
(2010) 07 KAR CK 0021

In the Karnataka High Court

Case No : IT Appeal No"s. 137 and 141 of 2005 (A. Ys. 1996-97 and 1998-99)

Commissioner of Income Tax

APPELLANT

Vs

Krone Communication Ltd.

RESPONDENT

Date of Decision : 07-07-2010

Acts Referred:

Income Tax Act, 1961 — Section 80 HHC, 80 HHC (3)

Citation : (2011) 333 ITR 497

Hon'ble Judges : N. Kumar, J;B.V. Nagarathna, J

Bench : Division Bench

Advocate : M.V. Seshachala, for the Appellant; Kumar, for the Respondent

Final Decision : Dismissed

Judgement

N. Kumar, J.—As these two appeals arise out of a common order passed against a common Assessee for the assessment years 1996-97 and 1998-99, they are taken up for consideration together and disposed of by this common order.

2. The facts leading to these appeals are as under:

The Assessee is carrying on business in the manufacture and sale of communication products. In respect of the assessment year 1998-99 the Assessee filed a return of income claiming the following:

(a) Excise duty and sales tax should be deducted when computing total turnover u/s 80HHC of the Act.

(b) 90 per cent of net agency commission should be considered to compute profits of business when allowing deduction u/s 80HHC of the Act.

(c) Bad debts of Rs. 22,51,550 should be allowed as a deduction.

3. The assessing authority by his order dated 25-1-2001 held that excise duty and sales tax should be added back when computing total turnover for allowing deduction u/s 80HHC of the Act. That 90 per cent of the gross agency

commission should be taken to compute profits of business. The bad debts written off was disallowed as the Assessee had failed to prove that it was a trade debt, it had become bad and it was written off as irrecoverable in its accounts. Aggrieved by the said order, the Assessee preferred an appeal. The Appellate Authority upheld the contention of the Assessee who allowed the appeal and granted the relief sought for by setting aside the order of the assessing authority to that extent. Aggrieved by the said order, the revenue preferred an appeal to the Tribunal. The Tribunal by its order dated 17-8-2004 has affirmed the order of the Appellate Tribunal and dismissed the appeal. Aggrieved by the same, the revenue is before us. The Appeal was admitted to consider the following substantial questions of law:

(1) Whether the Appellate Authorities were correct in holding that for the purpose of computation of deduction u/s 80HHC of the Act, the excise duty and sales tax should be deleted?

(2) Whether the Appellate Authorities direction that the expenditure from the gross commission should first be reduced and then 90 per cent of the net commission should be given credit to, was in consonance with Explanation (baa) to Section 80HHC of the Act?

(3) Whether the Tribunal was correct in holding that the claim of bad debt written off to the extent of Rs. 22,51,550 is an allowable deduction as it has been incurred in the normal trade transactions and the provisions for written off has been satisfied without actually examining the item and the corresponding evidence to support such a conclusion.

4. In the connected appeal ITA No. 137/2005 which relates to the assessment year 1996-97, the Assessee claimed deductions in a sum of Rs. 1,62,029 and Rs. 1,04,268, total Rs. 2,66,297 receivable from M/s. R.G. Electronics as written off. The assessing authority rejected the said request. In appeal, the Appellate Authority upheld the said claim and allowed the said claim which order was confirmed by the Tribunal by its order dated 17-8-2004. It is against the said order, the said appeal is filed which was admitted to consider the following substantial question of law:

Whether the Tribunal was correct in holding that the claim of bad debt written off to the extent of Rs. 2,66,297 is an allowable deduction as it has been incurred in the normal trade transactions and the provisions for written off has been satisfied without actually examining the item and the corresponding evidence to support such a conclusion.

5. Insofar as the first substantial question of law is concerned, the legal position is now well-settled by the judgment of the Apex Court in the case of Commissioner of Income Tax, Coimbatore Vs. Lakshmi Machine Works, where it has been held as under:

Section 80HHC(3) was a beneficial section. It was intended to provide incentives

to promote exports. The incentive was to exempt profits relatable to exports.

