. The Tribunal further pointed out that in loan transaction, only money is really involved,

but in a hire purchase transaction, hiring of asset other than money is involved; the title to the property will pass on to the hirer, when all the instalments are paid and when the hire purchaser exercises his option to purchase. Therefore, given the fact that the character of the transaction was pure and simple a hire purchase agreement and that the transaction had not in any manner undergone any change from the one which was the subject matter of consideration by the Tribunal for the earlier years, in respect of which, reference application filed by the Revenue was dismissed, the Tribunal came to the conclusion that the Assessing Officer had committed a serious error in ignoring the EMI method, to adopt SOD method.

19. We are in agreement with the reasoning of the Tribunal in this regard that when once the Revenue had accepted the character of the transaction as hire purchase transaction, the income that flows from the transaction has to necessarily follow the treatment that is given under the hire purchase agreement. Secondly, when the Revenue had not disputed the fact that on all the earlier years, the Revenue had treated the income as per the hire purchase agreement on EMI basis, there are no materials available as on record to show that following such method had really resulted in suppression of income, in other words, there was no true reflection of the income that has to be assessed under the Act."

3. It was also observed in the aforesaid Judgement that the Tribunal relied upon the Central Board of Direct Taxes Circular dated 13.01.1998 and allowed the computing of Interest component on the basis of EMI Method. The relevant portion is extracted for ready reference:

"11. It is a matter of relevance to point out that the assessee placed reliance on the circular of the Central Board of Direct Taxes, which, no doubt, was with reference to hire purchase cases. The Tribunal referred to the Central Board of Direct Taxes' circular dated 13.01.1998,

which specifically dealt with the hire purchase transactions' taxability with reference to interest element, to ultimately hold that Section 194 A of the Income Tax Act would not be attracted in case of payment of periodical instalment on the hire purchase agreement . Thus in the context of the circular of the Board No.127/(12)-I.T.42 dated 13.05.1943 as well as subsequent Circulars, particularly Circular No.275/9/80-IT (B) dated 25.01.1981 and Circular F.No.160/1/96 dated 13.1.1998, the Tribunal agreed with the assessee's case. Aggrieved by this, the Revenue has filed the above Tax Case (Appeals) before this Court."

4. The Andhra Pradesh High Court in Sri Chakra Financial Services Ltd. Vs. Commissioner of Income Tax [(2013) 350 ITR 398] , after discussing the Madras High Court's aforesaid view held that where there is no indication in the Hire Purchase Agreements reflecting the bifurcation of the EMIs into principal and interest components, the common and accepted usage of the Indexing system of accounting in the Hire Purchase trade must be held to be valid as otherwise the rate of interest under the mercantile system in so far as the later EMIs are concerned would be far higher and contrary to the rate prescribed in the assessee's agreements. The difference between the EMI and SOD method was illustratively explained by the Andhra Pradesh High Court in the following manner:

"6. To illustrate the difference in accounting of incomes as per the indexing method and the mercantile system, a hypothetical transaction involving hiring of machinery worth Rs.100/- is taken, on which hire purchase finance charges recoverable in 5 years is Rs.70/-. The following are the amounts of recovery shown in the books of account and in the computation of income as per the return filed.

Total value of machinery Rs.100/-  
Finance charges Rs. 70/-  
Rs.170/-

| Year | As per books based on Indexing Method |                 |       | As per income tax return based on Mercantile System |                 |       |
|------|---------------------------------------|-----------------|-------|-----------------------------------------------------|-----------------|-------|
|      | Principal                             | Finance charges | Total | Principal                                           | Finance Charges | Total |
| 1    | 7                                     | 27              | 34    | 20                                                  | 14              | 34    |
| 2    | 15                                    | 19              | 34    | 20                                                  | 14              | 34    |
| 3    | 22                                    | 12              | 34    | 20                                                  | 14              | 34    |
| 4    | 26                                    | 8               | 34    | 20                                                  | 14              | 34    |
| 5    | 30                                    | 4               | 34    | 20                                                  | 14              | 34    |
|      | 100                                   | 70              | 170   | 100                                                 | 70              | 170   |

Receipt of finance charges for the first and second years under the indexing system would thus be far higher than that reflected in the mercantile system of accounting. That is what has happened in the present case. The issue however is whether the income of the assessee under this head is to be assessed as per the entries in its own books of accounts or in accordance with the mercantile system of accountancy which it chose to adopt in its return of income."

5. The views of the Madras High Court was discussed by the Andhra Pradesh High Court in the following manner:

"Sri Krishna Kaundinya , learned counsel, sought to draw a distinction between the above decision and the case on hand by placing reliance on ASHOK LEYLAND FINANCE LIMITED V/s. ASSISTANT COMMISSIONER OF INCOME TAX (1979) 59 TTJ (Mad) 736. Therein, a Division Bench of the Madras High Court was dealing with a case which was somewhat

similar on facts to the present one. The appellant company before the Madras High Court was also engaged in the business of hire-purchase and lease financing. Its annual accounts were maintained in so far as finance charges were concerned on the reducing balance method (indexing method). However, the mercantile system of accounting was employed for the return of income as in the present case.

