
(2014) 06 KAR CK 0023
In the Karnataka High Court
Case No : Income Tax Appeal No. 329 of 2007

Commissioner of Income Tax

APPELLANT

Vs

Mcdowell and Co. Ltd.

RESPONDENT

Date of Decision : 16-06-2014

Acts Referred:

Citation : (2014) 369 ITR 293

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

Bench : Division Bench

Advocate : K.V. Aravind, Advocate for the Appellant; D.L.N. Rao, Senior Advocate for S.R. Anuradha, Advocate for the Respondent

Judgement

N. Kumar, J.—This appeal is by the Revenue challenging the order passed by the Appellate Tribunal dismissing the appeal filed by the Revenue wherein it had upheld the relief granted by the appellate authority setting aside the order of assessment. The assessee-company filed its return of income on December 31, 1999, for the assessment year 1999-2000 declaring a total income of Rs. 16,25,97,672. The return of income was processed under section 143(1). However, it was taken up for scrutiny by issuing a notice under section 143(2). The assessee, among other things, had claimed exclusion of unclaimed credit balances which was written off in a sum of Rs. 445.75 lakhs. The same was disallowed by the assessing authority on the ground that the assessee has not produced invoice particulars to match cheque receipt particulars and to prove that the amounts now written back were actually sale receipts already offered to tax in earlier years. Yet another claim which was disallowed by the assessing authority was the assessee had claimed lease foreclosure compensation paid of Rs. 5.31 crores as revenue expenditure in nature. Whereas the assessing authority held it as capital expenditure and declined to grant the relief. The third claim relates to the disallowance of depreciation of unused aircraft.

2. Challenging the said order, the assessee preferred an appeal to the Commissioner of Income-tax (Appeals).

3. The Commissioner (Appeals) held that the unilateral action by the assessee in writing back a liability does not amount to the assessee enjoying the benefit to be brought back to tax as profit under section 41(1) as held by the Supreme Court in the case of *The Chief Commissioner of Income Tax, Cochin Vs. Kesaria Tea Co. Ltd.*, . The Tribunal had taken that view in the case of the sister concern of the assessee. Following the same, the addition made by the assessing authority in this account was deleted. In so far as the disallowance of lease foreclosure compensation of Rs. 5 crores and 31 lakhs is concerned, it was held, when the hon''ble arbitrator has held, the assessee gained an overall increase in profit, the general principle is that what is spent for earning profit shall be allowed as a business expenditure and has to be allowed as revenue expenditure and, therefore, the same was also deleted in view of the decision rendered in the assessee''s case in the earlier years in his favour. The said disallowance was also set aside. Aggrieved by this order, the Revenue preferred an appeal to the Tribunal. On the issue of unclaimed credit balances, affirming the reasoning by the appellate authority they declined to interfere with the findings recorded by the appellate authority. In so far as the payment of Rs. 5.31 crores as compensation, it was held, after referring to various judgments on which reliance was placed, the transaction is at the arm''s length and is settled with the help of the judicial process. The compensation awarded is also keeping in view of the ability of the other party to compete and diminish the profit earned by the assessee and, therefore, it was of the view, the nature of payment is clearly revenue and not capital expenditure and, therefore, it declined to interfere on that question also. In so far as the disallowance of depreciation of unused aircraft is concerned, relief was granted to the assessee relying on the judgments of the earlier years. The same was the subject matter of appeal before this court. The orders passed by the authorities were set aside and the matter was remanded back to the assessing authority for fresh consideration. Therefore, it was submitted similar order be passed in this case.

4. This appeal was admitted. In the light of the aforesaid facts, substantial questions of law which arises for our consideration in this appeal are as under:

"1. Whether the appellate authorities were correct in holding that a sum of Rs. 445.75 lakhs unclaimed credit balances which had been treated as part of book profits by the assessee but later excluded from the statement of income cannot be treated as the income of the assessee as held by the Assessing Officer and in view of Explanation 1 to section 41 of the Act?

