SOLUTION :

	Sale consideration	
	Rs. 6.8 lakh Rs.	Rs. 18.90 lakh Rs.
Written down value on April 1, 2010	13,00,000	13,00,000
Less : Sale proceeds on transfer of 40% telecom licence	6,80,000	18,90,000
Remaining written down value	6,20,000	(-)5,90,000
Deduction under section 35ABB for remaining 13 years [*i.e.*, Rs. 6,20,000/13]	47,692	-
Amount taxable as business income for the previous year 2010-11 (subject to the maximum of deduction allowed earlier)	-	2,00,000
Short-term capital gain		
Sale proceeds	6,80,000	18,90,000
Less : Cost of acquisition of 40% licence [40% of Rs. 15,00,000]	6,00,000	6,00,000
Short-term capital gain	80,000	12,90,000

Expenditure on eligible projects or scheme [Sec. 35AC]

118. Deduction is available under section 35AC for promoting social and economic welfare or upliftment of the public.

118.1 ***Who can claim deduction*** - Any taxpayer can claim deduction under section 35AC as follows —

Assessee	To whom the payment should be made	Direct expenditure on eligible project
A company	Deduction is available if the taxpayer incurs any expenditure by way of payment of any sum to a public sector company or a local authority or to an association or institution approved by the National Committee for carrying out any eligible project or scheme.	A company can also directly incur expenditure in respect of eligible project and claim the same as deduction
A person other than a company	Same as above	Direct expenditure is not permitted

118.2 ***Amount of deduction*** - A deduction is allowed in respect of the expenditure incurred for an eligible project or scheme for promoting social and economic welfare or upliftment of the public as may be specified by the Central Government on the recommendations of the National Committee. Companies can also claim deduction in cases where the expenditure is incurred by them directly on an eligible project or scheme.

118.3 ***Certificate from the recipient/chartered accountant*** - Deduction is available only if a certificate is obtained by the payer from the donee-organisation in Form No. 58A†. If a company directly incurs expenditure in respect of eligible projects, a certificate should be obtained from a chartered accountant in Form No. 58B.†

118.4 ***Eligible project/scheme*** - "Eligible project or scheme" means such project or scheme for promoting the social and economic welfare of, or the upliftment of, the public as the Central Government may, by notification in the Official Gazette, specify in this behalf on the recommendations of the National Committee.

118.5 ***National Committee*** - "National Committee" means the Committee constituted by the Central Government, from amongst persons of eminence in public life.

*It is not possible to attach any certificate, statement or audit report with new income-tax return forms. The assessee should himself retain the certificate in Form No. 58A or 58B. It may be furnished in original whenever the Assessing Officer wants to examine it in assessment proceedings or otherwise.

118.6 ***Withdrawal of approval*** - Approval can be withdrawn if a few conditions are satisfied. The following points should be noted—

- *Consequences in the hands of payer* - Deduction under section 35AC shall not be denied merely on the ground that after the contribution made by the assessee to the institutions mentioned in section 35AC, the approval granted to these institutions has been withdrawn. In other words, contribution to these institutions is qualified for deduction even if after the date of making contribution, the approval granted to these institutions has been withdrawn.
- *Consequences in the hands of recipient* - Where the National Committee withdraws the approval granted by it to an institute given under section 35AC, the entire amount of contribution or donation received by such an entity shall be deemed to be the income of the association or institution. It is taxable in the year in which such approval or notification is withdrawn. It is taxable at the maximum marginal rate (*i.e.*, 33.99 per cent) without any exemption available under any other provision.

118.7 ***Double deduction not permissible*** - If a deduction is claimed and allowed under section 35AC, the same is not allowed as deduction under any other provisions of the Act.

Payment to the associations and institutions carrying out rural development programmes [Sec. 35CCA]

119. Section 35CCA provides deduction of sums paid by an assessee to :

a. any association or institution to be used for carrying out any programme of rural development approved before March 1, 1983 [sec. 35CCA(1)(*a*)];

b. an association or institution which has its object the training of persons for implementation of a rural development programme approved before March 1, 1983 [sec. 35CCA(1)(*b*)];

c. the National Fund for Rural Development set up by the Central Government [sec. 35CCA(1)(*c*), *see* para 119.1] ; and

d. the National Urban Poverty Eradication Fund set-up and notified by the Central Government.

119.1 ***National Funds for Rural Development - Guidelines*** - Taxpayers interested in joining the national effort of eradicating poverty, increasing agricultural production, creating employment and bringing about improvement in the rural life can make contributions in the name of the National Fund for Rural Development. The contributions can be sent to the Secretary, National Fund for Rural Development, Prime Minister's Office, South Block, New Delhi. The donors to the said Fund can also indicate their preference for area or locality and the rural development programme for which the donation is to be used as also the voluntary agency through which the programme may be implemented.

119.2 ***Double benefit not permissible*** - Where a deduction under this section is claimed and allowed for any assessment year, no deduction will be allowed in respect of such expenditure under section 35C or section 35CC or section 80G or any other provisions of the Act for the same or any other assessment year.

Payment to association and institution for carrying out programmes of conservation of natural resources [Sec. 35CCB]

120. No deduction under section 35CCB is available if expenditure is incurred after March 31, 2002.

Amortisation of preliminary expenses [Sec. 35D]

121. Certain preliminary expenses are deductible under section 35D.

121.1 ***Who can claim deduction*** - Deduction under section 35D is available in the case of an Indian company or a resident non-corporate assessee. A foreign company even if it is resident in India, cannot claim any deduction under section 35D.

121.2 ***Time and purpose of preliminary expenses*** - Expenses incurred at the following two stages are qualified for deduction under section 35D—

When expenses are incurred	*Why expenses are incurred*
1. Before commencement of business†	For setting up any undertaking or business
2. After commencement of business	In connection with extension of an undertaking or in connection with setting up a new unit.

121.3 ***Qualifying expenditure*** - The heads of qualifying expenditure specified for this purpose are the following —

The work should be carried on by the assessee itself or by a concern approved by the Board	*The work can be carried on by the assessee itself or by any concern (approved or not approved)*
▪ Expenditure in connection with preparation of feasibility report, preparation of project report, conducting a market survey (or any other survey necessary for the business of the assessee), or engineering services relating to the business of the assessee, provided the work is carried on by the assessee himself or by a concern which is for the time being approved in this behalf by the Board.	▪ Legal charges for drafting any agreement between the assessee and any other person relating to the setting up of the business of the assessee. ▪ Legal charges for drafting the memorandum and articles of association if the taxpayer is a company. ▪ Printing expenses of the memorandum and articles of association if the taxpayer is a company. ▪ Registration fees of a company under the provisions of the Companies Act. ▪ Expenses in connection with the public issue of shares or debentures of a company, underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of the prospectus. ▪ Any other expenditure which is prescribed (nothing is prescribed so far).

121.3-1 *GRANT OF APPROVAL TO CONSULTANCY CONCERNS* - Expenditure in connection with preparation of the feasibility report or the project report or the conducting of the market survey or other survey or the engineering services, qualifies for amortisation where work in connection with the aforesaid items is carried out within the organisation of the assessee or where it is entrusted to an outside approved concern [a list of approved concerns is reproduced in *Taxmann's Direct Taxes Circulars*, Vol. 1, 2008 edition].

121.3-2 *INTEREST ON SHARE APPLICATION MONEY* - Interest accruing on the share application money, lying with the bank under the mandate of section 73 of the Companies Act, is not taxable as "Income from other sources", and is required to be set off or adjusted against the public issue expenses, so as to reduce the amount of public issue expenses for the purpose of enabling the assessee to claim amortization under and in accordance with the provisions of section 35D—***CIT*** v. ***Neha Proteins Ltd.*** [2008] 171 Taxman 455 (Raj.).

121.4 ***Maximum ceiling*** - The aggregate expenditure cannot exceed the following—

In the case of a corporate assessee	*In the case of a non-corporate assessee*
a. 5 per cent* of cost of project; or	5 per cent* of cost of project
b. 5 per cent* of capital employed, whichever is more	

†Not before commencement of production.

*2.5 per cent in respect of expenses incurred before April 1, 1998.

121.4-1 COST OF PROJECT - It means the actual cost (or additional cost incurred after commencement of business in connection with extension or setting up an undertaking) of fixed assets [namely, land, buildings, leaseholds, plant, machinery, furniture, fittings and railway sidings (including expenditure on development of land and buildings)], which are shown in the books of the assessee as on the last day of the previous year in which the business of the assessee commences.

Where the amortisation is to be allowed with reference to expenditure incurred in connection with the extension of an existing undertaking or in connection with setting up of a new unit, the cost of project is defined to mean the actual cost of fixed assets, as stated above, which are shown in the books of the assessee as on the last day of the previous year in which the extension of undertaking is completed, or, as the case may be, the new unit commences production or operation in so far as such fixed assets have been acquired or developed in connection with the extension of the undertaking or setting up of the new unit of the assessee.

121.4-2 CAPITAL EMPLOYED IN THE BUSINESS OF THE COMPANY - The provisions are given below—

▪ *Expenditure incurred before commencement of business* - It is the aggregate of the issued share capital‡, debentures and long-term borrowings, as on the last day of the previous year in which the business of the company commences.

▪ *Expenditure incurred in the case of an existing concern* - It is the aggregate of issued share capital‡, debentures and long-term borrowing as on the last day of the previous year in which the extension of undertaking is completed or, as the case may be, the new industrial unit commences production or operation, insofar as such capital, debentures and long-term borrowings have been issued or obtained in connection with the extension of the undertaking or the setting up of the new industrial unit of the company.

▪ *Long-term borrowings* - The term "long-term borrowing" in the above context, comprises any money borrowed by the company from the Government or the Industrial Finance Corporation of India or the Industrial Credit and Investment Corporation of India or any other financial institution which is eligible for deduction under section 36(1)(*viii*) or any banking institution and any money borrowed or debt incurred by the company in a foreign country in respect of purchases outside India of capital plant and machinery, where the terms, under which such money are borrowed or debt is incurred, provide for the repayment thereof during a period of not less than 7 years.

121.5 ***Amount of deduction*** - One-fifth* of the qualifying expenditure is allowable as deduction in each of the five† successive years beginning with the year in which the business commences, or, as the case may be, the previous year in which the extension of the industrial undertaking is completed or the new industrial unit commences production or operation.

121.6 ***Provision of section 35D not intended to supersede any other provision*** - It may be noted that the provision of section 35D for amortisation is not intended to supersede any other provisions in the income-tax law under which expenditure is allowable as a deduction against profits.

For instance, where a company, which is already in business, incurs expenditure on issue of debentures, such expenditure is admissible as a deduction under section 37(1) by virtue of the decision of the Supreme Court in the case of *India Cements Ltd.* v. *CIT* [1966] 60 ITR 52. Similarly, expenditure on issue of bonus shares is deductible expenditure under section 37(1). Section 35D will not have the effect of bringing such expenses within the scope of the expenditure to be amortised against profits over a 5-year† period. As a corollary to this, where any expenditure has been included for the purpose of amortisation under section 35D (on a claim being made by the assessee in that

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*One-tenth in respect of expenses incurred before April 1, 1998.

†10 years in respect of expenses incurred before April 1, 1998.

‡Issued share capital can only be considered to be a sum of share capital *plus* amount outstanding as share premium account; sums standing to credit of 'Reserve and Surplus' Account cannot be considered as part of issued share capital - ***CIT*** v. ***Sirhind Steel Ltd.*** [2005] 97 ITD 502 (Ahd.). However, Delhi bench of Tribunal held that the premium collected by a assessee-company on its subscribed share capital is not 'capital employed in business of company' within meaning of section 35D - ***Berger Paints India Ltd.*** v. ***CIT*** [2006] 154 Taxman 293 (Delhi).

behalf), such expenditure will not qualify for deduction under any other provision of the Act for the same or any other assessment year.

Section 35D would apply only in respect of expenditure which is otherwise not allowable under the law, for example, capital expenditure—*CIT* v. *Mahindra Ugine & Steel Co. Ltd.* [2002] 120 Taxman 250 (Bom.).

The table given below highlights whether expenditure for raising capital/loan is deductible under section 35D or 37(1)—

Different expenses	*Incurred by a new concern before commencement of business*	*Incurred by an existing concern after commencement of business*
Expenditure on issue of bonus shares	Sec. 35D	Sec. 37(1)
Expenditure on issue of shares (not being bonus shares)	Sec. 35D	Sec. 35D
Expenditure on issue of debentures	Sec. 35D	Sec. 37(1)
Expenditure on raising long-term/short-term loan	Sec. 35D	Sec. 37(1)

121.7 ***Audit report*** - In the case of a person (other than a company/co-operative society), deduction is available only if a report of audit is obtained* from a chartered accountant in Form No. 3AE.

121.8 ***Consequences in the case of amalgamation or demerger*** - The benefit of amortisation of preliminary expenses under section 35D are ordinarily available only to the assessee who incurred the expenditure. The benefit is, however, not lost in a case where the undertaking of an Indian company which is entitled to the amortisation is transferred to another Indian company in a scheme of amalgamation or demerger within the 5-year† period of amortisation. In that event, the deduction in respect of previous year in which the amalgamation or demerger takes place and the following previous year within the 5-year† period, will be allowed to the amalgamated company or resulting company and not to the amalgamating company or demerged company.

121.8-1 *IN THE CASE OF AMALGAMATION OR DEMERGER OF CO-OPERATIVE BANKS* - In the case of amalgamation or demerger of co-operative banks, the following provisions given by section 44DB are applicable from the assessment year 2008-09—

- *In the year in which amalgamation or demerger takes place* - In the year in which change of ownership takes place because of the aforesaid reasons, deduction under sections 32, 35D, 35DD and 35DDA shall be calculated as under—

1. Find out the amount of deduction under the aforesaid sections of the previous year in which ownership of assets changes because of the aforesaid reasons on the assumption that the amalgamation or demerger has not taken place.

2. The amount of deduction so determined shall be apportioned between the (*a*) amalgamating co-operative bank and amalgamated co-operative bank, or (*b*) demerged co-operative bank and resulting co-operative bank, as the case may be, in the ratio of number of days for which the assets are used by them during the previous year in which ownership changes.

- *In subsequent years* - The provisions of sections 35D, 35DD and 35DDA shall, in a case where an undertaking of the amalgamating/demerged co-operative bank entitled to the deduction under that section is transferred before the expiry of the period specified in that section to amalgamated/resulting co-operative bank, apply to the successor in the financial years subsequent to the year of business reorganization as they would have applied to the predecessor, if the business reorganization had not taken place.

†10 years in respect of expenses incurred before April 1, 1998.

*It is not possible to attach any certificate, statement or audit report with new income-tax return forms. The assessee should himself retain the audit report in Form No. 3AE. It may be furnished in original whenever the Assessing Officer wants to examine it in assessment proceedings or otherwise.

121-P1 *XYZ Ltd. is incorporated on September 3, 2008. It commences its production on March 14, 2010. During the previous year 2008-09, the following preliminary expenses are incurred by it : (a) registration fees for incorporation : Rs. 17,600 ; (b) printing expenses of memorandum, articles, prospectus, etc. : Rs. 28,000 ; (c) legal charges for drafting the memorandum and articles : Rs. 36,000 ; (d) underwriting commission for issue of shares : Rs. 75,000 ; (e) cost of advertisements : Rs. 92,000 ; and (f) expenditure on the refund of the amount of over-subscription of shares : Rs. 81,000. Besides, the company has incurred the following expenses before commencement of business :*

- *preparation of feasibility report (the work is undertaken by the assessee) : Rs. 97,000 ;*
- *preparation of the project report (the work is undertaken by an approved concern) : Rs. 1,45,000;*
- *expenditure on conducting market survey necessary for the business for the company : Rs. 62,000 (the work is undertaken by a concern which is not approved for this purpose) ;*
- *legal charges for entering into a foreign collaboration : Rs. 43,000 ;*
- *engineering services in connection with the erection of plant and machinery : Rs. 3,12,900 ; and*
- *cost of plant and machinery : Rs. 87,92,000.*

Determine the amount deductible under section 35D for the assessment years 2009-10 and 2010-11 assuming the following figures of fixed assets and capital :

	On March 31, 2009 Rs.	On March 31, 2010 Rs.
Cost of fixed assets	*51,00,000*	*96,01,850*
Share capital	*26,00,000*	*57,00,000*
Debentures	*9,00,000*	*11,00,000*
Long-term borrowing from a financial institution	*3,08,000*	*24,00,000*

■

Since the company commences its business by starting commercial production on March 14, 2010, the benefit of amortisation of pre-commencement expenses under section 35D is available in 5 assessment years beginning with the assessment year 2010-11. The expenditure qualified for this purpose are the following :

	Rs.
Registration fees	17,600
Printing charges	28,000
Legal charges for drafting	36,000
Underwriting commission	75,000
Cost of advertisement	92,000
Expenditure on refund of amount of over-subscription	81,000
Cost of preparation of feasibility report	97,000
Cost of preparation of project report	1,45,000
Cost of conducting market survey (not included as the work is undertaken by an unapproved concern)	*Nil*
Legal charges for foreign collaboration	43,000
Engineering service for erection of plant	3,12,900
Total qualifying amount	9,27,500
Maximum qualifying amount	
Cost of project (being cost of fixed assets on March 31, 2010)	96,01,850
Capital employed on March 31, 2010 (i.e., Rs. 57,00,000 + Rs. 11,00,000 + Rs. 24,00,000)	92,00,000
5% of cost of project or capital employed at the option of assessee (i.e., 5% of Rs. 96,01,850)	4,80,093
Amount to be amortised in 5 assessment years beginning with the assessment year 2010-11	96,018.50

Note : Since the entire qualifying amount is not eligible for amortisation, it is advisable to include cost of engineering service for erection of plant in the "actual cost" of plant, which will be eligible for depreciation under section 32. If the company includes such cost in "actual cost" of the plant, the same will be excluded from qualifying amount which

will be reduced to Rs. 6,14,600. However, the maximum amount eligible for amortisation will be increased to Rs. 99,14,750 (*i.e.*, Rs. 96,01,850 + Rs. 3,12,900) and, consequently, the amount to be amortised in 5 instalments will become Rs. 99,147.50 (*i.e.*, 1/5 of 5% of Rs. 99,14,750).