Faced with a situation where two systems were adopted for accounting for the income, the Madras High Court held that the right to receive an amount under a contract accrues or arises depending upon the terms of the particular contract. In other words, income has to be computed even under the accrual system of accounting only on the basis of accrual as provided for in the agreements evidencing the transactions. In short, there can be no accrual of income de hors the terms and conditions of the agreement. Viewed in this light, the Madras High Court held that the technique of accounting followed by the assessee (Reducing balance method or the SOD method) in its books of account for recording the transactions cannot determine the accrual of income.

The Court held that accrual would depend on the terms and conditions of the contract between the parties, but not at the whims of either party. Upon perusing sample copies of the agreements, the Madras High Court held that it was not open to the assessee to adopt the SOD method or the reducing balance method when the agreement was to the contrary.

Examination of the above judgment reflects that the case before the Madras High Court differed from the present one on crucial factual aspects. The Madras High Court found on facts that the terms of the agreement in that case did not permit adoption of the Indexing System of accounting and therefore, use of the said system in the books of accounts was held to be contrary to the terms of the contract itself.

In the present case, however, there is no indication of the assessee's hire purchase agreements reflecting bifurcation of the EMIs into principal and interest components. In

the absence thereof, the common and accepted usage of the Indexing system of accounting in the hire purchase trade must be held to be valid as otherwise the rate of interest under the mercantile system in so far as the later EMIs are concerned would be far higher and contrary to the rate prescribed in the assessee's agreements. Further, as the assessee had itself employed this system of accounting in its books of account, applying the law laid down in SANJEEV WOOLEN MILLS (supra), the Department was bound to accept the same for the assessment proceedings.

Viewed thus, we are of the opinion that the law laid down by the Special Bench of the Income Tax Appellate Tribunal at Hyderabad in NAGARJUNA INVESTMENT TRUST LIMITED (supra) was correct. In the event the hire purchase or leasing agreement did not give the apportionment or bifurcation of the EMIs between the principal and interest components, the interest income in relation to such agreements, recognized on the basis of SOD system of accounting by the assessee in its books of account, represents the 'real income' accrued to the assessee. Reliance placed by the Tribunal on this judgment while allowing the Revenue's appeal in the present case was therefore justified. The substantial question of law is accordingly answered upholding the Revenue's computation of the assessee's income from finance charges and in favour of the Revenue and against the assessee. In consequence, the ITTA is dismissed, but in the circumstances, without any order as to costs."

6. Having perused the aforesaid Judgements, we are of the clear opinion that the later decision of Andhra Pradesh High Court relied on by the learned counsel for the Revenue does not help the case of the Revenue and Andhra Pradesh High Court itself distinguished the facts before it from the Madras High Court decision in the case of Ashok Leyland (Supra). Admittedly, the Assessee has been following the same method of E.M.I for bifurcation of its income into Principal and interest component for all these years in question. The S.O.D method gives higher finance charges (interest) for the initial years and lower finance charges (interest) for the later years, i.e, the Sum of Digits is sum total of the number of years e.g. If the Hire Purchase Agreement is for 10 years, the SOD is 55

(1+2+3+4+5+6+7+8+9+10 = 55). Therefore, total financial charges for the first year would be 10/55, for the second year 9/55, for third year 8/55 and so forth which would clearly give higher financial charges for interest taxable in the first year. This SOD method even though adopted by the Assessee in its Book of Accounts on the basis of Guidelines issued by the Institute of Chartered Accountants of India was not adopted in the Returns of Income filed by it which consistently adopted EMI method for taxability of interest income all these years. Since, for the previous assessment years, this Court has already approved such bifurcation of income and has held that interest income (Finance charges) on consistently adopted basis of E.M.I. would be taxable in the hands of the Assessee, the mere change of Accounting method in its Book of Accounts on the basis of S.O.D. does not alter the position in the tax in the hands of the assessee. Therefore, the Judgement of Andhra Pradesh High Court in the case of Sri Chakra Financial Services Ltd. Vs. Commissioner of Income Tax [(2013) 350 ITR 398] is distinguishable.

7. On the other hand, since in the case of Ashok Leyland Finance Ltd., (supra) the Coordinate Bench of this Court has upheld the taxability with regard to interest income on EMI method, which has been consistently followed, there is no reason to take a different view in the matter for the present Assessment years, in this case.

8. Accordingly, the present Appeal of Assessee is allowed and the questions of law are answered in favour of the Assessee and as against the Revenue. No order as to costs.

Sd/-

Assistant Registrar(CS iv)

//True Copy//

Sub Assistant Registrar

vsg

To,

1.THE ASSISTANT COMMISSIONER OF INCOME TAX COMPANY CIRCLE VI(4), CHENNAI.

2.THE INCOME TAX APPELLATE TRIBUNAL, MADRAS 'C' BENCH, CHENNAI.

3.THE COMMISSIONER OF INCOME TAX (APPEALS)-V, CHENNAI. 34.

+1cc to Mr. Subbrayan Aiyar, Advocate SR.No. 21342

+1cc to Mr.T.R.Ravikumar , Advocate SR.No. 20665

Tax Case Appeal No. 158 of 2009

A.SK(04/04/2019)