Just as commission received by an Assessee is relatable to exports and yet it cannot form part of "turnover", excise duty and sales tax also cannot form part of the "turnover". Just as interest, commission, etc., did not emanate from the "turnover", so also excise duty and sales tax did not emanate from such turnover. Since excise duty sales tax did not involve any such turnover, such taxes had to be excluded. Commission, interest, rent, etc. do yield profits, but they do not partake of the character of turnover and, therefore, they were not includible in the "total turnover". If so, then excise duty and sales tax also cannot form part of the "total turnover" u/s 80HHC(3), otherwise the formula becomes unworkable. Sales-tax and excise duty also do not have any element of "turnover" which is the position even in the case of rent, commission, interest etc. It is important to bear in mind that excise duty and sales tax are indirect taxes. They are recovered by the Assessee on behalf of the Government. Therefore, if they are made relatable to exports, the formula u/s 80HHC would, become unworkable. This reasoning is confined to the workability of the formula in Section 80HHC(3) as it stood at the material time.

6. In the light of the aforesaid authoritative pronouncement of the Apex Court, the Appellate Authority and the Tribunal were justified in setting aside the order passed by the assessing authority and holding that the excise duty and sales tax do not form part of turnover. In that view of the matter, that question of law is answered against the revenue and in favour of the Assessee.

7. Insofar as the second substantial question of law, namely, the receipts by way of commission to be reduced in the profits of business is concerned, it was contended on behalf of the revenue that, the objects and reasons clarifying the intent of Legislature makes it clear that it is the gross income from commission which is to be taken into consideration for deduction and not the net commission. In the said objects and reasons it has been stated as under:

It is therefore, proposed to clarify that "profits of the business" for the purpose of Section 80HHC will not include receipts by way of brokerage, commission, interest, rent, charges or any other receipt of a similar nature. As some expenditure might be incurred in earning these incomes, which in the generality of cases is part of common expenses, it is proposed to provide ad hoc 10 per cent deduction from such incomes to account for these expenses.

Therefore, he contends while calculating the profits of business, 90 per cent of the gross amount received by way of commission is to be deducted and not the net amount of commission.

8. In order to appreciate this contention it is necessary to look into the relevant provisions and the pronouncement of the various Courts on the point.

8.1 Section 80HHC(4C)(baa) defines what profits of business means. It reads as under:

For the purposes of this section--

(baa) "profits of the business" means the profits of the business as computed under the head Profits and gains of business or profession as reduced by--

(1) ninety per cent of any sum referred to in Clauses (iiia), (iiib), (iiic), (iiid) and (iiie) of Section 28 or of any receipts by way of brokerage, commission, interest, rent, charges or any other receipt of a similar nature included in such profits; and

(2) the profits of any branch, office, warehouse or any other establishment of the Assessee situate outside India.

8.2 In order to find out "profits of business", under the aforesaid provision, first, profits of the business as computed under the head profits and gains of profession is to be arrived at. Section 28 deals with profits and gains of business or profession. In arriving at the profits and gains Section 28 stipulates that the income referred to in Section 28 shall be computed in accordance with the provisions in Sections 30 to 43(d) which in substance provides for the deductions to be made out of total income. Section 37 deals with expenses to be deducted which are not provided for in Sections 30 to 36. It provides that, any expenditure not being in the nature of capital expenditure or personal expenses of the Assessee, laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head profits and gains of business or profession.

8.3 In this background of this provision, in the instant case the Assessee has income from exports, income from manufacturing activities within the country and also income from commission. Insofar as the income from commission is concerned, if any expenses is expended in earning the said income u/s 37 of the Act, the said expenses is deductible and after such deduction, the amount arrived at would become part of the profits and gains of business. Therefore, the question for consideration is, while deducting 90 per cent of the commission, in calculating the profits of the business, whether the gross commission is to be deducted or net commission is to be deducted. In the definition at Section 4C(baa) it is specifically mentioned what is to be reduced is 90 per cent of any receipts by way of commission "included in such profits". Therefore, it is clear it is not the receipt of 90 per cent of the entire commission, it is 90 per cent receipt of commission included in profits and gains of business.