Amortisation of expenditure in the case of amalgamation/demerger [Sec. 35DD]

121A. The provisions of section 35DD are given below—

1. The taxpayer is an Indian company.

2. It incurs expenditure for the purpose of amalgamation or demerger.

3. The expenditure is allowed as deduction in five successive years in five equal instalments.

4. The first instalment is deductible in the previous year in which amalgamation or demerger takes place.

5. No deduction shall be allowed in respect of the above expenditure under any other provision of the Act.

A similar provision is applicable in the case of amalgamation or demerger of co-operative banks [for detailed discussion *see* para 121.8-1].

Amortisation of expenditure under voluntary retirement scheme [Sec. 35DDA]

121B. The provisions of section 35DDA are given below—

1. An expenditure is incurred in any previous year by way of payment of any sum to an employee in connection with his voluntary retirement under any scheme of voluntary retirement.

2. One-fifth of the amount so paid shall be deducted in computing the profits and gains of the business for that previous year, and the balance shall be deducted in equal instalments for each of the four immediately succeeding previous years.

One should also keep in view the following points—

1. The above rule is applicable even if the scheme of voluntary retirement has not been framed in accordance with guidelines prescribed under section 10(*10C*).

2. Where the undertaking of an Indian company entitled to deduction for amortization of voluntary retirement expenses is transferred before the expiry of 5 years (as given above) to another Indian company in a scheme of amalgamation or demerger, the deduction shall be available for the remaining period to the amalgamated company or the resulting company as if the amalgamation or demerger had not taken place.

3. Similarly, in case of reorganization of certain forms of business whereby a firm or a proprietary concern is succeeded by a company, the deduction shall continue to be available to the successor company for the remaining period.

4. In the year of transfer, no deduction shall be available to the amalgamating company, the demerged company or to the firm or proprietary concern in cases given in (*2*) and (*3*) *supra*.

A similar provision is applicable in the case of amalgamation or demerger of co-operative banks [for detailed discussion *see* para 121.8-1].

5. No deduction shall be allowed in respect of the above expenditure under any other provision of the Act.

6. Each part of payment in connection with voluntary retirement is deductible in 5 years in 5 equal instalments.

Provision illustrated - According to voluntary retirement scheme of X Ltd., each employee will get voluntary retirement compensation in three instalments (35 per cent at the time of voluntary retirement, 10 per cent on November 1 of the first financial year immediately after retirement and remaining 55 per cent on December 1 of the second financial year immediately after retirement). The scheme is opened for the financial year 2008-09 only.

During the financial year, 17 employees take voluntary retirement (total compensation Rs. 80 lakh payable by way of 3 instalments as stated above).

Previous years in which the payment is deductible	First instalment of Rs. 28 lakh (being 35% payable during the financial year 2008-09) Rs.	Second instalment of Rs. 8 lakh (being 10% payable on November 1, 2009) Rs.	Third instalment of Rs. 44 lakh (being 55% payable on December 1, 2010) Rs.	Total Rs.
2008-09	5,60,000	-	-	5,60,000
2009-10	5,60,000	1,60,000	-	7,20,000
2010-11	5,60,000	1,60,000	8,80,000	16,00,000
2011-12	5,60,000	1,60,000	8,80,000	16,00,000
2012-13	5,60,000	1,60,000	8,80,000	16,00,000
2013-14	-	1,60,000	8,80,000	10,40,000
2014-15	-	-	8,80,000	8,80,000

Amortisation of expenditure on prospecting, etc., for development of certain minerals [Sec. 35E read with the Seventh Schedule]

122. Section 35E provides for the amortisation of expenditure incurred wholly and exclusively on any operation relating to prospecting for the minerals or group of associated minerals or on the development of a mine or other natural deposit of any such minerals or group of associated minerals specified in the Seventh Schedule.

122.1 ***Who can claim deduction*** - Deduction under section 35E is allowed only in the case of Indian companies and resident assessees other than companies. The benefit of amortisation is not available to a foreign company even if such company declares its dividends in India.

122.2 ***Qualifying expenditure - When it should be incurred*** - The qualifying expenditure should be incurred during the "year of commercial production" and four years immediately preceding that year. The term "year of commercial production" means the previous year in which, as a result of any operation relating to prospecting, commercial production of one or more of the specified mineral commences.

122.3 ***Qualifying expenditure - What does it include*** - Expenditure incurred wholly and exclusively on any operations relating to prospecting for any mineral (or group of associated minerals) specified in the Seventh Schedule or on the development of a mine or other natural deposit of any such mineral or group of associated minerals, is "qualifying expenditure". Expenses mentioned in para 122.4 are, however, excluded.

122.4 ***Qualifying expenditure - What it does not include*** - The following are not included in "qualifying expenditure"—

1. Expenditure which is met, directly or indirectly, by any person or authority.

2. Any proceeds realised by the assessee from sale, salvage, compensation or insurance in respect of any property or rights brought into existence as a result of the expenditure.

3. Expenditure on the acquisition of the site of the source of any of the specified minerals or groups of associated minerals or of any rights in or over such site.

4. Expenditure on the acquisition of the deposits of any of the specified minerals or groups of associated minerals or of any rights in or over such deposit.

5. Expenditure of a capital nature in respect of any building, machinery, plant or furniture for which depreciation is admissible under section 32.

122.5 ***Amount and period of deduction*** - The amortisation of qualifying expenditure is allowed in equal instalments over a period of 10 years. The amount deductible for each year is —

a. one-tenth of "qualifying expenditure"; or

b. income (before giving deduction under section 35E) of the previous year arising from commercial exploitation of any mine (*i.e.*, not only the mine in respect of which commercial exploitation resulted from the operation of development in question but also where commercial production has been established as a result of operations undertaken earlier) or deposit of minerals of any other nature,

whichever is less.

The following points should be noted —

1. Income in (*b*) *supra* includes only income from mine operations as specified in the Seventh Schedule. It does not include any other income of the taxpayer.

2. Deduction is available for a period of 10 years beginning with the year of commercial production.

3. The amortisation of qualifying expenditure is allowed over a period of 10 years against the profits arising from commercial exploitation of any mine or natural deposit.

4. Where the instalment of amortisable expenditure relating to a given year cannot be wholly absorbed by the profits against which the amortisation is to be allowed, the unabsorbed amount is to be carried forward to the subsequent year and added to that year's instalment and so on for succeeding previous years. Such carry forward is allowed only up to and including the tenth previous year as reckoned from the year of commercial production. If there is any unabsorbed amount at the end of the tenth year, it will lapse.

122.6 ***Audit report*** - If the assessee is a person, other than a company/co-operative society, then books of account of the relevant year(s) in which the expenditure is incurred should be audited. In such a case audit report in Form No. 3B should be submitted along with the return of income for the first year in which deduction is claimed under section 35E.†

122.7 ***Consequences in the case of amalgamation or demerger*** - The amortisation under section 35E is available only to the assessee who incurs the expenditure. However, in the case of an Indian company, the benefit of amortisation is preserved where the undertaking of the company is transferred to another Indian company under a scheme of amalgamation or demerger within the 10-year period. In such an event, the amortisation of outstanding instalments in respect of the previous year in which the amalgamation or demerger takes place and the remaining previous years of the 10-year period will be allowed to the amalgamated company/resulting company and not the amalgamating company or demerged company.

122.8 ***Double deduction not permissible*** - Where deduction under section 35E is claimed and allowed for any assessment year in respect of any expenditure qualifying for amortisation, the expenditure in respect of which the deduction is so allowed will not qualify for deduction under any other provision of the Act for the same or any other assessment year.

122-P1 *X Ltd., an Indian company, is engaged in the business of production of minerals since 1960. During the year ending March 31, 2008, it starts commercial exploitation of a new mine at Hazaribag. Compute the amount deductible under section 35E for the assessment years 2008-09 and 2009-10 from the given information —*

	Previous year 2007-08 Rs.	Previous year 2008-09 Rs.
Income from mining (before section 35E deduction)		
- from old mining	20,000	4,00,000
- from new mining at Hazaribag	25,000	75,000
Other business income	4,00,000	3,90,000

*It is not possible to attach any certificate, statement or audit report with new income-tax return forms. The assessee should himself retain the audit report in Form No. 3B. It may be furnished in original whenever the Assessing Officer wants to examine it in assessment proceedings or otherwise.

Qualifying expenditure	*Rs.*
Expenses for the purpose of exploring and locating mineral incurred up to March 31, 2003	*7,20,000*
Expenses for the purpose of exploring and locating mineral from April 1, 2003 to March 31, 2008 (out of which Rs. 6,000 is met by the State Government)	*9,36,000*
Acquisition of site on June 30, 2003	*4,00,000*
Purchase of plant, machinery and building on July 31, 2004	*6,00,000*

SOLUTION : *Computation of qualifying expenditure* —

1. Rs. 7,20,000 incurred prior to April 1, 2003 is not part of qualifying expenditure (expenditure incurred during 2007-08 and earlier 4 years will be considered)	—
2. Out of Rs. 9,36,000, Rs. 6,000 is met by the State Government ; only Rs. 9,30,000 shall be included	9,30,000
3. Expenditure on acquisition of site is not qualifying amount	—
4. Building, plant and machinery are qualified for depreciation ; deduction under section 35E is not available	—
Qualifying expenditure	9,30,000
Amount deductible during 10 years : assessment years 2008-09 to 2017-18	93,000
Assessment year 2008-09	
Income from mining (old and new)	45,000
Less : Deduction under section 35E (*i.e.*, Rs. 45,000 or Rs. 93,000 whichever is less)	45,000
Mining income	*Nil*
Other income	4,00,000
Net income	4,00,000

Note : The amount of unabsorbed deduction under section 35E of Rs. 48,000 (*i.e.*, Rs. 93,000 — Rs. 45,000) will become a part of deduction for the next year.

Assessment year 2009-10

	Rs.
Mining income (old and new)	4,75,000
Less : Deduction under section 35E (*i.e.*, Rs. 93,000 + Rs. 48,000, subject to a maximum of mining income)	1,41,000
Balance	3,34,000
Other business income	3,90,000
Net income	7,24,000

Insurance premium [Sec. 36(1)(*i*)]

123. The amount of any premium paid in respect of insurance against risk of damage or destruction of stocks or stores, used for the purposes of business or profession, is allowable as deduction.

■ Where the assessee, a partnership-firm, insured the lives of its partners to provide for liquid cash to pay-off outgoing partner or legal heirs of the deceased partner to enable surviving partners to continue business without interruption and the assessee paid insurance premia and was entitled to sum assured on maturity of policy or in the event of death of partner, it was *held* that it could not be said that life insurance policies were taken out against risk of damage or destruction to the stocks and, hence, insurance premium paid could not be allowed under section 36(1)(*i*)—*CIT* v. *Khodidas Motiram Panchal* [1986] 27 Taxman 208 (Guj.).

Insurance premium paid by a federal milk co-operative society [Sec. 36(1)(*ia*)]

124. Insurance premium paid by a federal milk co-operative society on the lives of cattle, owned by the members of a primary milk co-operative society affiliated to it, is allowed as deduction.

Insurance premium on health of employees [Sec. 36(1)(*ib*)]

125. Any premium paid by any mode other than cases by the assessee as an employer to effect or to keep in force an insurance on the health of his employees is allowed as deduction. Deduction is available only if premium is paid under a scheme framed in this behalf by the General Insurance Corporation of India and approved by the Central Government or any scheme of any other insurer approved by IRDA.

Bonus or commission to employees [Sec. 36(1)(*ii*)]

126. Bonus or commission paid to an employee is allowable as deduction subject to certain conditions :

126.1 ***Admissible only if not payable as profit or dividend*** - One of the conditions is that the amount payable to employees as bonus or commission should not otherwise have been payable to them as profit or dividend. The plain reading of the clause means that the profits of a business will not be allowed to be dwindled by merely describing the payment as bonus or commission if the payment is in lieu of dividend or profits—*Loyal Motor Service Co.* v. *CIT* [1946] 14 ITR 647 (Bom.).

126.2 ***Year of claiming deduction*** - Bonus/commission is deductible subject to the provisions of section 43B [*see* para 155].

Interest on borrowed capital [Sec. 36(1)(*iii*)]

127. Interest paid on capital borrowed for the purposes of business or profession is allowable as deduction. In order to avail deduction the following conditions must be satisfied :

Condition one	The assessee must have borrowed money.
Condition two	The money so borrowed must have been used for the purpose of business.
Condition three	Interest is paid or payable on such borrowing.

127.1 ***The assessee must have borrowed capital*** - Under section 36(1)(*iii*), interest paid in respect of capital borrowed for the purpose of business/profession is a permissible deduction. The expression "capital" used in section 36(1)(*iii*) in the context in which it occurs means money (not any other asset) because interest is payable on capital borrowed or loan of money and not on any other asset.

The following propositions one should also keep in view :

1. Interest on own capital not deductible - Interest on own capital is not deductible. In other words, interest shall be paid to another person. Interest paid by one unit of the assessee to another unit is not deductible.

2. Element of refund is a must - An element of refund or repayment is a must in the concept of borrowing. If there is no obligation to refund the capital provided, interest on such capital is not deductible under section 36(1)(*iii*)—*Pepsu Road Transport Corpn.* v. *CIT* [1981] 130 ITR 18 (Punj. & Har.).

3. Guaranteed interest to shareholders - Guaranteed interest paid to shareholder on paid-up capital is not deductible—*Ahmadpur Katwa Railway Co. Ltd., In re* [1935] 3 ITR 277 (Cal.).

4. Money allotted on partition - Interest paid to wife and daughters on money allotted to them on partition is deductible—*Addl. CIT* v. *M.R. Raghupathy* [1983] 139 ITR 476 (Mad.).

5. Capital borrowed by erstwhile firm - Where the assessee-firm created credits in favour of creditors of an erstwhile firm, it amounted to capital borrowed for business purposes and thus interest paid thereon was to be allowed as deduction—*Mills Store Co.* v. *CIT* [1971] 80 ITR 225 (Bom.).

6. Trust created by book entries - Interest credited to a trust which was created by mere book entries and there was no divestiture of properties by the settlor was not deductible—*Hanmantram Ramnath* v. *CIT* [1946] 14 ITR 716 (Bom.).

127.2 ***Must be used for the purpose of business*** - Capital should have been borrowed for the purpose of business or profession.

Subba Rao, J. explained the significance of the expression "for the purpose of business" in *CIT* v. *Malayalam Plantations Ltd.* [1964] 53 ITR 140 (SC) in the following words :

> "...The expression 'for the purpose of the business' is wider in scope than the expression 'for the purpose of earning profits'. Its range is wide : it may take in not only the day-to-day running of a business but also the rationalisation of its administration and modernisation of its machinery; it may include measures for the preservation of the business and for the protection of its assets and property from expropriation, coercive process or assertion of hostile title ; it may also comprehend payment of statutory dues and taxes imposed as a pre-condition to commence or for carrying on of a business ; it may comprehend many other acts incidental to the carrying on of a business. However wide the meaning of the expression may be, its limits are implicit in it. The purpose shall be for the purpose of the business, that is to say, the expenditure shall be for the carrying on of the business and the assessee shall incur it in his capacity as a person carrying on the business..."

