

(2013) 12 KAR CK 0399

In the Karnataka High Court

Case No : IT Appeal No's. 428 and 447 of 2007

Commissioner of Income Tax and Another

APPELLANT

Vs

Motorola India Electronics (P) Ltd.

RESPONDENT

Date of Decision : 11-12-2013

Acts Referred:

Citation : (2014) 265 CTR 94

Hon'ble Judges : Rathnakala, J;N. Kumar, J

Bench : Division Bench

Advocate : K.V. Aravind, for the Appellant; S. Parthasarathi, for the Respondent

Judgement

N. Kumar, J.—These appeals are filed by the Revenue challenging the order passed by the Tribunal holding that the interest payable on the fixed deposits constitutes profits of the business of the undertaking. As such, the assessee is entitled to the benefit under ss. 10A and 10B of IT Act, 1961 (hereinafter referred to as "the Act" for brevity). The assessee had earned interest from the following sources:

1. Deposits lying in the EEFC account, and
2. Advancing of inter-corporate loans out of the funds of the undertaking. The assessee had outstanding borrowings by way of external commercial borrowings (ECBs in short) obtained in earlier years. The assessee has to repay this borrowing only in accordance with the repayment schedule. It was stated that RBI has imposed restriction on prepayment of instalments. The undisputed fact is that the borrowings were for the business of STP undertaking. Under the Exchange Control Regulation, the assessee is prohibited from any pre-payment of ECBs. For any prepayment of the loan, the assessee had to seek prior permission of the Central Government. In the year 1999, the Government had formulated a policy on prepayment and the policy stated that approval of prepayment would be granted only to the extent of 10 per cent of the outstanding loan. Hence, even after going through the regulation, the assessee

would have to repay a small portion of its outstanding loans, though it had the liquidity to do so. Hence, it is required to temporarily park the funds, until the date of repayment, and also keep paying the interest on the loans. The assessee took a business decision to place these funds with various sister concerns as inter-corporate deposits. The assessee claims that the interest derived from deposits in the EEFC account and the interest income earned on inter-corporate deposits, have to be assessed under the head income from business. Further, the assessee claimed that the interest income as derived from the business of export of articles or things or computer software and the same is eligible for exemption under s. 10A of the Act for the asst. yrs. 1997-98 and 1998-99. For the asst. yr. 2001-02, he submits that, since the Act has undergone a change, the entire concept and basis of s. 10A have changed and thus, as per the provisions of law as applicable to the asst. yr. 2001-02, the interest income forms part of profit from the business of industrial undertaking and once the formula is applied as specified in sub-s. (4) of s. 10A, the assessee would be entitled for deduction, as the assessee is a 100 per cent exporter, i.e. the entire business of the assessee consists of development and export of software. The assessing authority did not agree with the said contention and therefore, he disallowed the exemption claimed for the asst. yr. 2001-02. Aggrieved by the said order, the assessee preferred an appeal to the CIT(A), which came to be dismissed. Aggrieved by the said order, the assessee preferred an appeal to the Tribunal. The Tribunal insofar as the asst. yr. 1998-99 is concerned, held that the interest income from EEFC account and the interest recovered on loans advanced to the sister concern are admissible deductions under the head income from business. It further held that as per the predominant view of the various High Courts, the interest income arising from the transaction connected with the business would be business income and they affirmed the findings recorded by the appellate authority. Hence, they extended the benefit under s. 10B of the Act, for the asst. yr. 1998-99.

2. However, while dealing with the very same question for the asst, yr. 2001-02, they took note of the change in the law. They extracted s. 10B(1) and (4) of the Act and held that it was an exemption section and income from these undertakings, which are covered by the section did not form part of the total income. However, by virtue of the amendment, in particular, introduction of sub-s. (4) to s. 10B of the Act, the methodology of arriving at the export profits of the business of the undertaking is given in a formula. The terminology used in sub-s. (4) is "profits of the business" of the undertaking in contradiction to the words "profits and gains derived by the assessee from a 100 per cent export-oriented undertaking". Finally, they held that the term "from the business of" is much wider than the term "derived from industrial undertaking". Keeping the said distinction in mind, they held that the entire profits deriving from the business of undertaking should be taken into consideration, while computing the eligible deduction under s. 10B/10A of the Act, by applying mandatory formula. After introducing s. 80HHC, it was observed, that the legislature intended to

exclude interest from the term "profits of business of undertakings" under ss. 10A and 10B of the Act and similar provision as in case of cl. (baa) would have been inserted. No such Explanation has been introduced in ss. 10A and 10B and therefore, it held that the interest income is exempted from payment of tax and also their claim for allowance of 5 per cent on scientific basis should be allowed. Aggrieved by the said order, the Revenue is in appeals.

3. Learned counsel for the Revenue assailing the impugned order contended that having regard to the s. 10B of the Act, what is to be taken into consideration is profits and gains derived from the export of articles or things or computer software and not the profits of the business of the undertaking. The words "derived from" are narrower in connotation and intend to cover sources not beyond the first degree. Therefore, when the interest from fixed deposits or interest from loans advanced to the sister concern or interest from EEFC account or the consideration received from sale of the import entitlement cannot be construed as profits and gains from export of computer software. Therefore, the said account is liable to be taxed.

