

(1976) 01 OHC CK 0011

In the Orissa High Court

Case No : Special Jurisdiction Case No. 205 of 1974

Commissioner of Income Tax

APPELLANT

Vs

J.N. Bhowmick

RESPONDENT

Date of Decision : 05-01-1976

Acts Referred:

Citation : (1976) 01 OHC CK 0011

Hon'ble Judges : R.N. Misra, J;N.K. Das, J

Bench : Division Bench

Advocate : B.M. Patnaik, for the Respondent

Judgement

R.N. Misra, J.—At the instance of the revenue, the Income Tax Appellate Tribunal, Cuttack Bench, has stated this case and referred the following question for opinion of the court:

"Whether, on the facts and in the circumstances of the case, the Tribunal was justified in allowing depreciation at 1/11th of the expenditure reckoned with the year of construction as deferred revenue expenditure ?"

2. Assessee is an individual and the relevant assessment year is 1969-70 corresponding to the accounting period ending on March 31, 1969. Assessee maintains accounts according to the mercantile system. During the year, assessee derived income from running of a hotel known as Sagarika Hotel located on the sea beach at Puri. The hotel premises were taken on lease by the assessee. Under the covenant of lease executed on 13th of July, 1967, assessee obliged himself to erect within eighteen months from the date of the lease, masonry structures on the two sides of the vacant plot of land in front of the existing building known as Ashu Bhavan as per plan to be approved by the lessors and the building was to be of very good type and the expenditure was estimated at Rs. 60,000 in the minimum. This masonry structure undertaken to be built by the assessee was to vest in the lessor on the expiry of the term of the lease (i.e., 12 years 11 months) and it was further expressly stipulated that

failure to raise the construction within the time indicated would entail forfeiture of the lease. During the year, assessee claimed deduction of a sum of Rs. 38,397 said to have been spent on the aforesaid head and the same was pressed to be accepted as revenue expenditure. The Income Tax Officer treated the expenditure to be of capital nature and rejected the claim for deduction.

3. Before the Appellate Assistant Commissioner, assessee reiterated his claim for deduction. Alternately, he claimed depreciation. The Appellate Assistant Commissioner was of the view that the fact that the expenditure was required to be incurred by the assessee under the covenant of lease did not alter the true nature of the expenditure. On an analysis, he came to the conclusion that no part of the payment could be taken as rent paid in advance and accordingly came to hold that the expenditure was of capital nature. He declined to accept the claim of depreciation in view of the fact that the asset was not owned by the assessee.

4. Before the Tribunal, upon further appeal by the assessee, the same claim was re-canvassed and it was disposed of by a single member with the following observation :

"The crucial point for my consideration is whether by the, additional construction the assessee has increased the existing holding capacity or whether such an outlay could be construed as payment of rent in advance. On a proper construction of the lease deed. I have no hesitation to hold that the amount in question cannot be designated as payment of advance rent- However, since the lease has to ensure for twelve years, the assessee is entitled to have depreciation admissible to a sum calculated at 1/11th of the expenditure reckoned with the year of construction as deferred revenue expenditure."

5. We must at the outset take note of a concession made by learned counsel for the assessee that there is no provision for a spreadover of the expenditure in the manner directed by the Tribunal. In view of the concession which we consider justified, it would follow that the direction given by the Appellate Tribunal to calculate the amount claimed as deferred revenue expenditure on a spreadover basis for eleven years is without the slightest justification. But, as rightly pointed out by Mr. Patnaik for the assessee, the main question which is really involved in the matter is whether the expenditure claimed (and about the incurring of which there is no dispute) is a capital expenditure or a revenue expenditure. If it is a revenue expenditure the deduction, would certainly be admissible in the year in question. Several decisions have been cited at the bar in support of the rival contentions--the revenue claiming the expenditure to be of capital nature and the assessee claiming the same to be a revenue expenditure. It is appropriate that we notice some of the decisions and ascertain the true principle to be applied to the facts of the case.

6. In the case of Benarsidas Jagannath, (1947) 15 ITR 185 Lahore , a Full Bench of the Lahore High Court attempted to deduce broad tests for distinguishing

capital expenditure from revenue expenditure. Mr. Justice Mahajan (as he then was) delivered the opinion of the Full Bench by saying (pages 198, 199) ;

"It is not easy to define the term "capital expenditure" in the abstract or to lay down any general and satisfactory test to discriminate between a capital and a revenue expenditure. Nor it is easy to reconcile all the decisions that were cited before us, for each case has been decided on its peculiar facts. Some broad principles can, however, be deduced from what the learned judges have laid down from time to time. They are as follows :

1. Outlay is deemed to be capital when it is made for the initiation of a business, for extension of a business, or for a substantial replacement of equipment : vide Lord Sands in Commissioners of Inland Revenue v. Granite City Steamship Company [1927] 13 TC 1. In City of London Contract Corporation v. Styles [1887] 2 TC 239, Bowen L.J. observed as to the capital expenditure as follows :

"You do not use it "for the purpose of" your concern, which means, for the purpose of carrying on your concern, but you use it to acquire the concern."