The following proposition taken from different judicial pronouncements should also be kept in view :

- *Actual utilization of asset* - Capital borrowed should be spend for the purpose of acquisition of a business asset during the relevant accounting year. It is sufficient for the purpose of claiming deduction of interest paid thereon. It is not necessary that the assessee must have used that business asset for doing business in the relevant accounting year—*C.T. Desai* v. *CIT* [1979] 120 ITR 240 (Kar.), *CIT* v. *Associated Fibre & Rubber Industries (P.) Ltd.* [1999] 236 ITR 471 (SC).

- *Non-assessable business* - If borrowed money is utilised in earning non-assessable income, no deduction is allowed for interest paid on such borrowing—*H.T. Conville* v. *CIT* [1936] 4 ITR 137 (Lahore).

- *Need to borrow* - It is not for the income-tax department to examine whether there was no need to borrow money because the assessee had ample fund of his own—*CIT* v. *Bombay Samachar Ltd.* [1969] 74 ITR 723 (Bom.). Interest on borrowed capital is allowed as deduction, if the same is employed for the purpose of business. Borrowing should, however, be a genuine borrowing and not a bogus one.

- *Capital asset* v. *Revenue asset* - Section 36(1)(*iii*) does not make any distinction between interest paid on capital utilised in acquiring a capital asset or a revenue asset—*India Cements Ltd.* v. *CIT* [1966] 60 ITR 52 (SC). If, however, money is utilised by an existing concern for acquiring a capital asset, then interest liability till the asset is put to use cannot be claimed as deduction under section 36 (such interest liability can be capitalised). In other words, interest liability pertaining to the period after the asset is put to use can be claimed as deduction under section 36(1)(*iii*) in the case of an existing concern. For detailed discussion, *see* para 109.10-1a.

- *When user of borrowed capital is unremunerative* - It is immaterial whether user of capital actually yielded profit or not—*Calico Dyeing & Printing Works* v. *CIT* [1958] 34 ITR 265 (Bom.). If, however, the capital borrowed is not utilised for the purpose of the business [for instance, capital borrowed is given by a firm to its partners for their personal use] no deduction is allowable—*Marolia & Sons* v. *CIT* [1981] 129 ITR 479 (All.). Similarly, where borrowed money is loaned to director without charging any interest, it is not deductible—*CIT* v. *Siyani Textiles (P.) Ltd.* [1985] 151 ITR 653 (Mad.). But if non-charging of interest is a general practice followed by the company, then it may be allowed as deduction.

- *Non-charging of interest on debit balance of its partners* - Where a firm borrows money from outside and in capital accounts of a partner there is a debit balance on which no interest is charged, then the mere fact that there is no possible explanation for not charging interest on debit balance when interest has been paid by the assessee on borrowing by itself would not be enough to infer that borrowings to the extent of debit balance in partners' account has not been utilised for business purpose—*CIT* v. *Alok Paper Industries* [1982] 138 ITR 729 (MP).

- *When borrowed funds are diverted for giving interest-free loan* - Non-charging of interest on loans given by an assessee cannot itself be a sufficient ground for disallowing interest paid by an assessee on loans taken by it in the absence of any nexus between borrowed capital and interest-free

advances or in the absence of any finding that borrowed funds or part thereof was diverted towards interest-free advances—***Meenakshi Synthetics (P.) Ltd.*** v. ***CIT*** [2003] 84 ITD 563 (Lucknow). Where nothing has been brought on record by the revenue to prove that interest-bearing funds available with the assessee is not utilised for the purpose of business but is given as interest-free loans or advances, disallowance of interest on borrowed capital is unjustified—*ITO* v. *Naresh Fabrics* [2002] 75 TTJ (Jodh.) 386.

The principles enunciated in various decisions are that if there are sufficient funds on a particular date to cover the advance, merely because the assessee has also taken some loan, it cannot be attributed that the interest-bearing funds are diverted for non-business purposes. In other words, the benefit of doubt of utilising the own funds from the common pool account, should be given to the assessee. However, the primary burden of establishing that on the date when each interest-free loan is given by the assessee there were sufficient non-interest bearing/own funds available with the assessee to advance the money to the sister concern without charging interest, is on the assessee. Merely because the overall interest-free funds available with the assessee were more than the interest-free loan given by the assessee, it cannot be said that the interest-free loans given by the assessee were out of its own funds—***Sanghvi Swiss Refills (P.) Ltd.*** v. ***ITO*** [2003] 85 ITD 59 (Mum.) (SMC-I).

▪ *Transfer of borrowed fund to a sister concern* - Once it is established that there is nexus between the expenditure and the purpose of the business (which need not necessarily be the business of the assessee itself), the Revenue cannot justifiably claim to put itself in the arm-chair of the businessman or in the position of the board of directors and assume the role to decide how much is reasonable expenditure having regard to the circumstances of the case. No businessman can be compelled to maximize its profit. The income tax authorities must put themselves in the shoes of the assessee and see how a prudent businessman would act. The authorities must not look at the matter from their own view point but that of a prudent businessman. One has to see the transfer of the borrowed funds to a sister concern from the point of view of commercial expediency and not from the point of view whether the amount is advanced for earning profits.

It is not correct that in every case interest on borrowed loan has to be allowed if the assessee advances it to a sister concern. It all depends on the facts and circumstances of the respective case. For instance, if the directors of the sister concern utilize the amount advanced to it by the assessee for their personal benefit, obviously it cannot be said that such money was advanced a measure of commercial expediency. However, money can be said to be advanced to a sister concern for commercial expediency in many other circumstances (which need not be enumerated here). Where it is obvious that a holding company has a deep interest in its subsidiary, and hence if the holding company advances borrowed money to a subsidiary and the same is used by the subsidiary for some business purposes, the assessee would, ordinary be entitled to deduction of interest on its borrowed loans—***S.A. Builders Ltd.*** v. ***CIT*** [2007] 158 Taxman 82 (SC).

▪ *Interest on money borrowed for payment of tax* - Interest on money borrowed to pay income-tax is not allowable as deduction under section 36(1)(*iii*). Interest on advance tax or for late filing of return is not allowable as deduction under section 36(1)(*iii*), as in such a case there is no borrowing of capital for business purposes—*see National Engg. Industries Ltd.* v. *CIT* [1978] 113 ITR 252 (Cal.). Similarly, where interest is paid for meeting tax liability of partners, such interest is not deductible—*Roopchand Chabildass & Sons* v. *CIT* [1967] 63 ITR 166 (Mad.).

▪ *Reasonableness of interest* - Interest paid or payable is deductible if the aforesaid conditions are satisfied. Test of reasonableness is wholly absent in section 36(1)(*iii*). The reason appears to be obvious. It is not possible for a party to raise loan in open market on a uniform rate. Nor can a debtor dictate his rate of interest to the creditor. Rate of interest naturally depends upon various factors such as the credit of the debtor in the market and availability of capital in the market at a particular time. On account of business exigencies a businessman may be forced to pay a higher rate of interest. It may be reasonable to hold that no businessman would agree to borrow capital at an excessive or unreasonable rate of interest—*Banshidhar Onkarmal* v. *CIT* [1965] 58 ITR 462 (Ori.).

▪ *Brokerage* - Brokerage or commission paid to an agent for arranging a loan for the purposes of business is not allowable under this section but is allowable as deduction under section 37(1)—*C. Mool Chand* v. *CIT* [1956] 29 ITR 449 (Hyd.).

▪ *Interest paid outside India* - Interest is not allowable as deduction unless tax has been paid or the tax has been deducted at source [sec. 40(*a*)(*i*)/(*ia*)].

▪ *Onus of proof* - Onus is on the Assessing Officer to prove that any part of the borrowed funds was diverted to a non-business use before he disallows part of interest—*Modipon Ltd.* v. *ITO* [1985] 22 TTJ (Delhi) 108.

127.3 ***Interest is paid or payable on borrowing*** - If the assessee maintains books of account on the basis of "cash" system of accounting, interest is deductible on "payment" basis. If books of account are kept on the basis of mercantile system of accounting, interest on borrowed capital is deductible on "accrual" basis [in some cases, governed by section 43B, however, a different rule is applicable - *see* para 155].

Discount on zero coupon bonds [Sec. 36(1)(*iiia*)]

127A. Discount is the difference between amount received and the amount payable on redemption/ maturity of zero coupon bonds by the issuing company. It is allowed as deduction on *pro rata* basis. The *pro rata* deduction is available under section 36(1)(*iiia*) having regard to the period of life of such bond as may be prescribed. "Period of life of the bond" means the period commencing from the date of issue of the bond and ending on the date of the maturity or redemption of such bond.

127A.1 ***Meaning of zero coupon bond*** - According to section 2(*48*), zero coupon bond must satisfy the following three conditions—

1. It is a bond issued by any infrastructure capital company or infrastructure capital fund or public sector company on or after June 1, 2005.

2. In respect of such bond, no payment/benefit is received (or receivable) before maturity/ redemption from infrastructure capital company or infrastructure capital fund or public sector company.

3. Such bond is specified by the Central Government by notification in the Official Gazette.

127A.1-1 GUIDELINES FOR NOTIFICATION - Zero coupon bonds are notified by the Central Government subject to the following guidelines -

▪ Application should be made in Form No. 5B.

▪ The application should be made at least 3 months before the date of issue of zero coupon bonds. However, such application cannot be made in respect of such bonds, which are to be issued after 2 financial years immediately following the financial year in which such application is made. For instance, if the proposed date of issue of bonds is June 14, 2008, the application can be made on or after April 1, 2006 but on or before March 13, 2008.

▪ The application should be accompanied by a copy of certificate of incorporation/a copy of registered trust deed/a copy of relevant Act under which the applicant has been incorporated.

▪ The life of bond should not be less than 10 years and more than 20 years.

▪ The applicant should have an investment grade rating from at least 2 registered credit rating agencies.

▪ The applicant should have made necessary arrangements for listing the zero coupon bonds.

▪ An undertaking should be furnished by the applicant to invest the money realized on issue of zero coupon bonds in the following manner—

If the applicant is an infrastructure capital company/fund	*If the applicant is a public sector company*
25 per cent or more of the money realized shall be invested before the end of the next financial year (*i.e.*, the financial year immediately following the financial year in which the bonds are issued) The balance should be utilized within a period of 4 financial years immediately following the financial year in which the bonds are issued.	15 per cent or more of the money realized shall be invested before the end of the next financial year (*i.e.*, the financial year immediately following the financial year in which the bonds are issued) The balance should be utilized within a period of 6 financial years immediately following the financial year in which the bonds are issued.

■ A certificate from a chartered accountant shall be submitted within 2 months from the end of each financial year specifying the amount invested in each financial year.

127A.2 ***Tax treatment in the hands of company issuing such bonds*** - The following points should be noted—

1. Discount is deductible on *pro rata* basis as stated above.

2. Tax will not be deducted at source under section 194A by the payer company.

127A.3 ***Tax treatment in the hands of investor*** - The following points should be noted—

1. Maturity/redemption of zero coupon bonds will amount to "transfer" under section 2(*47*)(*iva*).

2. If period of holding is more than 12 months, such bonds would be long-term capital asset under section 2(*42A*).

3. Long-term capital gains would be taxable at the rate of 10 per cent (+SC + EC + SHEC) without indexation under section 112.

127A-E1 *Zero coupon bonds are issued by X Ltd. (infrastructure capital company) on October 4, 2008 (issue price: Rs. 85, face value as well as amount payable at the time of redemption : Rs. 100, redemption date : July 10, 2019, number of bonds subscribed by public : 1,00,000). These bonds are notified by the Government as zero coupon bonds for the purpose of section 2(48).*

SOLUTION : Pro rata *deduction available to X Ltd.*

Amount of discount offered by X Ltd. [(Rs. 100 – Rs. 85) × 1,00,000] : Rs. 15,00,000 (a).

Date of issue : October 4, 2008

Date of issue (rounded off) : October 1, 2008 (if fraction is 15 days or more, it is taken as one month)

Date of redemption : July 10, 2019

Date of redemption (rounded off) : June 30, 2019 (if fraction is less than 15 days, it shall be ignored)

Period of life of the bond (June 30, 2019 *minus* October 1, 2008) : 129 months (b)

Pro rata deduction for 1 month : Rs. 11,628 [(a) ÷ (b)] (c)

Amount deductible for the previous year 2008-09 : Rs. 69,767 [(c) × 6]

Amount deductible for the previous years 2009-10 to 2018-19 : Rs. 1,39,535 [(c) × 12]

Amount deductible for the previous year 2019-20 : Rs. 34,884 [(c) × 3]

Employer's contribution to recognised provident fund and approved superannuation fund [Sec. 36(1)(*iv*)]

128. Employer's contribution towards recognised provident fund or an approved superannuation fund is allowable as deduction subject to the limits laid down for the purpose of recognising the provident fund or approving the superannuation fund [Fourth Schedule and rules 75, 87 and 88]. *See* para 155, regarding disallowance of unpaid statutory liability under section 43B. For claiming deduction under section 36, a scheme should either be framed under the Employees' Provident Funds Act, or should be approved by Commissioner under the Income-tax Act. If a scheme is

exempted from provisions of the Employees' Provident Funds Act, it does not become a scheme framed under that Act and contribution towards such scheme cannot be allowed under section 36—***CIT*** v. ***Kattabomman Transport Corpn. Ltd.*** [2005] 142 Taxman 375 (Mad.).

The contributions made towards recognised provident fund are deductible under section 36(1)(*iv*) even though the amount contributed is in violation of the company's articles of association—*CIT* v. *British India Corpn.* [1983] 142 ITR 563 (All.).

128.1 ***Limits in the case of recognised provident fund*** - The following limits are specified under rule 75 :

■ Where an employee of a company owns shares of more than 10 per cent of voting power in the employer-company, the sum of the contributions of the employee and employer to the recognised provident fund maintained by the company should not exceed Rs. 250 in any month†.

■ The aggregate contribution of an employer in any year, including the normal contribution, to the individual account of any one employee whose salary does not exceed Rs. 500 per month, should not exceed double the amount of the contribution of the employee in that year.

■ The amount of periodical bonuses and other contribution of a contingent nature which may be credited by an employer in any year to the individual account of any one employee cannot exceed the amount of contributions of the employee in that year. This limit is, however, not applicable to bonus contributions made by an employer under an award by an Industrial Tribunal (or under an order of Court or under an agreement with the employees' union) to the individual accounts of employees whose salary does not exceed Rs. 500 per month.

128.2 ***Limits in the case of approved superannuation funds*** - The ordinary annual contribution by the employer to a fund in respect of any particular employee should not exceed 27 per cent of his salary for each year as reduced by the employer's contribution to any provident fund (whether recognised or not) in respect of the same employee for that year. Moreover, in respect of initial contribution the amount to be allowed as a deduction on account of an initial contribution which an employer may make in respect of past services of an employee admitted to the benefits of a fund cannot exceed 25 per cent of the employee's salary up to September 21, 1997 (and after September 21, 1997 : 27 per cent) for each year of his past service with the employer as reduced by the employer's contribution, if any, to any provident fund (whether recognised or not) in respect of that employee for each such year [rules 87 and 88].

128.3 ***Conditions specified by the Board*** - The Board has specified the following conditions for deduction of contributions to recognised provident fund/approved superannuation fund in cases where the contributions are not in the nature of annual contributions of fixed amounts or annual contributions fixed on some definite basis by reference to the income chargeable under the head "Salaries" or to the contributions or to the number of members of fund :

■ The total amount of contribution shall not exceed 25 per cent of the employee's salary up to September 21, 1997 (and after September 21, 1997 : 27 per cent) for each year of his past service with the employer as reduced by the employer's contribution, if any, to any provident fund (whether recognised or not) in respect of that employee for each such year.

■ Subject to the above conditions, 80 per cent* of the amount actually paid by the employer by way of contribution during any previous year is deductible allowance.

■ One-fifth of such deductible allowance is to be allowed in the assessment year relating to the previous year in which the amount was actually paid and the balance of the deductible allowance is to be allowed in equal instalments for each of the four immediately succeeding assessment years.

Contribution towards approved gratuity fund [Sec. 36(1)(*v*)]

129. Employer's contribution towards an approved gratuity fund created by him exclusively for the benefit of his employees under an irrevocable trust is allowable as deduction.

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†The limit applies to the employer's contribution only—*CIT* v. *Raab Pipe Works (P.) Ltd.* [1997] 226 ITR 710 (Mad.).

*It falls outside of the power of the Board—*CIT* v. *Sirpur Paper Mills* [1999] 103 Taxman 352 (SC).