8.4 In fact that is what both the Appellate Authorities have held relying on several judgments of the various Courts. Though there appears to be no direct decision insofar as commission is concerned, support is drawn from other judgments which have a bearing on the subject.

8.5 In the case of Lakshmi Machine Works (supra), the Supreme Court while dealing with Section 80HHC has held as under:

The principal reason for enacting the formula u/s 80HHC was to disallow a part of Section 80HHC concession when the entire deduction claimed could not be

regarded as relatable to exports. Therefore, while interpreting the words "total turnover" in the formula in Section 80HHC one has to give a schematic interpretation to that expression. There is one more reason for giving schematic interpretation. The various amendments to Section 80HHC show that receipts by way of brokerage, commission, interest, rent etc., do not form part of business profits as they have no nexus with the activity of exports. If interest or rent was not regarded by the Legislature as business profits, the question of treating the same as part of the total turnover in the formula did not arise. In fact, Section 80HHC had to be amended several times since the formula on several occasions gave a distorted figure of export profits when receipts like interest, rent, commission etc., which did not have the element of turnover got included in the P&L a/c and consequently became entitled to deduction. This was clarified by the amendment to Section 80HHC commencing from 1st April, 1992.

Tax under the Act is upon income, profits and gains. It is not a tax on gross receipts. u/s 2(24) the word "income" includes profits and gains. The charge is not on gross receipts but on profits and gains. The charge is not on gross receipts but on profits and gains properly so-called. Gross receipts or sale proceeds, however, include profits. Therefore, schematic interpretation for making the formula in Section 80HHC workable cannot be ruled out. Similarly, purposeful interpretation of Section 80HHC which has undergone so many changes cannot be ruled out, particularly, when those legislative changes indicate that the Legislature intended to exclude items like commission and interest from deduction on the ground that they did not possess any elements of "turnover" even though commission and interest emanated from exports.

This is because the very basis for computing Section 80HHC deduction was "business profits" as computed u/s 28, a portion of which had to be apportioned in terms of the above ratio of export turnover to total turnover. Section 80HHC(3) was a beneficial section. It was intended to provide incentives to promote exports. The incentive was to exempt profits relatable to exports. In the case of combined business of an Assessee having export business and domestic business the Legislature intended to have a formula to ascertain export profits by apportioning the total business profits on the basis of turnovers. Apportionment of profits on the basis of turnover was accepted as a method of arriving at export profits.

8.6 The Supreme Court in the case of Hero Exports v. CIT (2007) 295 ITR 454 at para 14 held as under:

If the Assessee has two incomes with one common pool of expenses and since "principle of attribution" has been retained in the scheme of Section 80HHC, both in terms of Section 80HHC(3), Clause (e) to the Explanation to Section 80HHC(3) (a), (b) and (c) and in Clause (baa) to the Explanation to Section 80HHC, instead of going into lengthy exercise of dividing such common expenses, the Assessee has estimated the reduction of export turnover by 10 per cent of the other income of Rs. 1,60,000 (in the above example). Ultimately, Clause (baa) to the

Explanation is itself based on the assumption that 10 per cent of the income would be an expense. We make it clear that we are not reading Explanation (baa) into Section 80HHC(3)(b). What we say is as a guidance value/factor, 10 per cent of the total other income of Rs. 1,60,000 would be fair estimate. This guidance value is not flowing from Clause (baa) but from the scheme of Section 80HHC read with the Memorandum to the Finance Act of 1991. Take a reverse case, if allocation of expenses is to be done on actual basis, it would not only be very difficult but in some cases actual apportionment may not be in the interest even of the department.