2. Expenditure may be treated as properly attributable to capital when it is made not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade : vide Viscount Cave L.C. in Atherton v. British Insulated and Helsby Cables Ltd. [1925] 10 TC 155 . If what is got rid of by a lump sum payment is an annual business expense chargeable against revenue, the lump sum payment should equally be regarded as a business expense, but if the lump sum payment brings in a capital asset, then that puts the business on another footing altogether. Thus, if labour saving machinery was acquired, the cost of such acquisition cannot be deducted out of the profits by claiming that it relieves the annual labour bill, the business has acquired a new asset, that is, machinery.

The expressions " enduring benefit" or benefit "of a permanent character" were introduced to make it clear that the asset or the right acquired must have enough durability to justify its being treated as a capital asset.

3. Whether for the purpose of the expenditure, any capital was withdrawn, or, in other words, whether the object of incurring the expenditure was to employ what was taken in as capital of the business. Again, it is to be seen whether the expenditure incurred was part of the fixed capital of the business or part of its circulating capital. Fixed capital is what the owner turns to profit by keeping it in his own possession. Circulating or floating capital is what he makes profit of by parting with it or letting it change masters. Circulating capital is capital which is turned over and in the process of being turned over yields profit or loss. Fixed capital, on the other hand, is not involved directly in that process and remains unaffected by it."

7. In the case of Assam Bengal Cement Co. Ltd. Vs. The Commissioner of Income Tax, West Bengal, , the Supreme Court referring to the tests in (1947) 15 ITR

185 Lahore stated :

"This synthesis attempted by the Full Bench of the Lahore High Court truly enunciates the principles which emerge from the authorities. In cases where the expenditure is made for the initial outlay or for extension of a business or a substantial replacement of the equipment, there is no doubt that it is capital expenditure. A capital asset of the business is either acquired or extended or substantially replaced and that outlay whatever be its source whether it is drawn from the capital or the income of the concern is certainly in the nature of capital expenditure. The question however arises for consideration where expenditure is incurred while the business is going on and is not incurred either for extension of the business or for the substantial replacement of its equipment. Such expenditure can be looked at either from the point of view of what is acquired or from the point of view of what is the source from which the expenditure is incurred. If the expenditure is made for acquiring or bringing into existence an asset or advantage for the enduring-benefit of the business it is properly attributable to capital and is of the nature of capital expenditure. If on the other hand it is made not for the purpose of bringing into existence any such asset or advantage but for running the business or working it with a view to produce the profits it is a revenue expenditure. If any such asset or advantage for the enduring benefit of the business is thus acquired or brought into existence it would be immaterial whether the source of the payment was the capital or the income of the concern or whether the payment was made once and for all or was made periodically. The aim and object of the expenditure would determine the character of the expenditure whether it is a capital expenditure or a revenue expenditure. The source or the manner of the payment would then be of no consequence. It is only in those cases where this test is of no avail that one may go to the test of fixed or circulating capital and consider whether the expenditure incurred was part of the fixed capital of the business or part of its circulating capital."

8. Learned standing counsel placed emphasis upon the test indicated by the Andhra Pradesh High Court in the case of Taj Mahal Hotel, Secunderabad Vs. Commissioner of Income Tax, Hyderabad, . The facts of the case are the following :

"The assessee, carrying on hotel business, took a fresh lease of a hotel building in 1956 for 10 years on a rent of Rs. 1,300 per month with an option to renew the lease for another 10 years, on a rent of Rs. 1,400. Under the lease deed, the assessee was given liberty by the lessor to make any alterations or new constructions with the permission of the lessor and it was stipulated that the lessor could not demand enhanced rent. On termination of the lease, the assessee was to take away fittings and fixtures like fans; wash basins, wooden screens, etc., while the structures would remain the property of the lessor. During the accounting year 1956-57, the assessee put up new rooms for the comfort and convenience of guests and claimed the expenditure incurred, viz..

Rs. 60,000, as allowable deduction either u/s 10(2)(i) as rent spread over a number of years or u/s 10(2)(xv)."