The following points should be kept in view :

- The amount deductible on account of ordinary annual contribution cannot exceed 8.33 per cent of the salary of each employee.
- The amount to be allowed as a deduction on account of an initial contribution which an employer may make in respect of the past services of an employee admitted to the benefits of a fund cannot exceed 8.33 per cent of the employee's salary for each year of his past service with the employer.
- *See* para 155, regarding disallowance of unpaid statutory liability [sec. 43B].
- Payment directly to LIC towards Group Gratuity Fund is deductible—*CIT* v. *Textool Co. Ltd.* [2002] 122 Taxman 668 (Mad.).

Employees' contribution towards staff welfare schemes [Sec. 36(1)(*va*)]

130. Deduction in respect of any sum received by the taxpayer as contribution from his employees towards any welfare fund of such employees is allowed only if such sum is credited by the taxpayer to the employee's account in the relevant fund on or before the due date [*see* also para 6.2-14].

- For the purposes of this section, "due date" means the date by which the assessee is required as an employer to credit such contribution to the employee's account in the relevant fund under the provisions of any law or term of contract of service or otherwise. If such contribution is paid by the due date but within the grace period, the same will be deemed to have been paid within due date—***CIT*** v. ***Rotex Mfg. & Engg. (Guj.) (P.) Ltd.*** [2004] 2 SOT 924 (Ahd.), ***CIT*** v. ***Salem Co-operative Spinning Mills Ltd.*** [2006] 284 ITR 621 (Mad.).

If the remittance of employees' contribution to provident fund is not made within "due date", deduction under section 36(1)(*va*) is not available even if—

a. salary is actually paid to employees before the "due date", or

b. employees' contribution to provident fund is paid within the previous year;

c. employer's contribution to provident fund is deductible under section 43B on the basis of payment made on or before the due date of submission of return of income— ***CIT*** v. ***Madras Radiators & Pressing Ltd.*** [2003] 129 Taxman 709 (Mad.).

Regarding employees' contribution, section 43B is not applicable at all and the assessee's claim has to be considered under section 36(1)(*va*).

Write off allowance for animals [Sec. 36(1)(vi)]

131. In respect of animals which are used for the purpose of business or profession (not as stock-in-trade) and have died or become permanently useless, the difference between the actual cost of the animals to the assessee and the amount realised (if any) in respect of carcasses or sale of animals is allowable as deduction.

- Word 'animals' used in section 36(1)(*vi*) includes birds and chicken also—***India Poultry (P.) Ltd.*** v. ***CIT*** [2007] 104 ITD 299 (Hyd.).

Bad debts [Sec. 36(1)(vii)]

132. In order to claim deduction under section 36(1)(*vii*), one must keep in view the following points :

132.1 ***There must be a debt*** - Before claiming an amount as a bad debt, it must be shown that it is a proper debt. In other words, a bad debt presupposes the existence of a debt and relationship of debtor and creditor. Unless, therefore, there is an admitted debt, it cannot be allowed as bad debt when it is written off.

132.2 ***Debt must be incidental to the business or profession of the assessee*** - The debt which is claimed as bad debt under section 36(1)(*vii*) must be incidental to the business or profession carried on by the assessee. In other words, debts not connected with business or profession carried on by

the assessee or not arising out of the operation of business or profession carried on by the assessee, are not admissible as bad debts even if other conditions are satisfied. In the case of a non-banking or non-money-lending business, a debt, incidental to business or profession, may arise in two ways : on sale of goods on credit and on advancing money to a customer, employee or constituent. While bad debts, arising on account of sale of goods, are always incidental to the business of assessee, the question of admissibility of bad debts, arising out of advances, is to be decided on the facts and circumstances of each case—*CIT* v. *Dhanalakshmi Corpn.* [1962] 46 ITR 1031 (Mad.).

In the case of bad debts arising out of advances made in a business or profession, the deciding point is whether advances are made for the purpose of business or profession or whether they are related to the business or profession or results from it. For instance, bad debt arising out of advances made in ordinary course of business for supply of raw material is admissible as bad debt ; whereas bad debt arising out of advances made by a lawyer to his clients to purchase properties is not admissible as bad debt, as it is not part of a lawyer's business to advance money to his clients—*CIT* v. *Abdullabhai Abdulkadar* [1961] 41 ITR 545 (SC).

132.3 ***Debt must have been taken into account in computing assessable income*** - Bad debt is admissible as deduction only if it is taken into account in computing the total income of the assessee of the previous year in which it is written off or an earlier year. This condition is however, not relevant, if bad debts represents money lent in the ordinary course of money-lending or banking business.

In the case of mercantile system of accounting, income is taxable on accrual basis, even if it is not realised in cash in the year of accrual of income. If a debt of such business income becomes bad, a deduction is necessary in order to arrive at true profits of the business.

▪ *Banking or money-lending business* - In the case of banking or money-lending business, a claim of bad debt is admissible in respect of loan advanced during the ordinary course of business, irrespective of the method of accounting employed by the assessee, as money is treated as stock-in-trade in the case of banking/money-lending business.

132.4 ***Debt must have been written off in the books of account of the assessee*** - Bad debt is allowable as deduction under section 36(1)(*vii*) only if it is written off as irrecoverable in the books of the assessee in the previous year in which claim for deduction is made. "Writing off" is a technical term and it simply means cancellation of sum of money due. In accounting practice, "write off" means that an account which was previously shown as asset must be transferred to the expense account or the profit and loss account. The writing off of bad debts, without charging the same in the profit and loss account is not a write off at all—*CIT* v. *Hotel Ambassador* [2002] 121 Taxman 437 (Ker.). Though no particular form or manner of writing off a debt is prescribed, a debt may be written off as irrecoverable in the individual account of the debtor.

▪ The following point should be kept in view—

1. If amount is transferred to "provision for bad and doubtful debts account", then it shall not be taken as bad debts written off. The legal position is clear that if the amount of bad debt has been written off in the accounts of various persons, the same would be allowable as deduction. In case where the amount has been claimed as provision for bad and doubtful debts and is not written off in the accounts of various persons, the same would not be allowable as deduction. Even the RBI Guidelines would not override this provision of the Income-tax Act—***ITO*** v. ***Maruti Countrywide Auto Financial Services (P.) Ltd.*** [2008] 20 SOT 237 (Delhi).

2. It is not for the assessee to establish that the debt had become bad in the previous year. In other words, it is not obligatory for assessee to place demonstrative proof for establishing a debt as bad - ***Ajitkumar C. Kamdar*** v. ***CIT*** [2005] 1 SOT 183 (Mum.). If it has been written off as irrecoverable in the accounts of the assessee for the previous year, it will suffice for claiming it as bad debt. It is for the assessee to decide whether the debt has become bad or not and the Assessing Officer can never insist on production of demonstrative and infallible proof that the debt had become bad—*Newdeal Finance & Investment Ltd.* v. *Deputy CIT* [2000] 74 ITD 469/69 TTJ (Chennai) 410.

3. The requirement as per section 36(1)(*vii*) is to write-off bad debts in the accounts of the assessee "for the previous year". This clause does not say to write-off bad debt "in the previous year". It would have made a vast difference if the word 'in' would have been there in place of 'for'. In the clause, the words 'accounts of the assessee' are qualified with further words 'for the previous year'. It only means that the accounts in which the act of writing-off is to be done by the assessee should be for the previous year. Therefore, the law requires to write-off the bad debt in the accounts of the assessee for the relevant year. There is no condition in the provision that such writing-off should be done in the relevant previous year (*i.e.*, before the end of financial year). In other words, if the accounts of the assessee are open and subject to corrections by the auditors as per the Companies Act, 1956, then such writing-off can be done in those books. There is also no condition in this clause that the decision for treating the debt as bad or irrecoverable should be taken in the previous year itself. In other words, if it is possible for the assessee legally and otherwise to make entries in the books of a particular previous year then the claim of bad debt can be made in the books for that previous year. Where books of account are not closed and complete, have not been signed by the board of directors and have not been adopted by the shareholders as per the Companies Act, it is legally permissible to make adjustments before they are finally adopted—***U.P.R.N.N. Ltd.*** v. ***ITO*** [2008] 24 SOT 139 (Luck.). However, writing off of bad debt after the accounts are closed and complete (for instance, after approval in the annual general meeting or in reassessment proceedings) is not permissible—*CIT* v. *Hotel Ambassador* [2002] 253 ITR 430/121 Taxman 437 (Ker.).

Provisions illustrated - To illustrate the aforesaid provisions, the following examples are given—

1. X, a trader, sells goods on credit. Out of the credit sales made in the current year (or in the earlier years), Rs. 50,000 is written off as bad debt. As sales turnover is considered in calculating income, bad debts so written off is allowable as deduction.

2. Y owns an industrial undertaking. One of the plants in the factory is replaced by him. The old plant is sold for Rs. 60,000 on credit to A. A, however, becomes insolvent before making payment of sale consideration. This is capital loss and it cannot be debited to profit and loss account. It is, therefore, not deductible. In other words, "debt" should be revenue in nature.

3. Z, a money-lender, gives a loan to A. Before repaying the loan along with interest, A becomes insolvent. In this case if interest is included in income on "accrual" basis, it can be written off as bad debt and the same is allowable as deduction. Loss on account of non-recovery of loan is also deductible if it is written off in the books of account (the condition that the debt is deductible only if it was taken into account in computing the total income of the taxpayer is not applicable in the case of non-recovery of loan where it represents money lent in the ordinary course of money-lending business).

132.5 ***Adjustment at the time of recovery*** - A deduction on account of bad debt is based upon a mere estimate. Therefore, in a case where debt ultimately recovered is less than the difference between the amount of debt and bad debt allowed as deduction, such deficiency will be deductible in the previous year in which the ultimate recovery is made. Conversely, where the debt ultimately recovered is more than the difference between the debt and amount of bad debt written off and claimed as deduction, such excess amount will be chargeable to tax in the assessment year relevant to the previous year of recovery [sec. 41(4)].

132.5-P1 *X, a trader, sells goods on credit to Y (outstanding balance on April 1, 2008 : Rs. 40,000 and total bills issued during 2008-09 : Rs. 60,000). Out of Rs. 1,00,000, he recovers only Rs. 10,000 from Y during 2008-09. On March 31, 2009, he writes off Rs. 32,000 as bad debt. However, on December 19, 2009, X recovers from Y as full and final payment (a) Rs. 15,000, or (b) Rs. 55,000, or (c) Rs. 70,000. Find out the tax consequences for different assessment years.*

SOLUTION :

Assessment year 2009-10 - During the previous year 2008-09, X writes off Rs. 32,000 as bad debt. It is, therefore, deductible for the assessment year 2009-10.

Assessment year 2010-11 - Tax treatment, when recovery is made during the previous year 2009-10, will be as follows —

Amount of debt as on April 1, 2009 (i.e., Rs. 1 lakh — Rs. 10,000 — Rs. 32,000 being the amount written off) (1) Rs.	Amount recovered as full and final payment (2) Rs.	Deduction/income (2) – (1) Rs.
(a) 58,000	15,000	(-)43,000
(b) 58,000	55,000	(-) 3,000
(c) 58,000	70,000	12,000

In situation (a) Rs. 43,000 is deductible as bad debt if he writes off Rs. 43,000 in his books of account as bad debt during the previous year 2009-10. Likewise, in situation (b) Rs. 3,000 is deductible as bad debt if X writes off Rs. 3,000 in his books of account for the year ending March 31, 2010. In situation (c), however, Rs. 12,000, being the excess recovery, is taxable as business income by virtue of section 41(4) for the previous year 2009-10 [irrespective of the fact whether the business is in existence during the previous year 2009-10 or not].

132.6 ***Bad debt of a discontinued business is not admissible*** - In order to claim allowance for bad debt under section 36(1)(*vii*), the debt should be in respect of the business carried on by the assessee in the previous year. No allowance can, therefore, be claimed in respect of bad debts of a business which has been discontinued before the commencement of the previous year. Such bad debt cannot be deducted even from profits of a separate existing business. An assessee can avail deduction of bad debt of business which is carried on by him for at least sometime during the previous year ; it is not necessary that the business should be carried on throughout the previous year.

132.7 ***Bad debt allowable in the hands of successor in certain cases*** - Tax treatment in different situation is given below—

- *When a firm is dissolved* - Generally where a firm is dissolved, the debts due to the firm are divided amongst the partners as *capital assets* and if any of the debts become irrecoverable, the loss would be a capital loss which is not deductible under section 36(1)(*vii*).
- *When after dissolution of firm business is taken over by a partner* - If on dissolution of the firm, one of the partners takes over the business with all assets and liabilities and carries it on as successor, he is entitled to an allowance when a debt originally due to firm is written off as bad debt. It is because of the fact that the benefit of deduction of bad debts (which have been written off) under section 36(2)(*i*)(*b*) is not given to an assessee by way of personal relief but it is available to the business. Therefore, exemption is not only available to the assessee, but it is also available to the succeeding assessee inasmuch as "the assessee" referred to in section 36(2)(*i*) need not be the "same assessee".
- *Conversion of firm into company* - Bad debt of the firm is deductible in the hands of the company — *T. N. Shah (P.) Ltd.* v. *CIT* [1979] 120 ITR 354 (All.); *CIT* v. *Jagat Ram Om Prakash* [1979] 116 ITR 266 (P&H); *CIT* v. *Veerabhadra Rao, K. Koteswara Rao & Co.* [1976] 102 ITR 604 (AP).

The decision of the Andhra Pradesh High Court has been affirmed by the Supreme Court in *CIT* v. *T. Veerabhadra Rao* [1985] 22 Taxman 45.

132.8 ***Bad debt in the case of commercial banks and other assessees*** - In the case of an assessee to which section 36(1)(*viia*) applies, the amount of the deduction relating to any bad debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that clause [*see* problem 133.3-P1].

This rule is applicable only in respect of debts written off in books of account and for which deduction is available under section 36(1)(*viia*)—***South India Bank Ltd.*** v. ***CIT*** [2003] 130 Taxman 749 (Ker.).

Provision for bad and doubtful debts relating to rural branches of commercial banks [Sec. 36(1)(*viia*)]

133. The amount of deduction in respect of provision for bad and doubtful debts is given below :

	Amount deductible in respect of provision for bad and doubtful debts		
	In the case of a scheduled bank [other than a foreign bank] and a non-scheduled bank †	*In case of public financial institution, State financial corporation, State industrial investment corporation*	*In the case of a foreign bank*
■ Total income (computed before this deduction and amount deductible under sections 80C to 80U)	7.5 per cent of such income	5 per cent of such income	5 per cent of such income
■ Aggregate average advances made by rural branches	10 per cent of such advances	—	—

Note - With effect from the assessment year 2004-05, a scheduled bank (other than a foreign bank) or a non-scheduled bank shall, at its option, be allowed a further deduction in excess of the limits specified in the foregoing provisions, for an amount not exceeding the income derived from redemption of securities in accordance with a scheme framed by the Central Government. No deduction shall, however, be allowed under this provision unless such income has been disclosed in the return of income under the head "Profits and gains of business or profession".

133.1 *Rural branch - Meaning of* - "Rural branch" means a branch of scheduled bank [or a non-scheduled bank] situated in a place which has a population of not more than 10,000 according to the last preceding census of which the relevant figures have been published before the first day of the previous year.

133.2 *Aggregate average advance - Meaning of* - The aggregate average advances qualifying for the deduction are to be computed in the manner prescribed by rule 6ABA as under :

a. the amount of advances, made by each rural branch, as outstanding at the end of the last day of each month of the previous year, is aggregated separately ;

b. the sum so arrived at in the case of each such branch is to be divided by the number of months for which the outstanding advances have been taken into account ;

c. the aggregate of the sums so arrived at in respect of each of the rural branches is the aggregate average advances made by the rural branches of scheduled bank.

133.3 *Deduction in the case of an assessee who is eligible for deduction under section 36(1)(vii) and (viia)* - In the case of the above taxpayer, no deduction is allowed under section 36(1)(*vii*) in respect of bad debts unless the amount of bad and doubtful debt is debited to the provision for bad and doubtful debts account and the deduction admissible under section 36(1)(*vii*) is limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account.