2. Whether the appellate authorities were correct in holding that the payment of Rs. 5.31 crores cannot be treated as capital in nature as held by the Assessing Officer despite this payment been made to perfect its title and the right to manufacture IMFL by using own brand by regaining its business advantage and improving the right in the property acquired by it in the year 1993 as per the arbitration award?

3. Whether the appellate authorities were correct in allowing the expenses

incurred in maintaining aircrafts and the depreciation over the same is allowable despite the assessee not establishing by maintaining any records that these aircrafts were used in the course of the assessee's business?"

5. Question No. 1: In the return filed by the assessee it has added an amount of Rs. 445.75 lakhs as unclaimed credit balance and included the same as part of the book profit. However, the assessee excluded the same in the statement of income filed with a note that the old credit balance in the debtors and customers account amounting to Rs. 4,45,75,446 has been written back and claimed as exempted from tax relying on several judgments. Therefore, the assessee was claiming exemption contending that the conditions which requires to be fulfilled under section 41(1) is not fulfilled. Section 41(1) reads as under:

"Where an allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee (hereinafter referred to as the first-mentioned person) and subsequently during any previous year,--

(a) the first-mentioned person has obtained, whether in cash or in any other manner whatsoever, any amount in respect of such loss or expenditure or some benefit in respect of such trading liability by way of remission or cessation thereof, the amount obtained by such person or the value of benefit accruing to him shall be deemed to be profits and gains of business or profession and, accordingly, chargeable to income-tax as the income of that previous year, whether the business or profession in respect of which the allowance or deduction has been made is in existence in that year or not; or

(b) the successor in business has obtained, whether in cash or in any other manner whatsoever, any amount in respect of which loss or expenditure was incurred by the first-mentioned person or some benefit in respect of the trading liability referred to in clause (a) by way of remission or cessation thereof, the amount obtained by the successor in business or the value of benefit accruing to the successor in business shall be deemed to be profits and gains of the business or profession, and accordingly chargeable to income-tax as the income of that previous year."

6. The assessing authority, after considering the submissions on behalf of the assessee, held that the nomenclature given to the entry neither makes it taxable nor exempts it. The assessee has taken a plea that the sundry credit balances written back represented the sale receipts wrongly classified as sundry credit balances in sundry debtor register, instead of squaring them off against the sundry debtor balances. The income cannot be recognised both at the time of invoice as well as at the time of a sale receipt. The assessee has made a mistake in accounting. It is for the assessee to match invoice particulars to cheque receipt particulars and prove that the amounts now written back were actually sale receipts already offered to tax in earlier years. The assessee has not been able to offer such reconciliation till the date of passing of this order. As such, the

claimed credit balances written back of Rs. 445.75 lakhs is taken as the income of the assessee for the year. It is submitted that the statement is incorrect. The assessee has produced all the statements, invoices, particulars of tax to prove that the amounts written back were actually sale receipts already offered to tax in earlier years and the assessing authority has not looked into the same. In appeal the said statement was not produced before the appellate authority which the assessee could have done. However, that appears to be not the case which is pleaded before the Appellate Tribunal. The Appellate Commissioner, while considering the case of the assessee, has held as under:

"The Assessing Officer has invoked the provisions of section 41(1) to bring the said amount to tax. The same issue is discussed in detail in the case of the appeal for the same year of the sister concern, M/s. United Breweries Ltd. A copy of the said appellate order is annexed. The view taken by me in that case also hold good in the present case. Briefly stated on the basis of the latest Supreme Court decision *The Chief Commissioner of Income Tax, Cochin Vs. Kesaria Tea Co. Ltd.*, , a unilateral action by the assessee in writing back a liability does not amount to the assessee enjoying the benefit to be brought to tax as profit under section 41(1). The addition, therefore, is deleted."