9. The department disallowed the claim on the ground that it was capital expenditure and this finding was upheld by the High Court. At pages 313, 314 and 315 of the reports, the following discussion occurs:

"The assessee, which had been carrying on hotel business at Secunderabad in the premises from 1949, entered into a fresh lease in 1956, for a period of ten years certain, and for a further period of ten years at its option. So during the accounting year which ended on September 30, 1957, the firm Taj Mahal Hotel at Secunderabad was a going concern in that building and it spent Rs. 60,000 for making extensions to the existing building by constructing additional rooms for providing lodging to the guests, and contends that it should be deducted as a revenue expenditure.

The answer to this question mainly depends upon the form of the contract entered into by the assessee, and its construction.

A close examination of the relevant Clauses, 3, 4, 5, 11 and 13 of the lease agreement dated August 4, 1956, establish the following facts :

The assessee was not under any obligation to make at their cost any additions or new constructions, but it only provided that they may, if they deemed necessary for their business, but with the consent and permission of the lessor. It expressly provided that the entire cost shall be borne by the assessee, and for no part of it the lessor was liable. The lessor shall have no right to demand additional or enhanced rent for the additions effected by the lessee as aforesaid. The lessee was at liberty to sublet any portion of the premises on their risk, but they will be responsible for all the defaults of the sub-lessees. On the termination of the lease, the lessee was at liberty to take away fittings and fixtures such as electric fans, wash basins, wooden screens and other fittings of a detachable nature. Thus, the right of the lessee was only to the detachable fittings, but the structures and additions made to the building should remain as part of it, and become the property of the lessor.

The argument of the learned counsel for the petitioners is that the cost of construction, viz., Rs. 60,000, represented only rent for the lease period, though, paid in advance, and is, therefore, deductible u/s 10(2)(i). In any event, it is argued, that it is not in the nature of a capital expenditure but one laid out exclusively for the purpose of the hotel business and, as such, deductible, u/s 10(2)(xv) of the Act.

In view of the authoritative pronouncements cited above, we are unable to accept either of these contentions. Under the provisions of the Transfer of Property Act, consideration for lease may be a price paid or promised, or of money, or any other thing of value to be paid periodically or on specified occasions to the lessor by the lessee. Rent is distinct from premium, as the latter

represents money paid in consideration of the demise, and is not part of the rent. On the other hand, the consideration paid in return for the use and occupation of the land or premises demised is known as rent.

The sum of Rs. 60,000 spent for construction is not the amount which the assessee was under an obligation to pay to the lessor. It was intended to bring an enduring advantage for their hotel business by providing an additional number of rooms. If the assessee did not make these additions, the lessor could not complain of it, much less compel its performance. The result of the additional construction is, undoubtedly, in the nature of more or less of a permanent advantage. There is no covenant on the part of the assessee to pay Rs. 60,000 and the additions are only for the augmentation of the assessee's business during the lease period. An expenditure of that description cannot be called "rent" as understood in law. Nor has it the element of premium. It is only an expenditure incurred by the lessee to effect an improvement to secure an advantage and an asset to it, and to enjoy during the time of the lease, though it may be that, at the expiry of the lease, the additions for what they are worth would vest in the lessor. But there can be no doubt that during the subsistence of the lease, the lessee alone was entitled to have the advantage and the lessor could not claim any additional rent on the improvements made."

10. The lease in the case in hand, as we have already pointed out, cast an obligation on the assessee-lessee to raise the structure. Clause (xv) of the covenant of lease provided :

"That in the event of the lessee not completing the proposed building as aforesaid within the stipulated period of eighteen months from the date of these presents or within such further period extended by the lessors for the purpose, the lessors shall have the right to terminate the lease,"

11. It is thus clear that the construction undertaken by the assessee was an obligation which the lessee had undertaken to perform in order to keep up the leasehold where the hotel business was being run. This, in our view, brings about a substantial distinction and, therefore, the Andhra Pradesh decision referred to above would not assist in resolving the dispute arising on the facts of this case.