133.3-P1 *XY Ltd., a public financial institution, is eligible for claiming deduction under section 36(1)(viia). Its business income (before claiming this deduction) for the previous year 2008-09 is Rs. 160 lakh. Provision for bad and doubtful debts account has an opening balance of Rs. 1 lakh on April 1, 2008. XY Ltd. wants to write off Rs. 14 lakh during 2008-09 on account of bad debts. Compute the amount of deduction under section 36(1)(vii)/(viia). What are the formalities the taxpayer is required to complete ?*

SOLUTION : The amount of bad debt, *i.e.*, Rs. 14 lakh should be debited to "Provision for bad and doubtful debt" account as follows —

Provision for bad and doubtful debt account

[illegible]	(Rs. in lakh)		(Rs. in lakh)
March 31, 2009 To debtors a/c (being bad debt the taxpayer wants to write off)	14	*April 1, 2008* By balance b/d	1
		March 31, 2009 By P & L a/c [being deduction eligible under section 36(1)(viia), *i.e.*, 5% of Rs. 160 lakh]	8

†From the assessment year 2007-08 onwards, this benefit will also be available in the case of a co-operative bank but other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank.

	(Rs. in lakh)		(Rs. in lakh)
		March 31, 2009 By P & L a/c [being deduction under section 36(1)(*vii*)]	5
	14		14

The following conclusions, one can draw —

1. The amount of deduction under section 36 is as follows —

a. provision for bad and doubtful debts under section 36(1)(*viia*) : Rs. 8 lakh (being 5% of Rs. 160 lakh); and

b. bad debts under section 36(1)(*vii*) : Rs. 5 lakh.

2. In such a case, the amount of bad debt (*i.e.*, Rs. 14 lakh) should be debited to the provision for bad and doubtful debts account and only if such amount is more than the credit balance in the provision for bad and doubtful debts account (*i.e.*, Rs. 1 lakh + Rs. 8 lakh), the excess is eligible for deduction under section 36(1)(*vii*).

Transfer to special reserve [Sec. 36(1)(*viii*)]

134. The scheme of section 36(1)(*viii*) is given below :

134.1 ***Who can claim deduction*** - Deduction under section 36(1)(*viii*) is available to the following—

a. a financial corporation (including a public company and a Government company) which is engaged in providing long-term finance for industrial or agricultural development or development of infrastructure facility in India ; or

b. a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of residential houses in India.

■ *Long-term finance* - The expression "long-term finance" has been defined to mean any loan or advance, where the terms under which money are loaned or advanced provide for repayment along with interest thereof during a period of not less than 5 years.

From the assessment year 2008-09, the following persons can claim deduction in respect of amount transferred to the special reserve account within the ceiling given above—

Who can claim deduction in respect of amount transferred to the special reserve account	*What is eligible business for the purpose of calculating 20 per cent of the profit*
■ ICICI, IFCI, IDBI, LIC, UTI, Infrastructure Development Finance Company Limited, or a public financial institution notified by the Central Government under section 4A of the Companies Act, 1956 ■ A financial corporation established by or under any Central, State or Provincial Act or which is a Government company under section 617 of the Companies Act ■ Banking company ■ Co-operative bank (other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank)	The business of providing long-term finance in India for industrial or agricultural development or development of infrastructure facility or construction or purchase of residential houses in India
A housing finance company (*i.e.*, a public company formed in India with the main object of carrying on the business of providing long-term finance for purchase or construction of residential house in India)	The business of providing long-term finance for construction or purchase of residential houses in India
Any other financial corporation including the public company	The business of providing long-term finance for development of infrastructure facility

134.2 ***Amount of deduction*** - An amount of deduction under section 36(1)(*viii*) is as follows —

a. the amount transferred during the previous year to the special reserve account created for the purpose of section 36(1)(*viii*) ; or

b. 20 per cent (40 per cent upto the assessment year 2007-08) of the profits derived from the business activities mentioned in para 134.1 *supra* which is computed under section 28 but before claiming deduction under section 36(1)(*viii*) ; or

c. 200 per cent of (paid up-share capital and general reserve as on the last day of the previous year) *minus* the balance of the special reserve account on the first day of the previous year;

whichever is lower.

134.2-P1 *X Ltd. is a financial corporation for the purpose of section 36(1)(viii). Income of the taxpayer for the previous year 2008-09 from different sources is as follows —*

	Rs. in lakh
a. *from providing long-term finance for industrial/agricultural development or development of infrastructure facility (before any deduction under section 36)*	*1120*
b. *business income from other activities*	*105*

Compute the amount of deduction under section 36(1)(viii) for the assessment year 2009-10 taking into consideration the following data —

1. *Paid-up capital and general reserve on March 31, 2009 : Rs. 610 lakh*
2. *Balance standing to the credit of special reserve account as on April 1, 2008 : Rs. 1,050 lakh (and the same was allowed as deduction in the earlier years).*
3. *Amount transferred to special reserve account during 2008-09 is Rs. 220 lakh.*

SOLUTION : The amount of deduction under section 36(1)(viii) is the least of the following —

a. Rs. 220 lakh (being the amount transferred to the special reserve account during 2008-09) ;
b. Rs. 224 lakh (being 20% of Rs. 1120 lakh) ; or
c. Rs.170 lakh (being 200% of Rs. 610 lakh — Rs. 1,050 lakh).

Rs. 170 lakh (being the least) is deductible.

134.3 ***Infrastructure facility*** - For this purpose "infrastructure facility" means—

a. infrastructure facility as given in *Explanation* to section 80-IA(4)(*i*) or any other public facility of a similar nature as may be notified by the Board.†
b. an undertaking referred to in section 80-IA(4)(*ii*)/(*iii*)/(*iv*).
c. an undertaking referred to in section 80-IB(10).

134.4 ***Amount withdrawn from reserve account*** - If any amount is withdrawn from the aforesaid reserve account [in respect of which deduction was allowed under section 36(1)(*viii*)], it will be chargeable to tax in the year in which the amount is withdrawn, under section 41(4A), regardless of the fact whether the business is in existence in that year or not.

134.4-P1 *Assume in problem 134.2-P1, X Ltd. withdraws the following amount from the special reserve account—*

a. *Rs. 55 lakh on May 10, 2009 ; and*
b. *Rs. 20 lakh on June 10, 2009.*

SOLUTION : The balance at the credit of the special reserve account is as follows—

	Balance in the special reserve account (Rs. in lakh)	**Out of which deduction has been allowed in earlier years under section 36(1)(viii) (Rs. in lakh)**
Balance as on April 1, 2008	1,050	1,050
Amount transferred during 2008-09	220	170
Balance as on April 1, 2009	1,270	1,220

In other words, the taxpayer has to maintain a balance of Rs. 1,220 lakh without attracting any tax liability under section 41(4A). After the withdrawal of Rs. 75 lakh during the previous year 2009-10, the balance of the special reserve account is reduced to Rs. 1,195 lakh. Therefore, Rs. 25 lakh (i.e., Rs. 1,220 lakh — Rs. 1,195 lakh) is

†The following are notified for this purpose—

(*a*) Inland Container Depot and Container Freight Station notified under the Customs Act, 1962 (52 of 1962), (*b*) Mass Rapid Transit System, (*c*) Light Rail Transit System, (*d*) Expressways, (*e*) Intra-urban or semi-urban roads like ring roads of urban by-passes or flyovers, (*f*) Bus and truck terminals, (*g*) Subways, (*h*) Road dividers, (*i*) Bulk Handling terminals which are developed or maintained or operated for development of rail system, (*j*) Multilevel Computerized Car Parking - **Notification No. 188/2006** [F.No. 142/24/2006-TPL], dated July 20, 2006.

chargeable to tax for the assessment year 2010-11 under section 41(4A) even if the business of the taxpayer is not in existence during the previous year 2009-10.

Family planning expenditure [Sec. 36(1)(*ix*)]

135. Any *bona fide* expenditure incurred by a company for the purpose of promoting family planning among its employees is allowable as deduction. If, however, such expenditure is of a capital nature, one-fifth of such expenditure is allowable as deduction for the previous year in which it was incurred and the balance is deductible in equal instalments in the next four years.

The following points should be considered —

1. No deduction is available under section 36(1)(*ix*) in the case of a non-corporate assessee. A non-corporate assessee may claim deduction under sections 32 and 37(1) if the relevant conditions are satisfied.

2. Any capital family planning expenditure which is not allowed as deduction due to inadequacy of profit, shall be set off and carry forward as if it is unabsorbed depreciation [*see* para 109.9].

3. In the cases given below, the provisions of sections 35 and 41 regarding capital expenditure on scientific research shall be applied —

a. when an asset purchased for promotion of family planning amongst employees is sold without putting it to some other use ;

b. when such asset is used for the business of the company after it ceases to be used for family planning purposes.

4. If deduction is claimed and allowed under section 36(1)(*ix*), no deduction is available under any other provision of the Act.

Contribution towards Exchange Risk Administration Fund [Sec. 36(1)(*x*)]

136. The contribution made by the public financial institutions to the Exchange Risk Administration Fund will be allowed as a business deduction in computing their income up to the assessment year 2007-08.

Revenue expenditure incurred by entities established under any Central, State or Provincial Act [Sec. 36(1)(*xii*)]

137. Entities that are created under an Act of Parliament have the basic object and function of carrying on developmental activities in the areas as specified in the said Acts. By the Finance Act, 2001 and Finance Act, 2002, tax exemption of certain bodies set up through Acts of the Parliament was withdrawn. Subsequent to the removal of the tax shield, a doubt has arisen that some of the activities having no profit motive being carried on by such entities cannot be said to be business and, therefore, expenditure incurred on such developmental activities may not be allowed as a deduction while computing the income under the head "Profits and gains of business or profession".

Clause (*xii*) has been inserted in section 36(1) [with effect from the assessment year 2002-03] so as to provide that any expenditure (not being in the nature of capital expenditure) incurred by a corporation or a body corporate (by whatever name called) constituted or established by a Central, State or Provincial Act for the objects and purposes authorised by the Act under which such corporation or body corporation was constituted or established, shall be allowed as a deduction in computing the income under the head "Profits and gains of business or profession".

The above deduction shall be allowed only if such corporation or body corporate is notified by the Central Government*, having regard to the objects and purposes of the corresponding Central, State or Provincial Act.

Contribution to credit guarantee trust fund [Sec. 36(1)(*xiv*)]

137A. From the assessment year 2008-09, a public financial institution can claim deduction in

*Notified institution is National Dairy Development Board.

respect of its contribution to a notified credit guarantee trust fund for small industries (*i.e.*, Credit Guarantee Fund Trust for Micro and Small Enterprises).

Banking cash transaction tax, securities transaction tax and commodities transaction tax

138. These taxes are deductible as follows—

	Deduction under section 36	*Rebate under section 88E*
Banking transaction tax	Deductible	
Securities transaction tax	Deductible under section 36 from the assessment year 2009-10 onwards	For the assessment years 2005-06 to 2008-09, rebate is available under section 88E
Commodities transaction tax	Deductible under section 36 from the assessment year 2009-10 onwards	

Expenditure on advertisement [Sec. 37(2B)]

139. In view of section 37(2B), no allowance is available in respect of expenditure incurred by an assessee on advertisement in any souvenir, brochure, tract, pamphlet or the like, published by a political party. Any other expenditure on advertisement is governed by section 37(1).

Expenses deductible from commission earned by life insurance agents, UTI agents, post office/Government securities agents and agents of notified mutual funds

140. By Circular Nos. 594 (dated February 27, 1991), 648 (dated March 30, 1993) and 677 (dated January 28, 1994), the Board have specified conditions for giving *ad hoc* deductions from commission earned by the insurance agents, UTI agents, post office/Government securities agents and agents of mutual funds. These agents may be broadly divided into the following two groups :

140.1 ***Where commission earned is less than Rs. 60,000*** - The benefit of *ad hoc* deduction is available to agents who do not maintain detailed accounts for expenses incurred by them and have gross aggregate commission (from all sources specified in column *1* of the Table *infra*) of less than Rs. 60,000 during the previous year. In such a case, the amount of *ad hoc* deduction shall be determined as given in columns *2* and *3* below :

Commission	*Ad hoc deduction*	*Maximum deduction*
1. Agents of Life Insurance Corporation of India :		
1.1 First year's commission	50 per cent of first year commission	
1.2 Renewal commission	15 per cent of renewal commission	Rs. 20,000 in respect of 1.1 and 1.2 or 1.3.
1.3 First year commission and renewal commission where separate figures are not available	$33\frac{1}{3}$ per cent of first year commission and renewal commission	
1.4 Bonus commission	No deduction	Zero
2. Agents of Unit Trust of India		
2.1 Commission received by authorised agents	50 per cent of such commission	Not specified
3. Agents of specified securities [*see* Note]		
3.1 Commission received by authorised agents	50 per cent of such commission	Not specified
4. Agents of notified mutual fund under section 10(*23D*)		
4.1 Commission received by authorised agents	50 per cent of such commission	Not specified

Note : For the purpose of 3 *supra*, specified securities are : National Savings Certificates VIII Issue, Social Securities Certificates, Post Office Time Deposit Accounts, Post Office Recurring Deposit Accounts, National Savings Scheme, 1987, Post Office Monthly Income Account Scheme, Kisan Vikas Patra, Public Provident Fund Accounts, and Deposit Scheme for Retiring Government Employees, 1989.

140.2 ***Where commission earned is more than Rs. 60,000*** - The benefit of *ad hoc* deduction is not available to agents who have earned gross aggregate commission (from all sources specified in column *1* of Table *supra*) of more than Rs. 60,000 in the previous year. The admissibility of expenditure claimed by such agents will be decided according to the provisions of sections 30 to 43B.

General deduction [Sec. 37(1)]

141. Section 37(1) is a residuary section. In order to claim deduction under this section, the following conditions should be satisfied :

Condition one	The expenditure should not be of the nature described under sections 30 to 36.
Condition two	It should not be in the nature of capital expenditure.
Condition three	It should not be personal expenditure of the assessee.
Condition four	It should have been incurred in the previous year.
Condition five	It should be in respect of business carried on by the assessee.
Condition six	It should have been expended wholly and exclusively for the purpose of such business.
Condition seven	It should not have been incurred for any purpose which is an offence or is prohibited by any law.

141.1 ***Expenditure should not be covered by sections 30 to 36*** - For claiming deduction of an expenditure under section 37(1), it should be ensured that the expenditure is not in the nature described by sections 30 to 36. The rationale behind this condition is that if an item of expenditure is covered under any of the aforesaid sections, the same cannot be claimed under the residuary section 37(1)—*Noshirwan & Co. (P.) Ltd.* v. *CIT* [1970] 77 ITR 822 (MP). However, the mere fact that specific subject of deduction is expressly covered by sections 30 to 36 does not imply that a deduction in respect of that subject cannot be allowed under the residuary section. For instance, current repairs in respect of premises used for the purpose of the business or profession are deductible under section 30(*a*)(*ii*), but expenditure on repairs which are not current repairs but accumulated repairs or which are in respect of the premises not used but held for the purposes of business, may be allowed as deduction under section 37(1), because such repairs are not of the nature described in section 30(*a*)(*ii*).

141.2 ***Expenditure should not be in the nature of capital expenditure*** - Expenditure incurred by an assessee may be of two types—capital expenditure or revenue expenditure. The distinction between the two is vital because capital expenditure, even if incurred for the purpose of earning income, is not deductible while computing taxable income, unless the law expressly so provides. Revenue expenditure, on the other hand, is deductible while computing taxable income unless the law provides specific rules to disallow such expenditures wholly or partly. As the Act does not define the terms "capital expenditure" and "revenue expenditure", one has to depend upon their natural meaning as well as decided cases.

141.2-1 ***GENERAL PRINCIPLES*** - To decide whether an expenditure is capital or revenue in nature, the following points of distinction should also be kept in mind :

- *Acquisition of fixed assets* v. *Routine expenditure* - Capital expenditure is incurred in acquiring, extending or improving a fixed asset, whereas revenue expenditure is incurred in the normal course of business as a routine business expenditure.

