

(1994) 12 MAD CK 0085

In the Madras High Court

Case No : Tax Case No. 733 of 1982 (Reference No. 471 of 1982)

Commissioner of Income Tax

APPELLANT

Vs

Ramakrishna Engineering Industries (Coimbatore) Ltd.

RESPONDENT

Date of Decision : 21-12-1994

Acts Referred:

Income Tax Act, 1961 — Section 37, 37(1)

Citation : (1995) 215 ITR 723

Hon'ble Judges : Raju, J;K.A. Thanikkachalam, J

Bench : Division Bench

Advocate : C.V. Rajan, for the Appellant; S.A. Balasubramanian, for the Respondent

Judgement

Thanikkachalam, J.—At the instance of the Department, the Tribunal referred the following question for our opinion u/s 256(1) of the Income Tax Act, 1961 :

"Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in holding that the sum of Rs. 48,175 representing damages paid by way of interest and storage charges for breach of contract for purchase of a capital asset should be allowed as an expenditure allowable u/s 37 of the Income Tax Act, 1961 ?"

2. The assessee is a private limited company. The assessee wanted to set up a project for manufacturing chemical process and pumps in the medium scale sector. In that connection on August 6, 1973, the assessee placed an order with the Heavy Engineering Corporation Limited, Ranchi, for the manufacture and supply of a horizontal boring machine. Later, the assessee cancelled the order placed by it. But, the Heavy Engineering Corporation Limited insisted on damages by way of interest and storage charges. The assessee paid a sum of Rs. 48,175 by way of interest and storage charges. The assessee claimed that this sum is a revenue expenditure for the assessment year 1977-78. The Income Tax Officer disallowed the assessee's claim on the ground that the damage is due to purchase of machinery which is capital in nature. On appeal the Commissioner of

Income Tax (Appeals) confirmed the order passed by the Income Tax Officer. However, on appeal, the Tribunal allowed the claim made by the assessee. Learned standing counsel appearing for the Department submitted that in order to claim deduction u/s 37, the expenditure should relate to or be expended wholly and exclusively for the purpose of, business and should not relate to capital expenditure. In order to support his contention, learned standing counsel for the Department relied on a decision of the Supreme Court in *SWADESHI COTTON MILLS CO. LTD. Vs. COMMISSIONER OF Income Tax, U. P. (NO. 2).*, . According to the facts arising in that case, the appellant, which carried on the business of manufacturing and selling cloth and other textile goods, entered into contracts for the purchase of textile machinery in order to expand its factory. Having regard to the altered circumstances, the appellant subsequently cancelled the contracts, as the machinery to be purchased would not be required for the business, and paid Rs. 15,000 and Rs. 20,000, respectively, to the other contracting parties as compensation. On those facts, the Supreme Court held that the payment was made neither for the purpose of earning profits nor for the purpose of furthering, protecting or continuing its business which was to be carried on from day to day. The payment was made with the object of avoiding an unnecessary investment in capital assets and was in the nature of a capital expenditure. Learned standing counsel relied on a decision of the Delhi High Court in *Edward Keventer(S) Private Limited Vs. Commissioner of Income Tax, Delhi*, . According to the facts arising in that case, pending a writ petition filed by the assessee company in relation to the land belonging to it notified by the Government for compulsory acquisition, the assessee-company entered into an agreement with Delhi Glass Works for taking on lease for a period of thirty years the land measuring about 30 acres together with offices, bungalows, staff, workmen and other members. Under the agreement if the assessee vacated before the expiry of the period it was liable to pay rent for the unexpired period and if the assessee failed to take the lease, it was liable to pay rent for the entire period of the lease by way of damages for breach of contract. Consequent on the decision of the High Court, the assessee's land was not acquired and the assessee, therefore, did not take possession of the land from Delhi Glass Works. The latter claimed compensation for breach of agreement, but, the assessee repudiated its liability. This dispute was referred to an arbitrator. The arbitrator fixed the compensation at Rs. 1,70,000 and this amount was paid by the assessee during the accounting period relevant to the assessment year 1958-59. The assessee claimed this amount as revenue expenditure. The Delhi High Court held that the payment of Rs. 1,70,000 made by the assessee was not an expense laid out wholly and exclusively for the purpose of the business. According to the Delhi High Court, it was capital expenditure.

3. Learned standing counsel relied on a decision in *Dalmia Dadri Cement Ltd. Vs. Commissioner of Income Tax*, . According to the facts arising in this case, the assessee-company placed an order with a German company for the supply of a dryer plant for the cement manufacturing business and as desired by it opened