8.7 The Supreme Court in the case of CIT v. K. Ravindranathan Nair (2007) 295 TTR 228 (SC) held as under:

By Finance Act, 1991 with effect from 1-4-1992, for the first time, the expression profits of the business stood defined to mean the profits of the business as computed under the head Profits and gains of business under Sections 28 to 44D. Therefore, before giving deduction u/s 80HHC(3)(a), (b) or (c), the gross total income of the Assessee being profits from business had to be arrived at in terms of Clause (baa) to the Explanation. However, one point, needs to be noted, namely, while calculating business profits the same had to be done in terms of Section 28 to Section 44D alone.

8.8 The Delhi High Court had an occasion to consider a similar provision in the case of Rishi Dev Batra Vs. Dr. (Mrs.) Anup Suri where it was held as under:

The idea of Section 80HHC is to ensure that the exporter gets the benefit of the profits derived from export and not to depress the profit further. Therefore, it can only be the net interest which can be included in the profits. If netting were not to be permitted the result would be that the profits of the exporter would be depressed by an item that is expenditure incurred on earning interest, which does not form part of the profit at all. This could not have been the intention of the Legislature.

Explanation (baa) is relatable only to Clause (a) of Section 80HHC(3) and not to Clause (b) thereof. These operate in distinct areas and no inter-mixing is contemplated. Hence the word "interest" in Clause (baa) to the Explanation in Section 80HHC is indicative of "net interest", i.e., gross interest less the expenditure incurred by the Assessee in earning such interest.

To summarise the conclusions: (i) In computing what the profits derived from exports for the purposes of Section 80HHC(1) read with Section 80HHC(3) are, the nexus test has to be applied to exclude that which does not partake of profits that can be said to have been derived from the business of exports. (ii) In the specific context of Clause (baa) of the Explanation to Section 80HHC, while determining the "profits of the business", the assessing officer has to undertake a two-step exercise in the following sequence. He has to first "compute" the profits of the business under the head "Profits and gains of business or profession". In other words, he will have to compute business profits, in terms of

the Act, by applying the provisions of Sections 28 to 44 thereof. (iii) In arriving at the profits of the business by the above method, the assessing officer will exclude all such incomes which partake of the character of "income from other sources" which in any event are treated under Sections 56 and 57 of the Act and are therefore not to be reckoned for the purposes of Section 80HHC. (iv) Where surplus funds are parked with the bank and interest is earned thereon it can only be categorised as income from other sources. This receipt merits separate treatment u/s 56 of the Act which is outside the ring of profits and gains from business and profession. It goes entirely out of the reckoning for the purposes of Section 80HHC. (v) Interest earned on fixed deposits for the purposes of availing of credit facilities from the bank, does not have an immediate nexus with the export business and therefore has to necessarily be treated as income from other sources and not business income. (vi) Once business income has been determined by applying accounting standards as well as the provisions contained in the Act, the Assessee would be permitted, in terms of Section 37 of the Act, to claim as deduction, expenditure laid out for the purposes of earning such business income. (vii) In the second stage, the assessing officer will deduct from the profits of the business computed under the head "Profits and gains of business or profession" the following sums in order to arrive at the "profits of the business" for the purposes of Section 80HHC(3): (a) 90 per cent of any sum referred to in Clauses (iiia), (iiib) and (iiic) of Section 28, i.e., export incentives; (b) 90 per cent of any receipts by way of brokerage, commission, interest, rent, charges or any other receipt of a similar nature included in such profits: and (c) profits of any branch, office, warehouse or any other establishment of the Assessee situate outside India. (viii) The word interest in Clause (baa) of the Explanation connotes "net interest" and not "gross interest". Therefore, in deducting such interest, the assessing officer will take into account the net interest i.e., gross interest as reduced by expenditure incurred for earning such interest. (ix) Where, as a result of the computation of profits and gains of business and profession, the assessing officer treats the interest receipt as business income, then deduction should be permissible, in terms of Explanation (baa) of the net interest i.e., the gross interest less the expenditure incurred for the purposes of earning such interest. The nexus between obtaining the loan and paying interest thereon (laying out the expenditure by way of interest) for the purpose of earning the interest on the fixed deposit, to draw an analogy from Section 37, will require to be shown by the Assessee for application of the netting principle.