- *Several previous years* v. *One previous year* - Capital expenditure produces benefits for several previous years, whereas revenue expenditure is consumed within a previous year.
- *Improvements* v. *Maintenance* - Capital expenditure makes improvements in earning capacity of a business. Revenue expenditure, on the other hand, maintains the profit-making capacity of a business.
- *Non-recurring* v. *Recurring* - Usually capital expenditure is a non-recurring outlay, whereas revenue expenditure is normally a recurring outlay.
- *Lump sum payment* v. *Periodic payment* - In order to determine whether an expenditure is capital or revenue in nature, the fact that it is a lump sum payment or periodic payment is not important.
- *Expenditure out of capital* v. *Expenditure out of revenue* - For determining whether expenditure is of capital or revenue nature, it is immaterial whether expenditure is made out of money withdrawn from capital or out of profits—***Schenectady Beck India Ltd.*** v. ***CIT*** [2004] 91 ITD 23 (Mum.) (TM)

141.2-2 *JUDICIAL RULINGS* - Though the dividing line between a capital and revenue expenditure is real, yet sometimes it becomes difficult to draw. Therefore, a decision is to be taken in each case in the light of its facts and surrounding circumstances. However, the following judicial pronouncements should be kept in view while determining whether a particular expenditure is capital or revenue in nature :

- *Facilitation of trading operation* - 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. The test of enduring benefit is, therefore, not a certain or conclusive test and it cannot be applied blindly and mechanically without regard to the particular facts and circumstances of a given case—*Empire Jute Co. Ltd.* v. *CIT (supra)*.
- *Removal of a defect in title* - Where money is paid to perfect a title or as consideration for getting rid of a defect in the title or a threat of litigation, the payment would be capital payment and not revenue payment—*V. Jaganmohan Rao* v. *CIT* [1970] 75 ITR 373 (SC).
- *Mining lease* - In the case of mining leases, where mineral is part of the land and has to be won, extracted and brought to the surface, expenditure for acquiring the right over or in the land to win the mineral would be of a capital nature. When, however, mineral has already been gotten and is on the surface, expenditure incurred for obtaining the right to acquire the raw material, *i.e.*, the mineral, would be revenue expenditure laid out for the acquisition of stock-in-trade—*R.B. Seth Moolchand Suganchand* v. *CIT* [1972] 86 ITR 647 (SC).
- *Removal of recurring disadvantage* - A payment made to remove the possibility of a recurring disadvantage cannot be considered as a payment made to acquire an enduring advantage—*CIT* v. *Heath & Co. (Calcutta) (P.) Ltd.* [1978] 114 ITR 605 (Cal.).
- *In the case of stock-in-trade* - One has to bear in mind the demarcation whether the payment is incurred in order to ensure the source of stock-in-trade or to obtain the stock-in-trade itself. If payment is to ensure the source of stock-in-trade, then the expenditure incurred for this purpose would be capital expenditure. If, on the other hand, payment is made to obtain stock-in-trade under a source arrangement, then such payment would be revenue expenditure—*CIT* v. *Rishabh Investment Ltd.* [1979] 117 ITR 962 (Cal.).

141.2-3 *PRINCIPLES ENUMERATING FROM JUDICIAL PRONOUNCEMENTS* - Certain fundamental principles could be deducted from English cases to distinguish capital expenditure from revenue expenditure. The first is that capital expenditure cannot be attributed to revenue and *vice versa*. Secondly, it is equally clear that a payment in a lump sum does not necessarily make the payment a capital one. It may still possess revenue character in the same way as a series of payments. Thirdly, if there is a lump sum payment but there is no possibility of a recurrence, it is probably of a capital nature, though this is by no means a decisive test. Fourthly, if the payment of a lump sum closes the liability

to make repeated and periodic payments in the future, it may generally be regarded as a payment of a revenue character. Lastly, if the ownership of the money whether in point of fact or by a resulting trust is still with the taxpayer, then there is acquisition of a capital asset and not an expenditure of a revenue character—*Indian Molasses Co. (P.) Ltd.* v. *CIT* [1959] 37 ITR 66 (SC), *Hylam Ltd.* v. *CIT* [1973] 87 ITR 310 (AP).

Thakkar, J. in *CIT* v. *Navsari Cotton & Silk Mills Ltd.* [1982] 135 ITR 546 (Guj.) has evolved the following tests (which can be divided into two categories—positive tests and negative tests) for deciding whether a particular expenditure can be termed as revenue or capital expenditure. One (at least one) of the positive tests must nod its head and none (not even one) of the negative tests must do so in order to affirmatively hold that the expenditure is deductible under section 37(1).

The positive tests are : If the expenditure is incurred : (*i*) with a view to bring profits or monetary advantage either today or tomorrow ; (*ii*) to render the assessee immune from impending or reasonably apprehended litigation ; (*iii*) in order to save losses in foreseeable future ; (*iv*) for effecting economy in working which may pay dividends today or tomorrow ; (*v*) for increasing efficiency in working ; (*vi*) for removing inefficiency in the working ; (*vii*) where the expenditure incurred is such as a wise, prudent, pragmatic and ethical man of the world of business would conscientiously incur with an eye on promoting his business prospects, subject to the expenditure being genuine and within reasonable limits ; (*viii*) where it is incurred solely by way of a civil duty owed by the assessee to the society having regard to the nature of his business which brings him profits but results in some detriment to the public at large either by way of health hazard or ecological pollution or serious inconvenience to the citizens with a view to mitigate the aforesaid evil consequences and consequences of a like nature, subject to its being genuine and within reasonable limits.

The negative tests are : If the expenditure is incurred : (*i*) for a mere altruistic consideration; (*ii*) mainly in order to satisfy his philanthropic urges ; (*iii*) mainly in order to win applause or public appreciation ; (*iv*) for illegal, immoral or corrupt purposes or by any such means or for any such reasons ; (*v*) mainly in order to oblige a relative or an official ; (*vi*) mainly to earn the goodwill of a political party or a politician ; (*vii*) mainly to show off or impress others with his affluence or for ostentatious purposes ; (*viii*) apparently for a factor listed as a positive factor, but in reality for one of the obnoxious purposes listed as a negative factor ; (*ix*) on a nebulous plea or pretext by way of an *alibi* in the name of winning profits in remote future but really for one or the other of the purpose listed as negative tests ; (*x*) it is a bogus, fictitious or sham transaction ; (*xi*) it is unreasonable and out of proportion ; (*xii*) it is an expenditure merely with a view to avoid tax liability without any genuine purpose or reason in good faith ; and (*xiii*) the advantage to be secured by incurring the expenditure is of the nature of a remote possible advantage depending on "ifs" and "buts" and, if at all, to be secured at an uncertain future date which may be considered too remote.

As pointed out earlier, one of the positive tests must be attracted and none of the negative tests should be satisfied in order to claim deduction under section 37(1).

141.2-4 FEW INSTANCES OF CAPITAL EXPENDITURE - The following are few instances of capital expenditure :

- *Incoming partner* - The purchase price paid by an incoming partner for a share of profit in the firm, even if partnership is formed only for a single venture of a short duration—*R. Guruswamy Naidu* v. *CIT* [1952] 21 ITR 188 (Mad.).
- *Elimination of competition* - Annual payments made by the lessee of limestone quarries to the Government who were the lessor in consideration of the latter's entering into certain covenants which ensured to the lessee elimination of competition during the period of the lease—*Assam Bengal Cement Co. Ltd.* v. *CIT* [1955] 27 ITR 34 (SC).
- *Completing imperfect title* - Expenses incurred in completing imperfect title to an asset—*V. Jaganmohan Rao* v. *CIT* [1970] 75 ITR 373 (SC).
- *Maintenance of reputation* - Expenditure incurred on the maintenance of reputation of the assessee's business—*CIT* v. *Homi M. Mehta* [1943] 11 ITR 142 (Bom.).
- *Procurement of licence* - Expenses in connection with procuring a licence whose duration is eight years—*IR* v. *Adam* 1928 SC 738.

■ *Payment for obtaining rights* - Payments in addition to the stipulated royalty only with a view to obtaining the renewal or extension of lease agreement (it was *held* that the amounts so paid were capital expenditure, since there was no legal obligation to pay those amounts under the terms of the original agreements and the said amount could not form part of the price of the assessee's stock-in-trade)—*H. Dear & Co. (P.) Ltd.* v. *CIT* [1966] 60 ITR 546 (SC). Similarly, payment of percentage of profits for acquiring rights under sole selling agency—*CIT* v. *Jalan Trading Co. (P.) Ltd.* [1985] 155 ITR 536 (SC). Payment made for obtaining monopoly rights—*Mewar Sugar Mills Ltd.* v. *CIT* [1973] 87 ITR 400 (SC).

■ *Compensation for breach of a contract* - Compensation payable for breach of contract to purchase capital assets—*Swadeshi Cotton Mills Co. Ltd.* v. *CIT* [1967] 63 ITR 65 (SC).

■ *Shifting of a plant* - Cost of shifting a plant to another place—*Sitalpur Sugar Works Ltd.* v. *CIT* [1963] 49 ITR 160 (SC).

■ *Unsuccessful attempt to bore tubewell* - Expenditure incurred to bore a tube-well in a factory premises to supplement water supply which was inadequate for the assessee's business and the attempt to bore tube-well proved unsuccessful—*CIT* v. *Bazpur Co-operative Sugar Factory Ltd.* [1983] 142 ITR 1 (All.).

■ *Fees to obtain licence* - Fees paid to obtain licence to investigate, search and find out minerals for initiating mining operations—*R.B. Seth Moolchand Suganchand* v. *CIT* [1972] 86 ITR 647 (SC).

■ *Sum paid by instalment to get a right to excavate lime shells* - Sum paid for obtaining the exclusive right to excavate lime shells, irrespective of the fact that payments are made in a number of instalments—*Chengalvaroya Chettiar* v. *CIT* [1937] 5 ITR 70 (Mad.), *CIT* v. *Chengalvaroya Mudaliar* [1934] 2 ITR 395 (Mad.).

■ *Lease* - Sum spent by the assessee-manufacturer of bricks in taking leases of land for excavating earth for manufacturing of bricks—*Sardar Bahadur Sardar Singar Singh & Sons* v. *CIT* [1944] 12 ITR 504 (Oudh)/ *Ganeshi Lal Bhattawala, In re.* [1938] 6 ITR 489 (All.), *United Commercial Corpn.* v. *CIT* [1970] 78 ITR 800 (All.). Quarry lease rent paid by assessee for acquiring right to excavate granite on lease for ten years is capital expenditure—***Enterprising Enterprises*** v. ***CIT*** [2004] 268 ITR 95 (Mad.).

■ *Construction of pucca road* - Expenses of converting a kuccha approach road to the assessee's factory into a pucca road—*Modella Woollens Ltd.* v. *CIT* [1979] 120 ITR 726 (Bom.).

■ *Construction of dam* - Expenditure on construction of a dam to prevent disaster and to ensure safety of workers in coal-mining business—*CIT* v. *North Dhemo Coal Co. Ltd.* [1977] 106 ITR 592 (Cal.).

■ *Expenditure on raising new shares* - Expenditure incurred by a company in raising new shares—*Shree Digvijay Cement Co. Ltd.* v. *CIT* [1982] 138 ITR 45 (Guj.). However, expenditure on issue of bonus shares is revenue expenditure—***CIT*** v. ***General Insurance Corpn.*** [2006] 156 Taxman 96 (SC).

■ *Registration fee* - Registration fee paid for increase in authorised share capital—*Bharat Carbon & Ribbon Mfg. Co. Ltd.* v. *CIT* [1981] 127 ITR 239 (Delhi) [approved in *Punjab State Industrial Development Corporation Ltd.* v. *CIT* [1997] 93 Taxman 5 (SC)].

■ *Expenditure on issue of redeemable preference shares* - The expenditure incurred for payment of legal charges to solicitors for the issue of a prospectus for offering redeemable preference shares to the public and payment of underwriting commission and brokerage for the issue of the same—*Hindustan Gas & Industries Ltd.* v. *CIT* [1979] 117 ITR 549 (Cal.), *CIT* v. *Kisenchand Chellaram (India) (P.) Ltd.* [1981] 130 ITR 385 (Mad.), *Bombay Burmah Trading Corpn. Ltd.* v. *CIT* [1983] 12 Taxman 178 (Bom.).

■ *Abandoned project* - Expenditure incurred in connection with starting new project which has to be abandoned— *Kanoria Chemicals & Industries Ltd.* v. *CIT* [1995] 78 Taxman 455 (Cal.).

■ *Betterment charges* - Interest on instalment of betterment charges paid to municipal corporation— *CIT* v. *Ahmedabad Mfg. & Calico Printing Co. Ltd.* [1995] 215 ITR 735 (Guj.).

■ *Legal expenses incurred against refusal to register shares* - Legal expenditure incurred by the assessee towards fees for conducting an appeal before the Company Law Board in connection with the refusal of a company to register the shares, acquired by the assessee, in its name—*Jaya Hind Industries (P.) Ltd.* v. *CIT* [1985] Tax. 79(3)-246 (Bom.).

■ *Acquisition of goodwill* - Expenditure on acquiring goodwill whether it is paid in lump sum at one time or in instalments distributed over a definite period—*Mehra Khanna & Co.* v. *CIT* [2001] 115 Taxman 117 (Delhi).

■ *Proportionate expenditure on convertible part of debenture* - Where a company has issued partly convertible debentures and conversion was mandatory, the proportionate expenditure on convertible part of debenture is for the augmentation of equity base of the company - *Banco Products (India) Ltd.* v. *CIT* [1997] 63 ITD 370 (Ahd.).

■ *Commission for acquiring office* - Commission paid to party for acquiring new office premises on rent—*Bharat Steel Tubes Ltd.* v. *CIT* [2001] 119 Taxman 6/252 ITR 622 (Delhi).

■ *Compensation for warding off competition* - Where essence of an agreement is taking over of business of another company and warding off competition in that business, consideration paid for such takeover falls in category of capital expenditure—***Vinod Kothari Consultants Ltd.*** v. ***CIT*** [2004] 91 ITD 153 (Kol.) (TM). Payment made to ward off business competition for a long period of 10 years, is capital expenditure—***Montgomery Watson Consultants India (P.) Ltd.*** v. ***CIT*** [2004] 90 ITD 324 (Mum.).

■ Expenses incurred before commencement of businesses cannot be considered as revenue expenditure under section 37(1)—***CIT*** v. ***Mohan Steel Ltd.*** [2004] 191 CTR (All.) 279.

■ *Acquisition of leasehold right* - Leasehold right in a property is a capital asset and payment made for acquisition of such right (with renewal clause) would amount to capital expenditure—***CIT*** v. ***Tata Honeywell Ltd.*** [2005] 93 ITD 507 (Pune).

141.2-5 *FEW INSTANCES OF REVENUE EXPENDITURE* - The following are few instances of revenue expenditure :

■ *Compensation on account of negligence* - Compensation paid on account of negligence in carrying on business—*IR* v. *Alexander Von Glehn & Co. Ltd.* [1920] 2 KB 553.

■ *Construction of school building* - Amount spent on the construction of a school building for the benefit of the assessee's employees (is allowable as revenue expenditure, being a labour welfare measure, even though the building was handed over to the municipality for running the school)—*Palani Andavar Mills Ltd.* v. *CIT* [1977] 110 ITR 742 (Mad.).

■ *Quota rights* - Amount paid to a third party in order to use his quota rights—*M.S. Kandappa Mudaliar* v. *CIT* [1957] 32 ITR 313 (Mad.).

■ *Control and management of entire business* - Annual sum paid to take over the control and management of entire business with all powers of the original owner—*CIT* v. *P.N. Ethiraj* [1962] 46 ITR 484 (Mad.).

■ *Repair of road* - Contribution paid to the Government in order to repair the road up to the taxpayer's factory even if the road does not belong to him—*CIT* v. *Hindustan Motors Ltd.* [1968] 68 ITR 301 (Cal.).

■ *Loss of 'office'* - Compensation paid to directors on account of loss of office due to transfer of seat of management from one country to another—*Indian Copper Corpn. Ltd.* v. *CIT* [1960] 38 ITR 544 (Pat.).

■ *Payment to competitor* - Sums paid to competitor in order not to bid at auction sale to enable to secure stock-in-trade at an advantageous price—*V. Damodaran* v. *CIT* [1967] 64 ITR 26 (Ker.).

■ *Winding up petition* - Legal expenses in connection with resolving a winding up petition by shareholders—*CIT* v. *Jagatjit Distilling & Allied Industries Ltd.* [1961] 41 ITR 328 (Punj.).

■ *Use* v. *Acquisition of goodwill* - Annual sum paid for use of goodwill—*Vithaldas Thakordas & Co.* v. *CIT* [1946] 14 ITR 822 (Bom.). But sum paid for acquisition of goodwill is a capital expenditure.

■ *Premium to insurance company* - Premium paid to an insurance company in order to meet claims under the Workmen's Compensation Act—*Thomas Merthyr Colliery Co.* v. *Davis* [1933] 1 ITR 12 (CA).

■ *Statutory obligation* - Contribution made by sugar mill under a statutory obligation towards construction of Government owned roads, which would facilitate supply of sugarcane to factories—*Lakshmiji Sugar Mills Co. (P.) Ltd.* v. *CIT* [1971] 82 ITR 376 (SC).

■ *Royalty* - Royalty payment for obtaining stock-in-trade—*H. Dear & Co. (P.) Ltd.* v. *CIT* [1966] 60 ITR 546 (SC). Payment of royalty correlated with production—*Mewar Sugar Mills Ltd.* v. *CIT* [1973] 87 ITR 400 (SC).

■ *Bidi manufacturers* - Sum paid by a bidi manufacturer for obtaining lease of forest for plucking bidi leaves—*Mohanlal Hargovind* v. *CIT* [1949] 17 ITR 473 (PC)/*Shankerlal Dayaram* v. *CIT* [1956] 30 ITR 272 (Nag.).