7. Therefore, from the order of the appellate authority it is clear the appellate authority did not look into the records produced by the assessee nor any records were produced before the appellate authority by the assessee. On a legal proposition relief was granted to the assessee. In appeal against this order by the Revenue the Tribunal has held as under:

"We have heard both sides. It has been brought to our notice that exactly in similar circumstances in the case of *United Breweries Ltd.*, the Tribunal upheld the finding of the Commissioner of Income-tax (Appeals) where it has been held that section 41(1) has no application. In the present case, the learned Commissioner of Income-tax (Appeals) allowed relief to the assessee following the said decision and also the decision of the Supreme Court in the case of *The Chief Commissioner of Income Tax, Cochin Vs. Kesaria Tea Co. Ltd.*, , upholding that a unilateral action by the assessee in writing back a liability does not amount to the assessee enjoying benefit to be brought to tax as profit under section 41(1) of the Act. On verification of the materials, it was found by the Commissioner of Income-tax (Appeals) that these credit balances occurred in earlier years due to wrong coding of account heads. These amounts were already included in sales turnover of respective years and suffered tax. The company has now written back to the credit side of the profit and loss account. Therefore, section 41(1), has no application in the present case. Looking to the circumstances above and the issue is covered by the decision of the Tribunal, we are not inclined to interfere with the finding recorded by the Commissioner of Income-tax (Appeals)."

8. Therefore, the Tribunal proceeded on the assumption the Appellate Commissioner has recorded a finding of fact after verification of the materials

that these amounts were already included in sales turnover of respective years and suffered tax. We are unable to make out from the order of the appellate authority where that finding is recorded. The assessing authority asserts that no records were produced before it. No records were produced before the appellate authority also. Both the appellate authorities have not looked into the records. The assessing authority did not look into the records because the records were not produced before it.

9. In the circumstances, the findings recorded by the appellate authorities is based on no evidence and, therefore, the same cannot be sustained. In our view, the proper course would be to set aside the orders passed by all the three authorities, remand the matter back to the assessing authorities giving liberty to the assessee to produce necessary records to show that the amounts are already included in sales turnover of respective years and it has suffered tax which if proved would enable the assessee to claim the benefit on the ground that it does not come under section 41(1) of the Act.

10. Question No. 2: The assessee-company was under the agreement using the land, building and plant and machinery owned by a sister concern, M/s. Mysore Wine Products Ltd., for the manufacture of IMFL by using the assessee's own brand, i.e., McDowell. Since there were frequent labour trouble the production activity was leased to one M/s. Sapthagiri Distilleries P. Ltd. (SDPL) by way of an agreement by which SDPL was to produce and market the assessee's brands and was not authorised to compete against the assessee's business. This arrangement was made in 1986. Subsequently, in 1993, the assessee decided to take back the factory from SDPL, since the operations were now converted into profit-making from loss-making ones, as a result of solution of labour problems. The assessee paid a compensation of Rs. 4.5 crores to SDPL towards the saleable stocks and stores available at that point of time. SDPL, however, demanded compensation for the loss of the source of income. Though some compensation was paid as per an agreement, the disputes continued and could be resolved only by way of an arbitration award on March 18, 1999, where the hon'ble arbitrator directed payment of compensation of Rs. 5.31 crores to be paid by the assessee to SDPL for the loss of SDPL's source of income. It is because the assessee gained advantages whereas the said SDPL incurred loss. The assessing authority held that the assessee has got a benefit of enduring nature by way of improvement in the running of the distillery even compared to the situation when it was acquired back from SDPL in 1993. The payment of Rs. 5.31 crores paid for regaining the unit is in the nature of a capital payment and it cannot be allowed as a revenue expenditure. The payment of compensation was to provide a title, a right to manufacture on his own which has regained its business advantage. The said amount represents amount paid to improve the right in property. However, the Appellate Commissioner relying on the judgment of the apex court held the hon'ble arbitrator has held the assessee gained an overall increase in profit. The assessee has spent the said money for earning profit and, therefore, it shall be allowed as a business expenditure. The Tribunal, after referring to the judgments

of the apex court, held in terms of the recitals in the arbitration award, there is no acquisition of any assets, what has resulted is a settlement of business liability in the realm of working activities of the assessee. The assessee was able to secure a trouble-free source of raw material, avoid competition and was also to remove onerous business obligations. Through the arbitration it was able to protect and preserve its business. It has also made substantial profits from this action. Therefore, the benefits derived by the assessee cannot be called as capital in nature as no asset has been brought into existence. The payment does not augment any right of capital nature which was hitherto not existing in the hands of the assessee. Therefore, it upheld the order of the appellate authority. Therefore, the question is, in the light of those findings whether this income amount of Rs. 5.31 crores paid by the assessee to SDPL to reclaim business is a revenue expenditure or a capital expenditure.