an irrevocable letter of credit in favour of the said company. Subsequently, on account of some difference regarding the specifications of the plant, the assessee requested the bankers to cancel the letter of credit, but were told that the letter of credit could not be cancelled without the consent of the manufacturers. The manufacturers refused to release the letter of credit. A compromise was entered into whereby the letter of credit was released on payment of 15,000 pounds to the manufacturers. On those facts, the Delhi High Court held that the amount of Rs. 20,00,348 represented capital expenditure and was not a permissible deduction u/s 10(2) (xv) of the Indian Income Tax Act, 1922. The expenditure for the acquisition of a plant was surely of a capital nature and any loss suffered in that transaction would naturally be of a capital nature. Learned standing counsel also relied on a decision in *New Central Jute Mills Ltd. Vs. Commissioner of Income Tax, Central-I*, . According to the facts arising in this case, the assessee entered into an agreement to sell the land belonging to it which was pledged with the Government of Uttar Pradesh and received Rs. 40,00,000 as part payment. The assessee agreed to obtain release of the land from the Government of Uttar Pradesh and convey it by a specified time failing which it agreed to refund the sum and pay damages of Rs. 1,00,000 and interest on the sum of Rs. 40,00,000. The assessee was unable to obtain release of the land and refunded the sum of Rs. 40,00,000 and paid Rs. 1,00,000 as damages and Rs. 1,85,123 as interest on the sum of Rs. 40,00,000. It claimed deduction of both these amounts. The Calcutta High Court on a reference held that in view of the finding that the damages related to the capital assets of the assessee, the sum of Rs. 1,00,000 was not an allowable deduction.

4. Learned standing counsel lastly relied on the decision in *Fancy Corporation Ltd. Vs. Commissioner of Income Tax*, . According to the facts arising in this case, the assessee-company carried on the business of embroidering cotton cloth and art silk cloth. During the accounting year relevant to the assessment year 1967-68, it attempted to instal a borewell at its new factory site. The attempt failed. The assessee claimed deduction of the expenditure incurred. On these facts, the Bombay High Court held that if the well had been successfully bored, it would have added to the fixed capital of the assessee and would have become a part of its capital assets. As the expenditure was incurred in attempting to obtain a capital asset by boring the well, there can be little doubt that the expenditure was in the nature of capital expenditure.

5. On the other hand, in order to support his contention that the damages claimed by the assessee were in the nature of revenue expenditure and, therefore, liable as a deduction, learned counsel for the assessee relied on a decision in *Empire Jute Co. Ltd. Vs. Commissioner of Income Tax*, , wherein the Supreme Court held that the expenditure incurred for the purpose of operating the looms for longer working hours was primarily and essentially related to the operation or working of the looms which constituted the profit-making apparatus of the appellant and so the expenditure was laid out as part of the process of profit-earning. It was an outlay of a business in order to carry it on and to earn a

profit out of those expenditures as an expense of carrying it on, it was part of the cost of operating the profit-earning apparatus and was clearly in the nature of revenue expenditure. Another decision relied on in support of his contention is reported in Commissioner of Income Tax, Tamil Nadu-II Vs. Seshasayee Bros. P. Ltd., . According to the facts arising in that case, the assessee, a managing agency company, had been investigating several projects and, wherever feasible, promoting new industrial undertakings. If the new undertakings materialised the expenses were transferred and recovered from the new unit and the assessee secured the office of managing agents or technical consultancy or the like and earned profits. If, however, the project was unsuccessful, the assessee-company wrote off the expenses. In the assessment for the assessment years 1966-67 and 1967-68, the assessee claimed deduction of the sums of Rs. 9,865 and Rs. 10,785, respectively, which were project expenses incurred by it in a newsprint paper mill project which did not materialise. On those facts, this court held that the expenses incurred by the assessee were in the course of the business as promoters of companies or as managing agents and with a view to augmenting their income. Consequently, the expenditure is allowable as revenue expenditure.

6. According to the facts arising in the present case, the assessee placed an order with the Heavy Engineering Corporation, Ranchi, to purchase a horizontal boring machine on September 21, 1973, and paid an advance for the said purchase. Due to flexibility of the price, the assessee cancelled the order on February 17, 1974, and the company claimed interest and storage charges amounting to Rs. 48,175.

7. The point for consideration is whether the damages paid by the assessee to the Heavy Engineering Corporation can be considered as a revenue expenditure. In SWADESHI COTTON MILLS CO. LTD. Vs. COMMISSIONER OF Income Tax, U. P. (NO. 2)., , the Supreme Court held that the damages paid for the non-fulfilment of the contract cannot be considered to be a revenue expenditure. This decision of the Supreme Court applies on all fours to the facts arising in the present case. In the decision cited by learned counsel for the assessee in Commissioner of Income Tax, Tamil Nadu-II Vs. Seshasayee Bros. P. Ltd., , it was clearly pointed out that the expenditure was incurred for the purpose of augmenting the assessee's income and it was for the promotion of their venture. Therefore, according to this court, there is nexus between the expenditure incurred and the business conducted by the assessee. But, according to the facts arising in the present case, the expenditure was incurred for the purpose of promoting the business done by the assessee and not for augmenting its income. Unless the expenditure is wholly and exclusively laid out for the purpose of business, the expenditure cannot be allowed u/s 37 of the Act. In the decision of Empire Jute Co. Ltd. Vs. Commissioner of Income Tax, , the expenditure incurred by the assessee was treated as revenue expenditure since the said expenditure was incurred to earn a profit out of those expenses. The expenses were stated to be incurred for operating the profit-earning apparatus. That is not the purpose for which the expenditure was incurred in the present case. Therefore, following the

decision of the Supreme Court in SWADESHI COTTON MILLS CO. LTD. Vs. COMMISSIONER OF Income Tax, U. P. (NO. 2)., , we consider that the order passed by the Tribunal in holding that the damages paid by the assessee as a revenue expenditure is not acceptable. Accordingly, we answer the question referred to us in the negative and in favour of the Department. However, there will be no order as to costs.