
(1991) 07 CAL CK 0021

In the Calcutta High Court

Case No : Income-tax Reference No. 54 of 1989

Avery India Ltd.

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 18-07-1991

Acts Referred:

Citation : (1993) 114 CTR 39 : (1993) 199 ITR 745

Hon'ble Judges : Shyamal Kumar Sen, J;Ajit K. Sengupta, J

Bench : Division Bench

Advocate : D. Pal, for the Appellant;

Judgement

Ajit K. Sengupta, J.—In this reference made at the instance of the assessee, the following questions of law have been referred for the assessment year 1980-81 by the Tribunal u/s 256(1) of the Income Tax Act, 1961, for the opinion of this court :

" 1. Whether, on the facts and in the circumstances of the case, the Tribunal was right in not allowing the sum of Rs. 19,36,797 representing expenses in connection with the issue of shares required for the purposes of complying with the Foreign Exchange Regulation Act, 1973 ?

2. Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that, since the demand of sales tax of Rs. 5,75,203 was being disputed in the previous year, it could not be allowed as a deduction till the matter was finally decided ?

3. Whether, on the facts and in the circumstances of the case, the surtax liability of the previous year was an admissible deduction in computing the total income of the assessee?"

2. This reference relates to the Income Tax assessment of the assessee-company for the calendar year 1979 corresponding to the assessment year 1980-81. The facts relating to the first question are that the assessee-company, in order to

comply with the provisions of the Foreign Exchange Regulation Act, 1973, issued fresh share capital during the relevant previous year with the object of reducing the level of non-resident interest in the equity capital of the company from 60 per cent. to less than 40 per cent. The assessee-company incurred an aggregate expenditure of Rs. 19,36,797 in connection with the issue of shares as aforesaid. The Tribunal held that the share issue expenditure was capital in nature following the decision of the Kerala High Court in Commissioner of Income Tax Vs. Commonwealth Trust Ltd., . In that case, the Kerala High Court held that, where the expenditure was incurred for the purpose of changing the capital structure of the assessee-company to suit the requirements of the Foreign Exchange Regulation Act by obtaining shares held by foreigners and transferring them to Indian citizens, the structure, character and status of the assessee-company was changed by the expenditure. The expenditure was incurred for creating or curing or for perfecting title to the share capital of the company in accordance with the requirements of the statute and not for the protection of the business of the company. The expenditure was, accordingly, held to be capital in nature.

3. At the hearing before us, Dr. Pal, learned counsel for the assessee, has submitted that the expenditure was incurred in connection with the issue of shares required for the purposes of complying with the provisions of the Foreign Exchange Regulation Act, 1973. When the Foreign Exchange Regulation Act, 1973, came into existence, the assessee-company had to apply to the Reserve Bank of India u/s 29 of the Foreign Exchange Regulation Act for permission to carry on the business. The directors, in their report for the year 1977, pointed out that the Reserve Bank of India had granted permission to the company to carry on the business u/s 29 of the Foreign Exchange Regulation Act on the condition that the non-resident interest in the equity capital of the company shall be reduced to a level not exceeding 40 per cent. The directors, in their report for the year 1979, observed that in order to reduce the level of the non-resident interest in the equity capital of the company to slightly below 40 per cent., the shares of Rs. 10 each, at a premium of Rs. 9 per share, were offered to the Indian public. The object of the issue of the said shares, as will appear from the prospectus, was to reduce the non-resident interest in the equity capital of the company to a level not exceeding 40 per cent. in compliance with the direction of the Reserve Bank of India. Dr. Pal, therefore, contends that the object of the issue of the shares is, to reduce the non resident interest in the equity capital of the company in order to comply with the directions of the Reserve Bank of India. The direction of the Reserve Bank of India was, as pointed out earlier, that the company is permitted to continue to carry on the business on the condition that the non-resident interest in the equity capital of the company is reduced to a level not exceeding 40 per cent.

4. It is also his contention that the company had no loan or any overdraft to carry on the business of the company. On the other hand, the company had huge fixed deposits with banks. Thus, the object of the issue of the share capital was not to augment the financial resources of the company by issuing further capital.

The object, of the company was to reduce the non-resident interest in the equity capital in order to comply with the directions of the Reserve Bank of India so that the company may carry on the business after complying with Section 29 of the Foreign Exchange Regulation Act. The expenditure was incurred, therefore, to facilitate the carrying on of the business and the aim and object of the expenditure was not to increase the share capital for the purposes of obtaining financial resources.