11. The apex court in the case of *Bikaner Gypsums Ltd. Vs. Commissioner of Income Tax, Rajasthan*, has held as under (pages 44 and 49):

"The question whether a particular expenditure incurred by the assessee is of capital or revenue nature is a vexed question which has always presented difficulty before the courts. There are a number of decisions of this court and other courts formulating tests for distinguishing the capital from revenue expenditure. But the tests so laid down are not exhaustive and it is not possible to reconcile the reasons given in all of them, as each decision is founded on its own facts and circumstances. . .

where the assessee has an existing right to carry on a business, any expenditure made it during the course of business for the purpose of removal of any restriction or obstruction or disability would be on revenue account, provided the expenditure does not acquire any capital asset. Payments made for removal of restriction, obstruction or disability may result in acquiring benefits to the business, but that by itself would not acquire any capital asset."

12. Again, the Supreme Court in the case of *Empire Jute Co. Ltd. Vs. Commissioner of Income Tax*, held whether it is a capital expenditure or revenue expenditure would have to be determined having regard to the nature of the transaction and other relevant factors. Following this and other decisions, this court in the case of *The Commissioner of Income Tax, C.R Building, Queens Road, Bangalore, The Deputy Commissioner of Income Tax Special Range - 15, Bombay and DY. Commissioner of Income Tax, Circle 11 (3) Rashthrothana Building, Nrupathunga Road, Bangalore Vs. M/s H.P Global Soft Ltd. (Formerly M/s Digital Equipment (1) Ltd.) Digital house, No. 45/14, Tumkur Road. Yeshwanthpur 2nd Stage, Bangalore* has held at paragraph 17 as under (page 474):

"The authorities both in this country and in England have pointed out the difficulties in formulating the precise rules for distinguishing capital expenditure from revenue expenditure. The line of demarcation has been found to be very

thin. Certain broad tests have, however, been laid down. Each case turns on its own facts. The aim and object of the expenditure would determine the character of the expenditure whether it is a capital expenditure or a revenue expenditure. When an expenditure is made for acquiring or bringing into existence an asset or an advantage for the enduring benefit of the business, it is properly attributable to capital and is of the nature of capital expenditure. 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. 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. 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. Enduring benefit is meant enduring in the way that fixed capital endures. If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even though the advantage may endure for an indefinite future. Similarly, 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 would be revenue expenditure. If for running the business or working it with a view to produce the profits, if expenditure is incurred, it is a revenue expenditure. The Legislature has made a distinction between expenses incurred by a tenant for "repairs" of the premises and expenses incurred by a person who is not a tenant towards "current repairs" to the premises. This distinction has to be given a meaning. Perhaps the logic behind the distinction was that a tenant would, by the very nature of his status as a tenant, not undertake expenditure as would endure beyond his likely period of tenancy or create a new asset whereas, an owner may undertake expenditure so as to even bring about new assets of capital nature. It was, therefore, necessary to qualify the expenditure on repairs. It follows, therefore, that the cost of repairs that have been incurred by a tenant in respect of such premises would have to be allowed under section 30(a)(i). The question of disallowing such an expenditure and relegating the assessee to claim depreciation under section 32 does not arise. The amount spent on providing wooden partition, painting of leased premises, carrying out repairs so as to make the premises workable, to replace glasses, etc., has to be considered as revenue expenditure. It is for the businessman to see as to in what manner the leased premises is to be maintained and what are the necessary repairs which are required to be done. All such expenditure which were incurred on painting, polishing of the floor, providing wooden panelling, etc., is revenue expenditure and the nature of repairs is not of an enduring character so as to characterise as capital expenditure."

13. Therefore, from the aforesaid judgment it is clear, keeping in mind the

aforesaid legal principles with the given set of facts the court has to find out whether a particular expenditure is capital in nature or revenue in nature.