4. Per contra, learned counsel for the assessee submits "that was the position prior to the amendment in 2001. That is why, for the asst. yr. 1998-99, the Tribunal has declined to extend the said benefit and the assessee has accepted the said finding. But in view of the change in the law, he is entitled to the said benefit and the Tribunal after taking note of the change in the law, has extended the said benefit, which is in tune with the legislative intention. Therefore, the impugned order cannot be found fault with". In the light of the aforesaid facts and rival contentions, IT Appeal No. 428 of 2007 was admitted on 19th Nov., 2011 and IT Appeal No. 447 of 2007 was admitted on 14th March, 2008 to consider the following substantial questions of law, which read as under:

In IT Appeal No. 428 of 2007:

(1) Whether in the facts and circumstances of the case, the finding of the appellate authorities that interest received by the assessee out of surplus funds and deposited in banks and other sister concerns should be brought to tax under the head "Income from business" and not under the head "Income from other sources", is perverse, arbitrary and contrary to law?

2. Whether the finding of the appellate authorities having regard to the facts and circumstances of the case and the law that the interest income deposited out of surplus funds in banks and sister concerns and EEFC account should be treated as part of the total income for the purpose of computing deduction under ss. 10A and 10B of the IT Act, is perverse and arbitrary?

In IT Appeal No. 447 of 2007:

1. Whether the appellate authorities committed an error in holding that the interest income deposited out of surplus funds in banks and sister concerns and EEFC account should be treated as part of the total income for the purpose of

computing deduction under ss. 10A and 10B of the IT Act?

2. Whether the appellate authorities were correct in holding that the management expenses attributable to the income earned by way of interest is allowable @ 5 per cent and not @ 4 per cent as computed by the AO without assessing any cogent reasons for applying such charges?

5. Learned counsel for the Revenue in support of his contentions relied on several judgments, which are as under:

The apex Court in the case of Pandian Chemicals Ltd. Vs. Commissioner of Income Tax, , while dealing with s. 80HH of the Act has held as under:

6.....The word "derived" is not a term of art. Its use in the definition indeed demands an enquiry into the genealogy of the product. But the enquiry should stop as soon as the effective source is discovered. In the genealogical tree of the interest land indeed appears in the second degree, but the immediate and effective source is rent, which has suffered the accident of non-payment. And rent is not land within the meaning of the definition.

7. This definition was approved and reiterated in 1955 by a Constitution Bench of this Court in the decision of Bacha F. Guzdar Vs. Commissioner of Income Tax, Bombay, . It is clear, therefore, that the word "derived from" in s. 80HH of the IT Act, 1961, must be understood as something which has direct or immediate nexus with the appellant's industrial undertaking. Although electricity may be required for the purposes of the industrial undertaking, the deposit required for its supply is a step removed from the business of the industrial undertaking. The derivation of profits on the deposit made with Electricity Board cannot be said to flow directly from the industrial undertaking itself.

The apex Court in the case of Liberty India Vs. Commissioner of Income Tax, , while interpreting s. 80-IB of the Act, which also allowed deduction in respect of profits and gains derived from eligible business has held as under:

14.....The words "derived from" are narrower in connotation as compared to the words "attributable to". In other words, by using the expression "derived from", Parliament intended to cover sources not beyond the first degree.

That is the distinction between the words "derived from industrial undertaking" as against "profits attributable to industrial undertaking".

The apex Court in the case of Commissioner of Income Tax, Karnataka Vs. Sterling Foods, Mangalore, , while dealing with s. 80HH has held as under:

There must be, for the application of the words "derived from", a direct nexus between the profits and gains and the industrial undertaking.

In the case of Commissioner of Income Tax Vs. Menon Impex P. Ltd., , the Court while dealing with exemption under s. 10A of the Act, has held as under:

It was pointed out that unless the source of the income is from an industrial

undertaking, such income cannot be regarded as "derived from" industrial undertaking. It was held that the income derived from sale of import entitlement could only be said to be the export promotion scheme and not the industrial undertaking.