5. It is no doubt true that, if an expenditure has been made not for the purposes of bringing into existence an asset or advantage for the enduring benefit of the business but for running the business or working it with a view to producing profit, it is a revenue expenditure and the aim and object of the expenditure would determine the character of the expenditure, whether it is a capital or a revenue expenditure. Whether a particular expenditure is revenue expenditure incurred for the purposes of the business must be determined on a consideration of all the facts and circumstances and by the application of the principles of commercial trading. The question must be viewed in the larger context of business necessity or expediency. If the outgoing or expenditure is so related to the carrying on or conduct of the business that it may be regarded as an integral part of the profit-earning process and not for the acquisition of an asset or a right of a permanent character the possession of which is a condition for the carrying on of the business, the expenditure may be regarded as a revenue expenditure.

(See Assam Bengal Cement Co. Ltd. Vs. The Commissioner of Income Tax, West Bengal, and BOMBAY STEAM NAVIGATION CO. (1953) PRIVATE LTD. Vs. COMMISSIONER OF Income Tax, BOMBAY., .

6. But, in the instant case, although the object of the expenditure was to reduce the non resident interest in the equity capital in compliance with the directives of the Reserve Bank of India, the effect of such expenditure was to increase the financial resources of the company. It is immaterial whether the object of the expenditure was to increase the financial resources of the company or whether the assessee had large amounts of fixed deposits in banks to its credit. The aim and object of the expenditure was no doubt to comply with the directives of the Reserve Bank of India, but, if, in the process of such compliance, the capital structure of the company is changed by issuance of further share capital, such expenditure must be held to be on capital account.

7. Our attention has been drawn to a decision of this court in the case of Brooke Bond India Ltd. Vs. Commissioner of Income Tax, . In that case, the question was of allowance of expenses incurred in connection with the issue of a fresh lot of shares. There, this court held as follows (at page 284) :

" In our opinion, where the object of incurring the expenditure, as in the instant case, was to affect the capital structure, as a result of which certain incidental advantage flows, it will be of a capital nature. We are also unable to accept the

contention that it is only the acquisition of a right of a permanent character, the creation of which was a condition for the carrying on of the business, which could be rightly treated as an expenditure on the capital account. Capital expenditure can be incurred after the company was floated or it started business, if it resulted in bringing in a capital advantage."

8. In *Union Carbide India Ltd. Vs. Commissioner of Income Tax*, , a Division Bench of this court, following the decision in *Brooke Bond India Ltd. Vs. Commissioner of Income Tax*, , held that the fees paid to the Registrar of Companies in connection with the increase of the authorised capital of a company is capital expenditure.

9. Dr. Pal, however, has contended that the Bombay High Court in *Commissioner of Income Tax Vs. Glaxo Laboratories (India) Ltd.*, , distinguished the decision in *Brooke Bond India Ltd. Vs. Commissioner of Income Tax*, . In the case before the Bombay High Court, the question was whether the share issue expenses were allowable as revenue expenditure. In that case, the assessee, a manufacturer of pharmaceuticals, had entered into an agreement of technical collaboration with its parent company in the United Kingdom which was due to expire in the beginning of 1967. The assessee applied to the Government of India for permission to enter into a fresh technical collaboration agreement so that it could continue to obtain the benefit of research being carried out by the parent company and also day-to-day advice in respect of the manufacture of existing and new products. It was common ground that the Government informed the assessee that it would approve of such an agreement only if the assessee agreed to dilute the shareholding of the parent company in its capital by offering at least 25 per cent. thereof to the Indian public. As the Government insisted upon the fulfilment of this pre-condition, the assessee issued fresh equity capital. It did so although it had a cash balance of over Rs. 50 lakhs and a borrowing capacity from banks of more than Rs. 10 crores. It was common ground that had the assessee resorted to the acquisition of additional working funds by borrowings, it would have been cheaper than issuing of fresh capital. For issue of fresh capital, the assessee incurred an aggregate expenditure of Rs. 9,32,946. This was on account of underwriters' fees, printing, bank collection charges, stamp duty, etc.

10. There, the Bombay High Court held (at page 65) :

" It is clear that we must find the aim and objects, from a businessman's point of view, in incurring the said expenditure. It is established, upon the Tribunal's finding, that the assessee had no need for funds. It is established that it had need only of the technical collaboration arrangement to run profitably. What, therefore, motivated the businessman in the assessee was the expediency of ensuring the continuance of the technical collaboration arrangement. The object and purpose of the said expenditure, therefore, seen from the businessman's point of view, must be held to be to obtain the approval of the Government to the continuance of the technical collaboration arrangement. This being the object and purpose, the said expenditure must be held to be revenue expenditure and

an allowable deduction. That an advantage of an enduring character, namely, the increase in the share capital resulted cannot, in the circumstances, be held to be decisive."