■ *Brokerage for obtaining premises on lease* - Brokerage or commission paid for obtaining certain premises on lease for the purpose of locating factory and for the residence of sales manager—*CIT* v. *Burroughs Wellcome & Co. (India) (P.) Ltd.* [1982] 133 ITR 37 (Bom.).

■ *Technical fees* - Technical aid fees paid by the assessee to foreign company for use of its scientific data and information under an agreement which did not provide for the sale or transfer of any right or asset—*CIT* v. *Wheels India Ltd.* [1983] 141 ITR 748 (Mad.).

■ *Renovation of office* - Expenses incurred by the assessee-company on renovation of office premises by panelling the walls with plywood and installing book case and safe—*CIT* v. *J.K. Industries (P.) Ltd.* [1980] 125 ITR 218 (Cal.).

■ *Fluorescent lights* - Expenditure on replacement of ordinary lighting by fluorescent tube lighting in factory premises—*Addl. CIT* v. *India United Mills Ltd.* [1983] 141 ITR 399 (Bom.).

■ *Expenditure on issue of debentures* - Expenditure incurred on stamp duty, registration fee, lawyer's fee, etc., in respect of the issue of debentures by an existing company—*Premier Automobiles Ltd.* v. *CIT* [1971] 80 ITR 415 (Bom.).

■ *Benefits for a few years* - Fact that expenditure brings some benefit to assessee for a few years, alone is not sufficient to treat expenditure as an expenditure of a capital nature—***CIT*** v. ***Modi Olivetti Ltd.*** [2004] 3 SOT 22 (Delhi).

■ *Renovation in hotels* - Carpets in the hotel business require frequent replacement. They are not capital assets. Expenditure incurred for replacement of carpets is, thus, revenue expenditure. Linen includes napkins, towels, etc., in the hotel business. Such linen articles need to be replaced very frequently. It is incorrect to contend that linen used in a hotel is nothing but furnishings used for decoration and, hence, such linen partakes of characteristics of furniture—***CIT*** v. ***Piem Hotels Ltd.*** [2005] 1 SOT 383 (Mum.)

■ *Construction of railway side* - Expenditure incurred by assessee-company on construction of railway siding, which belonged to the Government, for easy movement of raw materials and finished goods is allowable as revenue expenditure—***CIT*** v. ***Tata Sponge Iron Ltd.*** [2004] 90 ITD 138 (Ctk.).

■ *Stock exchange membership fee* - Payment made to stock exchange by way of membership fee cannot be termed as a capital expenditure—***Paresh B. Gandhi*** v. ***CIT*** [2005] 142 Taxman 33 (Mum.) (Mag.).

■ *Medicines for chicks* - Expenditure incurred by assessee, engaged in business of poultry farm, in providing feed and medicines for chicks till they attained their egg-laying stage, would be revenue expenditure—***Vasu Farms (P.) Ltd.*** v. ***CIT*** [2005] 95 ITD 125 (Chennai).

■ *Marketing research* - Marketing research expenses and advertisement expenses for promoting corporate image are allowable as revenue expenditure—***Gujarat Ambuja Cements Ltd.*** v. ***CIT*** [2005] 4 SOT 59 (Mum.).

■ *Replacement of carpets in hotel* - Expenditure on replacement of carpets and linen in hotel business is allowable as revenue expenditure—***CIT*** v. ***Piem Hotels Ltd.*** [2005] 1 SOT 382 (Mum.).

■ *Expenditure on issue of bonus shares* - Such expenditure is revenue expenditure—***CIT*** v. ***General Insurance Corpn.*** [2006] 156 Taxman 96 (SC).

■ *Lump sum amount to film star* - Where assessee-company doing entertainment business, paid certain lump sum amount to two film stars by virtue of agreements for obtaining their services for 120 days for each year, for next ten years, payment made to artists is not of capital nature because it is for user of talents and not for acquisition of capital as such; such payment is allowable as revenue expenditure—***Amitabh Bachchan Corpn. Ltd.*** v. ***CIT*** [2006] 9 SOT 208 (Mum.).

■ *On-going business* - Expenditure incurred by an assessee in respect of on-going business would be a revenue expenditure. For instance, where marketability of new model is entirely dependent on sale promotion and holding of training/seminar so that new model is well received in market, expenditure incurred on sale promotion and holding of training/seminar cannot be treated as capital expenditure—***Honda Siel Cars India Ltd.*** v. ***CIT*** [2006] 157 Taxman 76 ITAT Delhi Bench.

■ *Facilitating trading operations* - If advantage consists of merely facilitating trading operations of assessee or enables management to conduct business more profitably or efficiently, expenditure would be on revenue account, even though advantage may ensure for indefinite period—***Honda Siel Power Products Ltd.*** v. ***CIT*** [2006] 157 Taxman 76.

■ *Dies and moulds* - Where vendors are given monies to develop moulds and dies required for manufacture of generator parts for being supplied to assessee, and said moulds and dies are to remain property of vendors and not of assessee and also amounts paid to vendors are non-refundable, it can be said that advantage derived by assessee is in revenue field and it helped assessee to run its business more efficiently and profitably and, therefore, amount paid by assessee shall be allowed as revenue expenditure—***Honda Siel Power Products Ltd.*** v. ***CIT*** [2006] 157 Taxman 76 ITAT Delhi Bench 'G'.

■ *Replacement of machinery* - Amount spent on replacement of machinery is revenue expenditure. Expenditure incurred on upgradation of computers by changing certain parts thereby enhancing configuration of computers for improving their efficiency without making any structural alterations is not of an enduring nature and, therefore, has to be treated as revenue expenditure—***CIT*** v. ***Southern Roadways Ltd.*** [2007] 158 Taxman 1(Mad.)

■ *Replacement of machinery* - Expenditure on replacement of machinery is allowable as revenue expenditure—***CIT*** v. ***Sri Raju Cotton Mills*** [2006] 283 ITR 351 (Mad.)

■ *Remodelling* - Expenditure on remodelling of generator is revenue expenditure—***CIT*** v. ***Salem Co-operative Spinning Mills Ltd.*** [2006] 284 ITR 621 (Mad.)

■ *Non-competition covenant fees* - Since assessee had made payment of non-competition fees on account of business necessity and commercial expediencies in order to settle down itself in a new acquired business of shipping and benefit derived out of it is only to enhance its profitability, and is for a limited period of 5 years; and that too only in Indian territory, in such circumstances, payment of non-competition fees is allowable as a revenue expenditure. Since assessee had acquired a benefit over a period of 5 years, said expenditure should be spread over for a period of 5 years and corresponding expenditure was to be allowed in every year—***Adsteam Agency (India) Ltd.*** v. ***CIT*** [2007] 16 SOT 414 (Mum.).

■ *Setting of a new business for the benefit of an existing business* - Manufacture of raw material for benefit of its existing business cannot amount to setting up a new business, and, therefore, expenditure incurred by assessee in setting up manufacturing unit for raw material is allowable as revenue expenditure—***CIT*** v. ***Usha Iron & Ferro Metal Corpn. Ltd.*** [2007] 163 Taxman 256 (Delhi).

The Delhi High Court in ***CIT*** v. ***Relaxo Footwears Ltd.*** [2007] 293 ITR 231/162 Taxman 238, also held that the expenses incurred by the assessee for the setting up of the new unit which was a part of the existing business were to be allowed as a revenue expenditure.

■ *Accounting treatment - Not relevant* - An expenditure which is otherwise revenue in nature, cannot be treated as capital expenditure merely because assessee has treated it in its books as capital expenditure on an incorrect understanding of legal position—***Indo Arab Granites Ltd.*** v. ***CIT*** [2007] 105 ITD 336 (Hyd.) (SMC).

■ *Construction of strong room* - Expenditure incurred by a banker on construction of a strong room is revenue expenditure—***Muthoot Bankers*** v. ***CIT*** [2007] 11 SOT 603 (Cochin).

■ *ISO certification expenditure* - ISO Certification expenditure is allowable as revenue expenditure—***CIT*** v. ***Tirupati Microtech (P.) Ltd.*** [2007] 111 TTJ (Jodh.) 149.

141.3 ***Expenditure should not be personal expenditure of the assessee*** - Section 37(1) expressly prohibits the deduction of personal expenses. Personal expenses mean expenses satisfying personal needs such as food, cloth, shelter, etc., which are not related to the business.

In the case of a company, there can be no question of disallowance of expenditure on vehicles on the ground of personal use even if they are personally used by directors—*Dinesh Mills Ltd.* v. *CIT* [2002] 122 Taxman 384/254 ITR 673 (Guj.).

141.4 ***Expenditure should have been incurred in the previous year*** - In order to claim deduction, the amount should have been laid out or expended in the previous year. The words "laid out or expended" clearly point out the idea of what is paid out or away and is something which is gone irretrievable. However, in the case of mercantile system of accounting, the word "expended" is capable of being interpreted as "expenditure" or "to be expended"—*Calcutta Co. Ltd.* v. *CIT* [1959] 37 ITR 1 (SC). The law is settled : if a business liability has definitely arisen in the accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date. What should be certain is the incurring of the liability. It should also be capable of being estimated with reasonable certainty though the actual quantification may not be possible. If these requirements are satisfied, the liability is not a contingent one. The liability is *in praesenti* though it will be discharged at a future date. It does not make any difference if the future date on which the liability shall have to be discharged is not certain—*Bharat Earth Movers* v. *CIT*[2000] 112 Taxman 61 (SC).

141.5 ***Expenditure should have been laid out wholly and exclusively for the purpose of business or profession*** - The main requirement of the provision of section 37(1) is that expenditure should have been laid out wholly and exclusively for the purpose of the business. The nexus between the expenditure and the business, in connection with which expenditure has been incurred, has to be established before the assessee gets entitled to deduction under section 37(1).

■ *Commercial expediency* - If a payment or expenditure is incurred for the purpose of the trade of the assessee, it is deductible even if it may bring a benefit to a third party—*CIT* v. *Chandulal Keshavlal & Co.* [1960] 38 ITR 601 (SC). Further, in applying the test of commercial expediency for determining whether an expenditure is wholly and exclusively laid out for the purpose of the business, reasonableness of the expenditure has to be adjudged from the point of view of

businessman and not of the revenue. For instance, an employer in fixing the remuneration of his employees is entitled to consider the extent of his business, the nature of duties to be performed, and the special aptitude of the employee, future prospect of extension of the business and a host of other related circumstances. The rule that increased remuneration can only be justified if there be corresponding increase in the profits of the employer is erroneous—*CIT* v. *Walchand & Co. (P.) Ltd.* [1967] 65 ITR 381 (SC), *see* also *Travancore Titanium Products Ltd.* v. *CIT* [1966] 60 ITR 227 (SC).

▪ *Penalty for infraction of law* - Where a penalty is incurred for the contravention of any specific statutory provision, it cannot be said to be a commercial loss falling on the assessee as a trader. The Finance (No. 2) Act, 1998 has inserted an *Explanation* in section 37(1) to this effect to provide that any expenditure incurred by an assessee which is an offence or which is prohibited by any law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.

The Punjab & Haryana High Court in ***CIT*** v. ***Hoshiari Lal Kewal Krishan*** [2007] 160 Taxman 96 held that a penalty or fine paid under any law would not always be in the nature of punishment for breach of law. It may be of the nature of compensatory liability irrespective of the nomenclature used. In the instant case, the Court allowed deduction of payment of fine paid to Excise Department for belated payment of excise duty instalment.

Likewise, amount paid as penalty on account of late delivery, short delivery, short margin, etc., to National Stock Exchange Ltd. is allowed as revenue expenditure as these expenses are not for infraction of law—***Arch Finance Ltd.*** v. ***CIT*** [2007] 165 Taxman 188 (Delhi) (Mag.).

▪ *Supreme Courts ruling in T.A. Quereshi's case* - Subsequent to the recovery and seizure of huge quantity of heroin drugs from the assessee-doctor's possession, he filed his return claiming that since the heroin seized from him formed part of his stock-in-trade, its loss on account of seizure was an allowable deduction while computing his profits and gains of business/profession. The Assessing Officer, however, disallowed the assessee's said claim. The Apex Court held that the heroin seized was the assessee's stock-in-trade, and the assessee was doing the business of manufacture and sale of heroin. Once the income-tax authorities recorded such a finding of fact, it followed that any loss from such a business was a business loss. The *Explanation* to section 37 had really nothing to do with the instant case as it was not a case of a business expenditure, but of business loss. Business losses are allowable on ordinary commercial principles in computing profits—***Dr. T.A. Quereshi*** v. ***CIT*** [2006] 157 Taxman 514 (SC).

▪ *Compelling necessity* - The assessee can claim deduction under section 37(1), even though there is no compelling necessity to incur such expenditure—*Sassoon J. David & Co. (P.) Ltd.* v. *CIT* [1979] 118 ITR 261 (SC).

The phraseology—laid out or expended wholly and exclusively for the purposes of business or profession—embraces within it 'wholly' which refers to the quantum of expenditure and the word 'exclusively' refers to the motive, objective and purposes of the expenditure. The expression 'wholly and exclusively' does not mean 'necessarily'. If an amount is incurred for promoting the business and to earn profits, the assessee can claim deduction therefor even though there is no compelling necessity to incur such expenditure—***Jamna Auto Industries*** v. ***CIT*** [2008] 167 Taxman 194 (Punj. & Har.) (FB).

▪ *Compounding of an offence* - The assessee was a builder, and he built the 8th floor in an apartment without there being any sanctioned plan, in contravention of the provisions of the Municipal Corporation Act. This Act provided for composition of offences, and the assessee paid the compounding fee. The High Court held that compounding of the offence cannot take away the rigour of the aforesaid *Explanation* to section 37(1) in view of the expression 'shall not be deemed to have been incurred' used in that *Explanation*, and that the assessee's claim was to be rejected—***CIT*** v. ***Mamta Enterprises*** [2004] 135 Taxman 393 (Kar.).

▪ *Memorandum of Association* - Memorandum of company is not conclusive of the nature of expenditure incurred by a company—*A.V. Thomas & Co. Ltd.* v. *CIT* [1963] 48 ITR 67 (SC).

141.5-1 *INTEREST ON DELAYED PAYMENTS TO MICRO SMALL AND MEDIUM ENTERPRISES NOT DEDUCTIBLE* - The Micro, Small and Medium Enterprises Development Act, 2006 (MSMEDA, 2006) which provides for facilitating the promotion and development and enhancing the competitiveness of micro, small and medium enterprises has come into force from October 2, 2006. The provisions of sections 22 and 23 of the said Act have a bearing on the assessment of 'buyers'. Here, the term 'buyer' means a person who buys any goods or receives any services from a 'supplier' for a consideration.

Section 23 of MSMEDA, 2006 lays down that the amount of interest payable or paid by any buyer under or in accordance with the provisions of this Act shall not be allowed as deduction in the computation of income. Section 22 of the MSMEDA, 2006, *inter alia*, requires disclosure of the principal and interest due thereon separately in the annual statement of accounts. This enables the Assessing Officers to ascertain correct amount of disallowance on account of interest payable or paid by the buyer—**Instruction No. 12/2006,** dated December 14, 2006.

141.6 ***Expenses should be in respect of the business carried on by the assessee*** - For the purpose of claiming deduction under section 37(1), expenditure should be incurred for the purpose of the business which is carried on by the assessee in the previous year and profits of which are to be computed and assessed and expenditure should be incurred after the business is set-up. For detailed discussion, *see* para 105.

141.7 ***Onus of proof*** - The onus of proving necessary facts in order to avail the deduction under section 37(1) is on the assessee. If, therefore, the assessee fails to establish the facts necessary to support his claim for deduction under section 37(1), the claim for deduction of expenditure is not admissible—*CIT* v. *Calcutta Agency Ltd.* [1951] 19 ITR 191 (SC).

141.8 ***Instances of expenses deductible (or not deductible) under section 37(1)*** - A complete list of instances where expenses have been held to be allowable under section 37(1) cannot be drawn. However, to have better understanding of section 37(1), a few instances are given below where expenditure is allowable (not allowable) under section 37(1) :

141.8-1 *ACQUISITION OF BUSINESS ASSETS* - It covers expenses on acquisition of business, business assets or capital assets.

■ *General rule* - Expenditure on the purchase of income-bearing asset is a capital expenditure not deductible from the income from that asset—*Commissioners of Inland Revenue* v. *Pilcher* [1949] 31 Tax Cas. 314. Expenditure incurred for perfecting title to an asset is capital expenditure—*V. Jaganmohan Rao* v. *CIT* [1970] 75 ITR 373 (SC).