14. In the instant case, the undisputed facts are that the assessee's sister concern, M/s. Mysore Wine Products Ltd., leased its distillery factory to SDPL in 1986 as it could not handle the labour problems then. SDPL had entered into licence manufacturing agreement with the assessee to manufacture the assessee's products. SDPL ran the management of this factory successfully, solved the labour problems, invested some amounts in machinery and turned around the factory from a loss-making company to a profit-making company. In 1993, the assessee decided to take back the said factory from SDPL. Through a subsidiary concern, CDL (which merged with the assessee's concern on March 31, 1994), the assessee paid a consideration of Rs. 4.5 crores and took back the factory. The consideration paid pertained to stock available and machinery introduced by SDPL and it did not contain any element of compensation. SDPL demanded compensation for losing its very source of income. An agreement was reached on March 25, 1993, that some compensation will be paid to SDPL by the assessee. Over a period the assessee paid a sum advances but has shown the same as liability from SDPL. As the issue of amount of compensation reached a deadlock, SDPL approached an arbitrator and the assessee also agreed to abide by the decision. The arbitrator gave an award on March 18, 1999, six years after the assessee taking back possession of the unit and allowed an amount of Rs. 5.31 crores paid till then by the assessee as the amount of compensation. The arbitrator has observed in the award, the assessee made a gain by running the distillery after its regain and it was able to remove the bottleneck for supply of raw material and finished goods and it also gained by avoiding compensation from SDPL. In so far as the loss sustained by SDPL is concerned, the arbitrator observed that SDPL was losing its source of income, losing the time and funds it has spent in establishing the distillery. The assessing authority was of the view, the payment of compensation was basically to perfect a title, a right to manufacture on its own. It has regained its business advantage and the amount paid was for improving the right in the property.

15. From the aforesaid facts, it is clear this unit run by SDPL was running under loss. It was taken on lease by them from the sister concern of the assessee. Then the assessee granted the licence to manufacture the assessee's products. SDPL was in complete management of the factory, it successfully solved the labour problems, invested amounts in machinery and it was made into a profit-making company. What was paid by way of Rs. 4.5 crores was for transfer of stock available on the date of transfer as well as for the machinery. This Rs. 5.31 crores was paid to regain the entire unit which was a profit-making unit on the date when payment was made. The assessee was not in possession of the said unit. As there was a transfer of interest in favour of SDPL, that interest which was transferred in 1986 was retransferred to the assessee. It is for retransfer of that unit a sum of Rs. 5.31 crores is paid by the assessee. The assessing authority by saying perfecting his title that the assessee was the owner of the

unit as it fell with the possession of SDPL and it was SDPL who was manufacturing liquor under an agreement entered into between them and the assessee was marketing it. It was in complete management and possession of this unit. The only right of the assessee which was rental amount or fee for the licence granted to them. By payment of Rs. 5.31 crores the entire profit-making unit is transferred back to the assessee. This expenditure was made for regaining the asset as well as an advantage for the enduring benefit of the assessee's business. It is properly attributable to capital and capital expenditure. It is not a case where the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct the assessee's business to be carried on more efficiently or more profitably. It is not the expenditure which is incurred to improve the business of the concern or spend for its expansion of its business or for substantial replacement of its equipment. This amount is paid to regain the profit-making unit which had gone out of the hand of the assessee and, therefore, the expenditure incurred in regaining this profit company unit is in the nature of a capital expenditure and not the revenue expenditure. Therefore, the appellate authorities were not justified in recording a finding to the contrary solely based on the judgments referred by them when those judgments expressly stated in every case it is the facts of that particular case which should matter and only in that context the law has to be applied. The said finding cannot be sustained. That question is answered in favour of the Revenue and against the assessee. Question No. 3: As the earlier orders passed by the authorities have been set aside and the matter is remanded back to the assessing authority for fresh consideration, as the impugned order is also passed relying on those decisions which are already set aside by this court, the finding on the question of depreciation and unused aircraft is set aside and the matter is remanded back to the assessing authority for fresh consideration in accordance with law.

Ordered accordingly.