12. In the case of Travancore Sugars and Chemicals Ltd. Vs. Commissioner of Income Tax, Kerala, , the Supreme Court considered whether the claim in question was a deductible revenue expenditure or a capital expenditure. The facts were these :

The promoters of the assessee-company, which was floated to take over the assets of certain undertakings run by the Government of Travancore, entered into an agreement with the Government, whereunder the assets of a sugar manufacturing concern, a distillery and a tincture factory were agreed to be sold by the Government to the assessee. The cash consideration for the sale of the assets of the sugar manufacturing concern was Rs. 3.25 lakhs, that for the sale of the distillery was agreed to be arrived at as a result of joint valuation by

engineers to be appointed by the parties, and that for the sale of assets of the tincture factory was the book value. Government agreed to recognise the transfer of the licence to the assessee for the distillery and to secure the continuance of the licence for a period of five years after the termination of the existing licence and also to purchase the pharmaceutical products manufactured by the assessee-company in the tincture factory for its medical requirements. Government was entitled to nominate a director on the board of directors of the assessee-company, who was not entitled to any voting power or to interfere with its normal management, and the books of the company were to be open to inspection by the authorised officers of Government. Apart from the cash consideration, Clause 7 of the agreement provided that the Government shall be further entitled to 20 per cent. of the annual net profits subject to a maximum of Rs. 40,000 after providing for depreciation and remuneration of the secretaries and treasurers. This clause was amended in January 28, 1947, to the effect that the Government shall be entitled to 10 per cent. of the annual net profits, which was explained to mean the net amount for which the company's audited profits were assessed to Income Tax in Travancore. For the previous year relevant to the assessment year 1958-59, the amount payable to the Government under Clause 7 worked out at Rs. 42,480 and the question that arose for consideration was whether this payment represented a deductible expenditure or was in the nature of capital expenditure.

13. Examining the case, the court found that the payment of the sum of Rs. 42,480 under Clause 7 of the agreement was in the nature of revenue expenditure and not capital expenditure, because,

(i) the payment was for an indefinite period and had no limitation of time attached to it;

(ii) the payment was related to the annual profits which flowed from the trading activities of the assessee and had no relation to the capital value of the assets ; and

(iii) the payment was not related to, or tied up, in any way, to any fixed sum agreed between the parties as part of the purchase price of the three undertakings.

14. In the case of Commissioner of Income Tax Vs. S.B. Ramakrishnan, , the facts were the following :

The assessee, in order to obtain a lease of a new building, paid a sum of Rs. 1,001 to the landlord as an extra payment, over and above the stipulated rent, and claimed deduction of the same as a revenue expenditure. The claim was disallowed by the departmental authorities but allowed by the Tribunal on the view that the expenditure was akin to the payment of rent for the new premises. The Madras High Court held that the expenditure not having been incurred for the purpose of bringing into existence any asset or advantage of an enduring character and the payment not having been made in order to secure the lease for

any term of years but only for the purpose of continued running of the business, though, in a new premises, the sum of Rs. 1,001 was deductible in arriving at the assessee's income,

15. In the case of Lakshmiji Sugar Mills Co. P. Ltd. Vs. Commissioner of Income Tax, New Delhi, , the facts were the following :

The assessee, a private company carrying on the business of manufacture and sale of sugar, paid to the Cane Development Council certain amounts by way of contribution for the construction and development of roads between the various sugarcane producing centres and the sugar factories of the assessee. This expenditure was incurred under a statutory obligation for the development of roads which were originally the property of the Government and remained so even after the improvement had been done. There was no finding that the roads were to be altogether newly made or that the assessee would get an enduring benefit from those roads.

16. The Supreme Court held that the expenditure was not of a capital nature and had to be allowed as an admissible deduction in computing the profits of the assessee's business. The expenditure was incurred for the purpose of facilitating the running of its motor vehicles and other means employed for transportation of sugarcane to its factories and was, therefore, incurred for running the business or working it with a view to producing profits without the assessee gaining any advantage of an enduring benefit to itself. The decision of the Calcutta High Court in the case of COMMISSIONER OF Income Tax, WEST BENGAL Vs. HINDUSTHAN MOTORS LTD., was approved.

17. If the expenditure in question had not been made with a view to satisfying the terms of Clause (xv) of the covenant of lease, the lease itself would have stood forfeited, thereby depriving the assessee of the source of income. In order to keep up the business, the expenditure became necessary. It is true, in a way, the benefit obtained by the assessee by the new construction was an enduring asset to last as long as the lease subsisted. But that cannot be the sole guideline for all types of cases. When an overall picture of the matter is taken, on the facts, in this case it would be appropriate to hold that the expenditure was incurred for keeping up the business, and, therefore, was revenue expenditure. The deduction, however, is admissible only in the year in question and there can be no spreadover of it.

18. Our answer to the question referred, therefore, is :

"On the facts and in the circumstances of the case, though the Tribunal was not justified in allowing depreciation at 1/11th of the expenditure reckoned with the year of construction as deferred revenue expenditure, the expenditure was of revenue nature."

19. We make no order as to costs of the proceeding.

N.K. Das, J.

20. I agree.