Following the aforesaid Judgments, the Madras High Court in the case of (2002) 257 ITR 60 has held that the Interest which is earned by the assessee from the bank deposits would not have a direct nexus with the industrial undertaking of the assessee and would only be incidental income thereto and, therefore, such interest has to be ignored from the allowable profits under s. 80HH. Following the aforesaid judgments, the Division Bench of this Court in the case of Shri. Anil Dang Prop. Tycoon International Vs. The Income Tax Officer, has held that the primary condition to claim deduction under s. 80HHC would be that the assessee should have derived profits from export of goods or merchandise and bailee. The assessee would not be allowed to compute the total income by deducting profits derived from export. The Bombay High Court in the case of The Commissioner of Income Tax Vs. Shah Originals, has held that "an assessee who is an exporter, is not under an obligation of law to maintain the export proceeds in EEFC account but, this is a facility which is made available by the RBI. The transaction of export is complete in all respects upon the repatriation of the proceedings. It lies within the discretion of the exporter as to whether the export proceeds should be received in a rupee equivalent in the entirety or whether a portion should be maintained in convertible foreign exchange in the EEFC account. The exchange fluctuation that arises, it must be emphasized, is after the export transaction is complete and payment has been received by the exporter. Upon the completion of the export transaction, what the seller does with the proceeds, upon repatriation, is a matter of his option. The exchange fluctuation in the EEFC account arises after the completion of the export activity and does not bear a proximate and direct nexus with the export transaction so as to fall within the expression "derived" by the assessee in sub-s. (1) of s. 80HHC.

6. Relying on these judgments, it was contended that the interest received or the consideration received from sale of import entitlement has no direct nexus with the profits and gains derived from the export of software and therefore, the assessee is not eligible for exemption. All the judgments were rendered prior to the amendment in the year 2001 and therefore, there cannot be any quarrel with the law laid down in these cases. All the judgments are rendered in the context of s. 80HHC. Therefore, the judgment of the Tribunal for the asst. yr. 1998-99, where it has declined the benefit to the assessee cannot be found fault with. But there is change in the law for the asst. yr. 2001-02. Sec. 10B(1) and (4) reads as under: Sec. 10B. Special provisions in respect of newly established hundred per cent EOU.--(1) Subject to the provisions of this section, a deduction of such profits and gains as are derived by a hundred per cent EOU from the export of articles or things or computer software for a period of ten consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or

things or computer software, as the case may be, shall be allowed from the total income of the assessee:

Provided that where in computing the total income of the undertaking for any assessment year, its profits and gains had not been included by application of the provisions of this section as it stood immediately before its substitution by the Finance Act, 2000, the undertaking shall be entitled to the deduction referred to in this sub-section only for the unexpired period of aforesaid ten consecutive assessment years:

Provided further that for the assessment year beginning on the 1st day of April, 2003, the deduction under this sub-section shall be ninety per cent of the profits and gains derived by an undertaking from the export of such articles or things or computer software:

Provided also that no deduction under this section shall be allowed to any undertaking for the assessment year beginning on the 1st day of April, 2012 and subsequent years:

Provided also that no deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under sub-s. (1) of s. 139.

(4) For the purposes of sub-s. (1), the profits derived from export of articles or things or computer software shall be the amount which bears to the profits of the business of the undertaking, the same proportion as the export turnover in respect of such articles or things or computer software bears to the total turnover of the business carried on by the undertaking.

By Finance Act, 2001, w.e.f. 1st April, 2001, the present sub-s. (4) is substituted in the place of old sub-s. (4). No doubt sub-s. 10(B) [sic-sub-s. (1)] speaks about deduction of such profits and gains as derived from 100 per cent EOU from the export of articles or things or computer software. Therefore, it excludes profits and gains from export of articles. But sub-s. (4) explains what is the profit derived from export of articles as mentioned in sub-s. (1). The substituted sub-s. (4) says that profits derived from export of articles or things or computer software shall be the amount which bears to the profits of the business of the undertaking and not the profits and gains from export of articles. Therefore, profits and gains derived from export of articles are different from the income derived from the profits of the business of the undertaking. The profits of the business of the undertaking include the profits and gains from export of the articles as well as all other incidental incomes derived from the business of the undertaking. It is interesting to note that similar provisions are not there while dealing with computation of income under s. 80HHC. On the contrary, there is specific provisions like s. 80HHB which expressly excludes this type of income. Therefore, in view of the aforesaid provisions, it is clear that, what is exempted is not merely the profits and gains from the export of articles but also the income from the business of the undertaking.

In the instant case, the assessee is a 100 per cent EOU, which has exported software and earned the income. A portion of that income is included in EEFC account. Yet another portion of the amount is invested within the country by way of fixed deposits, another portion of the amount is invested by way of loan to the sister concern which is deriving interest or the consideration received from sale of the import entitlement, which is permissible in law. Now the question is whether the interest received and the consideration received by sale of import entitlement is to be construed as income of the business of the undertaking. There is a direct nexus between this income and the income of the business of the undertaking. Though it does not partake the character of a profit and gain from the sale of an article, it is the income which is derived from the consideration realized by export of articles. In view of the definition of "income from profits and gains" incorporated in sub-s. (4), the assessee is entitled to the benefit of exemption of the said amount as contemplated under s. 10B of the Act. Therefore, the Tribunal was justified in extending the benefit to the aforesaid amounts also. We do not find any merit in these appeals. Therefore, the first substantial question of law raised in IT Appeal No. 428 of 2007 is answered in favour of the Revenue and against the assessee and the first substantial question of law in IT Appeal No. 447 of 2007 is answered in favour of the assessee and against the Revenue. In the light of the aforesaid findings, the second substantial question of law in both the appeals does not arise for consideration.

Parties to bear their own costs.