11. The Bombay High Court distinguished the decision in *Brooke Bond India Ltd. Vs. Commissioner of Income Tax*, as follows (at page 64) :

"In *Brooke Bond India Ltd. Vs. Commissioner of Income Tax*, the assessee had issued shares and incurred expenditure which had been claimed as a revenue deduction. The Tribunal had found that the assessee had itself stated that, by the expenditure, the capital base of the assessee was reinforced on a permanent basis and that this was the main purpose of the assessee. It was submitted before the Calcutta High Court that the object and purpose of the expenditure was to strengthen the capital structure and, only as an incidental result, more funds had flowed to the assessee making more working funds available to it. The High Court held that that could not change the essential object and purpose of incurring the expenditure and the resultant fact, that is to say, the fundamental change in the income-earning machinery and structure. It held that, therefore, the Tribunal had been right in disallowing the expenditure. In its exhaustive judgment, the High Court said that if the main object, purpose and nature of the transaction was to affect the income earning machinery or structure as such and not only to make the inflow of more funds available, then the expenditure would be on the capital side. It was true that the alteration in the capital structure by raising the share capital would make more funds available, but that was not decisive. The essential object and purpose for incurring the expenditure and the resultant fact was the fundamental change in the income-earning machinery or structure. It was the resultant advantage obtained by incurring the expenditure, along with the purpose and object of incurring the expenditure, which was the guide to answering the question."

12. Dr. Pal has contended that *Brooke Bond India Ltd. Vs. Commissioner of Income Tax*, was a case where the Tribunal found that the assessee had itself stated that, by the expenditure, the capital base of the assessee was reinforced on a permanent basis and this was the main purpose of the assessee. It is because of this admission and the finding of the Tribunal that the High Court observed that, if the main object and purpose of the expenditure was to affect the income-earning machinery or structure as such, the expenditure was to be a capital expenditure.

13. We are, however, unable to accept this contention. *Brooke Bond India Ltd. Vs. Commissioner of Income Tax*, did not proceed on the basis of the concession. Whether or not an expenditure is revenue expenditure or capital expenditure does not depend on the admission of the assessee ; the admission of the assessee cannot convert an expenditure which is otherwise revenue in nature into capital expenditure. The Tribunal in *Brooke Bond India Ltd. Vs. Commissioner of Income Tax*, held as follows :

"Expenditure incurred in connection with the increase in or addition to the existing share capital definitely affects the profit-making apparatus of the company and adds to the capital cost of the company. Any alteration in or addition to the capital structure of the company essentially involved capital expenditure. In fact, the assessee itself has stated in the grounds of appeal that by this expenditure the capital base of the company was reinforced on a permanent basis. This admission by itself would spell out an advantage of an enduring nature. The purpose for which the share capital was raised is not material and would not assist the assessee at all. Whether the expenditure was incurred for buying capital assets or for meeting day-to-day requirements of the company is beside the point. Any expenditure incurred in connection with the alteration of or addition to the existing share capital of the company must be treated as on capital account not only in the light of the settled principle of law but also of the well-known principles of accountancy."

14. We have already extracted the observation of the Division Bench, in *Brooke Bond India Ltd. Vs. Commissioner of Income Tax*, , which would indicate that the Division Bench decided the question in the light of the principles laid down by the several authorities referred to in the said judgment and not on the basis of the admission of the assessee.

15. In this case, admittedly, there has been further issue of share capital inasmuch as 7,46,606 shares of Rs. 10 each were issued afresh at a premium of Rs. 9 per share to the Indian public. *Avery Ltd.*, the foreign company, also offered for sale 1,55,000 shares of Rs. 10 each held by it at a premium of Rs. 9 per share on right basis to the existing shareholders. By that process, not only the non-resident company was converted into a resident company but the structure and character of the company changed as held by the Kerala High Court in *Commissioner of Income Tax Vs. Commonwealth Trust Ltd.*, .