8.9 In fact, the aforesaid judgment has been followed by a Division Bench of this Court in the case of CIT v. Gokuldas Exports IT Appeal No. 25 of 2003 and connected matters dated 9-7-2008.

9. Therefore, the law on the point is fairly well-settled. Tax under the Act is upon income, profits and gains. It is not a tax on gross receipts. u/s 2(24) the word "income" includes profits and gains. The charge is not on gross receipts but on profits and gains. Gross receipts or sale proceeds, however, include profits. The

very basis for computing Section 80HHC deduction was "business profits" as computed u/s 28, a portion of which had to be apportioned in terms of the above ratio of export turnover to total turnover. In the case of combined business of an Assessee having export business and domestic business the Legislature intended to have a formula to ascertain export profits by apportioning the total business profits on the basis of turnovers. Apportionment of profits on the basis of turnover was accepted as a method of arriving at export profits. If the Assessee has two incomes with one common pool of expenses and since "principle of attribution" has been retained in the scheme of Section 80HHC, both in terms of Section 80HHC(3). Clause (e) to the Explanation to Section 80HHC(3)(a), (b) and (c) and in Clause (baa) to the Explanation to Section 80HHC, instead of going into lengthy exercise of dividing such common expenses, the Legislature has estimated the reduction of export turnover by 10 per cent. Ultimately, Clause (baa) to the Explanation is itself based on the assumption that 10 per cent of the income would be an expense. This guidance value is not flowing from Clause (baa) but from the scheme of Section 80HHC read with the Memorandum to the Finance Act of 1991. By Finance Act, 1991 with effect from 1-4-1992, for the first time, the expression profits of the business stood defined to mean the profits of the business as computed under the head Profits and gains of business under Sections 28 to 44D. Therefore, before giving deduction u/s 80HHC, the gross total income of the Assessee being profits from business had to be arrived at in terms of Clause (baa) to the Explanation. While calculating business profits the same had to be done in terms of Section 28 to Section 44D alone. The idea of Section 80HHC is to ensure that the exporter gets the benefit of the profits derived from export and not to depress the profit further. Therefore, it can only be the net commission, interest, rent, etc., which can be included in the profits. If netting were not to be permitted the result would be that the profits of the exporter would be depressed by an item that is expenditure incurred on earning commission, interest, rent, etc., which does not form part of the profit at all. This could not have been the intention of the Legislature. Hence the words commission, interest, rent, etc., in Clause (baa) to the Explanation in Section 80HHC is indicative of "net interest", i.e., gross amount less the expenditure incurred by the Assessee in earning such amount. Where, as a result of the computation of profits and gains of business and profession, the assessing officer treats the commission, interest, rent receipt as business income, then deduction should be permissible, in terms of Explanation (baa) of the net commission, interest, rent, etc., i.e., the gross commission, interest, rent, etc., less the expenditure incurred for the purposes of earning such commission, interest, rent, etc.

10. In the light of the aforesaid discussion, we are of the view that the findings recorded by both the Appellate Authorities is legal and correct and do not call for any interference. Accordingly, the said substantial question of law is held against the revenue and in favour of the Assessee.

11. Insofar as the third question of law is concerned the Supreme Court in the

case of TRF (T.R.F.) Limited Vs. Commissioner of Income Tax, Ranchi, has held that after 1-4-1989 it is not necessary for the Assessee to establish that the debt, in fact, has become irrecoverable; it is enough if the bad debt is written off as irrecoverable in the accounts of the Assessee.

12. In view of the aforesaid settled legal position, the Appellate Authorities were justified in allowing the deduction under the head by setting aside the order of the assessing authority who was of the view that the Assessee has to first prove that it was a trade debt and secondly, it was irrecoverable and thirdly, it was actually written off. Therefore, the said substantial question of law is answered against the revenue and in favour of the Assessee. Accordingly, the substantial question of law in the other connected appeal also answered in like terms. Hence, we pass the following:

ORDER

(a) Both the appeals are dismissed.

(b) No costs.