16. When we were about to deliver the judgment, our attention was drawn to a decision of a Division Bench of this court in the case of *Commissioner of Income Tax Vs. Machine Tools (India) Ltd.*, . In that case, the assessee, a FERA company, decided to increase its subscribed share capital to ensure that 60 per cent. of the increased subscribed capital would be in the hands of Indian nationals in view of the amendment made to the Foreign Exchange Regulation Act. The assessee created two trusts in October, 1973, for the welfare of its employees. Each of the trusts received Rs. 500 as initial contribution. In December, 1973, the company transferred Rs. 1,73,440 to the two trusts and, on the same day, the trustees utilised the amount to purchase shares of the company. The assessee claimed deduction of the amount but the Income Tax Officer and the Commissioner of Income Tax (Appeals) rejected the claim on the ground that the sole purpose of making the contribution to the trusts was to enable them to purchase the equity shares issued by the assessee-company. No evidence was produced to show that any amount was spent by these two trusts for the benefit of the employees. The Tribunal, however, held that the amount had been spent for the welfare of the

assessee's employees and that it was deductible u/s 37 of the Income Tax Act, 1961, There, the court held that the Tribunal had arrived at the finding that the expenditure incurred by the assessee was for the purpose of the welfare of the assessee's employees and this finding had not been challenged. Whether the money was spent for the welfare of the employees directly or indirectly or whether the object of creating the two trusts was really to retain control over the shares of the company and, at the same time, comply with the FERA regulation was a matter that should have been investigated in greater detail. But this was not done. The Tribunal overlooked this aspect. However, no specific question had been raised challenging the decision of the Tribunal in this regard. In view of this finding of fact, the amount of Rs. 1,73,440 was allowable as a deduction. This decision has no application to the facts of the present case as the point in issue in this reference was neither raised nor decided in that decision.

17. For the foregoing reasons, we answer the first question in the affirmative and in favour of the Revenue.

18. The second question relates to the sales tax liability in the sum of Rs. 5,75,203. The facts as stated by the Tribunal are as under :

The assessee received the following sales tax assessment orders imposing Central sales tax on transfer of machines manufactured at Faridabad works to places outside Faridabad :

Financial year Demand Date of order

Rs.

1973-74 21,963 28-9-1978

1974-75 1,63,009 20-3-1979

1975-76 3,82,231

24-8-1979

5,75,203

19. The assessee's accounting year ended on December 31, 1979. The assessee did not make any provision in its books of account in respect of the aforesaid liability. The Commissioner of Income Tax (Appeals) directed the Income Tax Officer to verify the facts relating to sales tax liability and allow deduction in respect thereof only if it was found that demands were raised for the first time during the previous year in question and were also accepted and paid by the assessee-company during the same previous year. The Tribunal, however, held that if the assessee had not objected to the demand of sales tax during the previous year in question, the same should be allowed as a deduction. In case, however, the assessee has disputed the assessment order so passed, the liability should be allowed only in the year in which the disputes are finally settled and the liability is finally determined.

20. We, however, find that the approach adopted by the tax authorities is not strictly in accordance with law. Under the sales tax law, the charge to sales tax arises in the year of sale or transfer. Where, therefore, an assessee follows the mercantile system of accounting, the liability to sales tax should be claimed as a deductible expenditure only in the year in which such sale or transfer takes place. The liability for sales tax cannot be claimed as a deductible expenditure in the year in which the sales tax assessment is made. However, if an additional liability is raised as a result of the sales tax assessment order, such additional liability being in excess of what could reasonably be taken as a sales tax liability on the basis of sales or transfers taking place during the relevant previous year, in that event, the additional liability so raised is deductible as business expenditure in the year in which the sales tax demand is raised as a result of the assessment made by the authorities under the Sales Tax Act. We do not find that either the tax authorities or the Tribunal have made any enquiries in the manner as aforesaid. The entire sum of Rs. 5,75,203 does not appear to be an additional liability arising on assessment in the relevant previous year. At least, in the first case, the liability of Rs. 24,963 is stated to have been raised as per order dated September 28, 1978, which is clearly outside the relevant previous year. It is not clear as to how this amount can be claimed as a deductible business expenditure in the year under reference when even the order of assessment was passed in the earlier year.

21. We are, therefore, of the view that the entire controversy covered by question No. 2 should be remanded to the Tribunal. The Tribunal will enquire as to why the provision for this liability was not made in the year in which the sale or transfer took place and as to whether the amount could be claimed as a business expenditure in the year under reference on the basis of the assessment order passed in this year. We, however, agree with the learned counsel appearing for the assessee that the mere fact that the liability in question is being disputed by the assessee is no ground for disallowing the claim for deduction of such liability. We, therefore, decline to answer the second question and remand the matter to the Tribunal to make proper enquiries, ascertain the facts and redetermine the issue in accordance with law after giving opportunity to the assessee as well as the Revenue. The assessee will be entitled to place fresh evidence before the Tribunal.

22. The third question is directly covered by the decision of this court in *Molins of India Ltd. Vs. Commissioner of Income Tax*, . Following the said decision, we answer the third question in the affirmative and in favour of the Revenue.

23. There will be no order as to costs.

Shyamal Kumar Sen, J.

I agree.