■ *Examples of deductible expenses* - The following are held as deductible —

1. Stamp duty, registration and drafting charges incurred in connection with transfer of a part of business are deductible—*CIT* v. *Bharat Nidhi Ltd.* [1966] 60 ITR 520 (Punj.).

2. Brokerage paid for obtaining lease of premises for business purpose is a revenue expenditure—*CIT* v. *Burroughs Wellcome & Co. (India) (P.) Ltd.* [1982] 133 ITR 37 (Bom.). Expenditure incurred on payment of stamp charges, registration fees and legal expenses in connection with the lease are to be allowed as revenue expenditure—*CIT* v. *Hoechst Pharmaceuticals Ltd.* [1978] 113 ITR 877 (Bom.), *CIT* v. *Katihar Jute Mills (P.) Ltd.* [1979] 116 ITR 781 (Cal.), *Sri Krishna Tiles & Potteries (Madras) (P.) Ltd.* v. *CIT* [1988] 173 ITR 311 (Mad.), *Richardson Hindustan Ltd.* v. *CIT* [1988] 169 ITR 516 (Bom.).

3. Expenses, *viz.*, interest on borrowings, etc., incurred by a grower and manufacturer of tea in connection with purchase of a tea estate, which did not materialise, are deductible—*CIT* v. *Abhoyjan Tea Estate (P.) Ltd.* [1977] 110 ITR 251 (Gauhati).

4. Expenses on setting up of a new business are capital expenditure ; but where the setting up does not amount to starting of a new business but expansion or extension of the business already being carried on by the assessee, expenses in connection with such expansion or extension of the business must be deductible as revenue expenses—*Kesoram Industries & Cotton Mills Ltd.* v. *CIT* [1992] 196 ITR 845 (Cal.).

5. Expenditure incurred on foundation laying ceremony of an additional factory to augment production is allowable—*CIT* v. *Merck Sharp & Dohme of India Ltd.* [1983] 140 ITR 332 (Bom.).

6. Expenditure on installation of hired data processing machine or computer is deductible even if it is quite substantial—*CIT* v. *Nizam Sugar Factory Ltd. (No. 2)* [1979] 116 ITR 706 (AP), *CIT* v. *Alembic Chemical Works Ltd.* [1995] 123 CTR (Guj.) 351.

7. Payment made by the assessee to vendor of a running business taken over by the assessee, for use of trade name, pending import licences, contracts and other trading benefits and advantages, is a revenue expenditure since the rights acquired only facilitate the day-to-day trading operations of the assessee—*R.G.S. Industries* v. *CIT* [1990] 51 Taxman 467/183 ITR 31 (Gauhati).

8. Where the assessee pays certain sum to the Electricity Board for laying service lines which augment its productivity and such service lines do not vest in the assessee, such expenditure is a revenue expenditure—*CIT* v. *Panbari Tea Co. Ltd.* [1985] 151 ITR 726 (Punj. & Har.).

9. Expenditure on renewal of rail tracks is allowable as revenue expenditure—*Rhodesia Railways Ltd.* v. *Income-tax Collector* [1933] 1 ITR 227 (PC).

10. Payment made by the assessee to the Government for legalising certain unauthorised constructions in its business premises, which is used for business purposes, is allowable under section 37 as the assessee gained an extra advantage for his business—*Jaswant Trading Co.* v. *CIT* [1995] 212 ITR 293 (Raj.).

11. Where an assessee makes concessions in the interest of his business, instead of taking a stand strictly on his legal obligations, loss will be the expenditure laid out wholly and exclusively for the purpose of business—*CIT* v. *Nainital Bank Ltd.* [1966] 62 ITR 628 (SC).

12. Expenditure incurred for laying a new pipeline for supply of water to factory premises which did not belong to the assessee is allowable as revenue expenditure—*CIT* v. *Chowgule Chemicals (P.) Ltd.* [1995] 80 Taxman 417 (Bom.).

13. Expenditure on furniture and electrical fittings in old retail depots is allowable—*Delhi Cloth & General Mills Co. Ltd.* v. *Addl. CIT* [1986] 160 ITR 857 (Delhi).

14. Development expenditure incurred for perfecting designs is allowable—*CIT* v. *Praga Tools Ltd.* [1986] 157 ITR 282 (AP).

15. Expenditure incurred for the purchase of pumps, electric cables, C.D. sheets, etc., by the assessee, a construction contractor, is revenue expenditure—*CIT* v. *Prakash Ch. (P.) Ltd.* 1989 Tax LR 349 (Cal.).

16. Expenditure incurred by the assessee on shifting of employees to another place consequent on shifting of factory to another site due to labour unrest was allowable as revenue expenditure—*CIT* v. *Bimetal Bearings Ltd.* [1994] 210 ITR 945 (Mad.).

17. Merely because an expenditure is referable to immovable property, it cannot be said in all cases that it is capital expenditure—*Gujarat Machinery Mfg. Ltd.* v. *CIT* [1995] 211 ITR 1010/81 Taxman 413 (Guj.).

18. Inauguration expenses have got to be considered to be part of the normal business expenses of the assessee and are to be allowed—*Srinivasa Ultrasound Scanning Centre* v. *Asstt. CIT* [1998] 61 TTJ (Bang.) 619/101 Taxman 67 (Mag.).

■ *Examples of non-deductible expenses* - The following are not held as deductible —

1. Where the assessee is engaged in raising coal, the expenditure incurred on tram line and pumping set has to be treated as capital expenditure—*R.J. Trivedi (HUF)* v. *CIT* [1987] 166 ITR 856 (MP).

2. Expenses on shifting of the registered office are capital in nature—*CIT* v. *Jamshedpur Engg. & Machine Mfg. Co. Ltd.* [1986] 157 ITR 730 (Pat.).

3. Development charges paid by the assessee to the Government in respect of plot of land purchased by it in industrial area are of capital nature—*Jaswant Trading Co.* v. *CIT* [1995] 212 ITR 293 (Raj.).

4. Contribution made by the assessee towards water pollution treatment plant scheme of the Government is not allowable as revenue expenditure—*Jaswant Trading Co.* v. *CIT* [1995] 212 ITR 293 (Raj.).

5. Expenses incurred on purchase of asset for advertisement of business is a capital expenditure—*CIT* v. *Patel International Film Ltd.* [1976] 102 ITR 219 (Bom.).

6. Expenditure incurred by the assessee-company on construction of airstrip on a leasehold land is a capital expenditure—*Indian Explosives Ltd.* v. *CIT* [1984] 147 ITR 392 (Cal.).

7. Where the assessee for the first time took over a running business by executing a lease deed, whereunder it secured leasehold rights for an initial period of ten years, expenditure incurred in this connection by way of stamp duty, registration charges and legal fees will be an expenditure of a capital nature—*Hotel Rajmahal* v. *CIT* [1985] 152 ITR 218 (Kar.).

8. Expenditure on improvement to property, which a lessee is obliged to make, is capital expenditure—*M. Subbiah Nadar* v. *CIT* [1953] 23 ITR 58 (Mad.).

9. Premium paid for securing lease of land for thirty years is capital expenditure even though paid in annual instalments—*CIT* v. *Project Automobiles* [1987] 167 ITR 781 (MP).

10. Where the trader adds to the existing business another new line of business, the pre-operative expenditure for such expansion has to be treated as capital expenditure—*Ashoke Marketing Ltd.* v. *CIT* [1994] 73 Taxman 126/208 ITR 941 (Cal.).

141.8-2 ***EXPENDITURE TO SAVE BUSINESS REPUTATION*** - It covers expenses incurred by a taxpayer to save business reputation.

▪ *General rule* - Expenditure incurred to save business reputation is admissible as a deduction—*CIT* v. *Delhi Safe Deposit Co. Ltd.* [1982] 133 ITR 756 (SC). A payment made to procure the disposal of an onerous or disadvantageous asset is attributable to capital whereas a payment made to remove an obstacle to profitable trading is attributable to revenue—*Lawson (Inspector of Taxes)* v. *Johnson Matthey PIC.* [1994] 209 ITR 761 (HL).

▪ *Examples of deductible/non-deductible expenses* - The following are held as deductible —

1. Expenditure incurred for the purpose of preserving the capital asset of a business can properly be regarded as a revenue expense only when there is a business going on and when the capital asset is supporting an actual business—*Associated Mining Industries Ltd.* v. *CIT* [1955] 27 ITR 429 (Cal.).

2. If in compromising a *bona fide* dispute and as part of an arrangement for enabling the assessee to continue business, an amount is paid, it is allowable as deduction—*CIT* v. *Hindustan Copper Ltd.* [1991] 55 Taxman 392 (Cal.).

3. Payment made to protect title to business is deductible—*Ghansham Singh* v. *CIT* [1983] 141 ITR 601 (Mad.).

4. Expenses incurred in establishing title to deposit in bank are not allowable—*Rani Bhawani Devi* v. *CIT* [1962] 46 ITR 973 (All.).

5. Where the assessee has an existing right to carry on a business, any expenditure incurred by it during the course of business for the purpose of removal of any restriction or obstruction or disability is on revenue account, provided the expenditure does not result in acquisition of any capital asset—*Bikaner Gypsums Ltd.* v. *CIT* [1990] 53 Taxman 279/[1991] 187 ITR 39 (SC).

6. Expenditure to prevent extinction of business is deductible—*CIT* v. *Royal Calcutta Turf Club* [1961] 41 ITR 414 (SC).

141.8-3 ***EXPENSES/CONTRIBUTION FOR CONSTRUCTION OF ROAD*** - It covers expenses for construction of roads in factory/office as well as contribution to others for road construction.

▪ *General rule* - Expenditure on road construction is a capital expenditure which is eligible for depreciation. Contribution to outsiders for road construction is deductible if it is advantageous to the assessee's business—*L.H. Sugar Factory & Oil Mills (P.) Ltd.* v. *CIT* [1980] 125 ITR 293 (SC), *Panipat Co-operative Sugar Mills Ltd.* v. *CIT* [1977] 108 ITR 111 (Punj. & Har.), *D.P. Chirania & Co.* v. *CIT* [1978] 112 ITR 12 (Kar.), *Hindustan Machine Tools Ltd.* v. *CIT* [1988] 40 Taxman 43 (Kar.). On the other hand, if construction of a road is not advantageous to the assessee's business, contribution towards its construction is not an allowable deduction—*L.H. Sugar Factory & Oil Mills (P.) Ltd.* v. *CIT* [1980] 125 ITR 293 (SC).

141.8-4 ***ACQUISITION OF RAW MATERIAL*** - It covers expenses on acquisition of raw material/mining rights —

▪ *General rule* - A trader may spend money to acquire his raw materials, or his stock-in-trade, and the payment may often be on revenue account but not necessarily—*K.T.M.T.M. Abdul Kayoom* v. *CIT* [1962] 44 ITR 689 (SC). All revenue expenditure need not always be equated with expenditure in connection with stock-in-trade—*CIT* v. *Amalgamated Development Ltd.* [1967] 65 ITR 395 (SC). If payment is to ensure the source of stock-in-trade, then expenditure incurred for that purpose will be capital expenditure. If, on the other hand, payment is made to obtain stock-in-trade under a source arranged for, then such payments is payments for supply of stock-in-trade and for carrying on business—*CIT* v. *Rishabh Investment Ltd.* [1979] 117 ITR 962 (Cal.).

▪ *Examples of deductible/non-deductible expenses* - The following are held as deductible —

1. Where payment is made to a third party in respect of stock-in-trade taken over from another party, it is allowable as revenue expenditure—*CIT* v. *SM.M. Muthappa Chettiar & SM.KR. Karuppan Chettiar Firm* [1983] 139 ITR 396 (Mad.).

2. In computing income from tea business, the market value of agricultural produce (such as bamboo, thatch) used as raw materials is to be deducted—*CIT* v. *Hantapara Tea Co. Ltd.* [1973] 89 ITR 258 (SC).

3. Notional cost of raw material where there is no outgoing of cash, is not deductible—*K. Sankaranarayana Iyer & Sons* v. *CIT* [1977] 110 ITR 571 (Mad.).

4. Expenditure incurred for purchase of contract rights for supply of flowers to distillery is allowable—*G. Venkata Bhooma Reddy* v. *CIT* [1961] 43 ITR 100 (AP).

5. Payments made to stranger for having found means for procurement of raw materials is revenue expenditure—*CIT* v. *Dalmia Dadri Cement Ltd.* [1970] 77 ITR 410 (Punj. & Har.).

6. Where royalty is paid for obtaining stock-in-trade, expenditure is of revenue nature—*H. Dear & Co. (P.) Ltd.* v. *CIT* [1966] 60 ITR 546 (SC).

7. Where the assessee-company manufacturing sugar has paid some extra amount for sugarcane supplied by its subsidiary company and has also foregone interest on loan given to said company, both extra purchase price and interest forgone are allowable—*CIT* v. *Gwalior Sugar Co. Ltd.* [1984] 150 ITR 320 (MP).

8. Where the assessee acquired forest land in order to obtain regular supply of raw materials and later the State nationalised the said land and did not pay any compensation, interest on unpaid cost price of land and bank guarantee commission paid by the assessee in respect of the unpaid balances shall be allowed as a revenue expenditure — *CIT* v. *Gwalior Rayon Silk Mfg. (Wvg.) Co. Ltd.* [1999] 102 Taxman 433/237 ITR 253 (Bom.).

141.8-5 *PRELIMINARY EXPENSES* - Such expenses are covered by section 35D. If, however, conditions of section 35D are not satisfied, then deduction is available under section 37(1) if certain conditions are satisfied.

▪ *General rule* - The commencement of business is not sole factor on which nature of expenditure can be decided—*CIT* v. *Vallabh Glass Works Ltd.* [1982] 137 ITR 389 (Guj.). Expenses incurred after setting up of business and before its commencement are allowable deductions but expenses incurred before setting up are not allowable—*Western India Vegetable Products Ltd.* v. *CIT* [1954] 26 ITR 151 (Bom.). Claim for expenditure related to period prior to take-over of business by the assessee is not admissible—*K. Sankaranarayana Iyer & Sons* v. *CIT* [1977] 110 ITR 571 (Mad.). Pre-commencement expenses have to be capitalised—*CIT* v. *Cochin Refineries Ltd.* [1988] 173 ITR 461 (Ker.). Subsequent abandonment of a project does not convert pre-commencement expenditure, which is in nature of capital expenditure, into revenue expenditure—*E.I.D. Parry (India) Ltd.* v. *CIT* [2002] 257 ITR 253 (Mad.).

▪ *Examples of deductible/non-deductible expenses* - The following are held as deductible/non-deductible expenses —

1. Expenditure incurred on getting expert opinion for setting up factory is not an allowable deduction—*CIT* v. *S.L.M. Maneklal Industries Ltd.* [1977] 107 ITR 133 (Guj.).

2. Expenditure incurred on obtaining techno-economic feasibility report and by way of payment of consultancy fees in connection with acquisition of capital asset, is capital expenditure—*Saurashtra Cement & Chemical Industries Ltd.* v. *CIT* [1992] 196 ITR 237 (Guj.).

3. Expenditure on market survey about readership of the assessee's publications is revenue expenditure—*CIT* v. *Ananda Bazar Patrika (P.) Ltd.* [1989] 47 Taxman 436/[1990] 184 ITR 542 (Cal.).

4. Expenditure incurred after manufacture of a product but before marketing it in order to test its suitability for marketing, is revenue expenditure—*Gujarat Small Scale Industries Corpn. Ltd.* v. *CIT* [1983] 142 ITR 35 (Guj.).

5. Expenditure on preparation of feasibility studies and project reports is revenue expenditure—*CIT* v. *Karnataka State Industrial & Investment Development Corpn.* [1987] 163 ITR 657 (Kar.), *CIT* v. *Kerala State Industrial Development Corpn. Ltd. (No. 1)* [1989] 47 Taxman 5/[1990] 182 ITR 62 (Ker.). However, a contrary opinion has been expressed in *Triveni Engineering Works Ltd.* v. *CIT* [1998] 232 ITR 639 (Delhi) where it was held that the amount spent on a project report would be capital expenditure and it could not be allowed as revenue expenditure merely because the project did not materialise. In *CIT* v. *Graphite India Ltd.* [1996] 221 ITR 420 (Cal.), it was held that expenditure incurred by the assessee for obtaining feasibility report for manufacture of raw material was allowable even where the project had not materialised. Likewise, payments made to

consultancy firms for making feasibility studies to identify projects that may be taken up advantageously and for preliminary study regarding availability of limestone deposits, would be allowable as revenue expenditure when the study taken up by the assessee was for utilisation of surplus funds and it had not resulted in setting up of new business—*CIT* v. *Coromandal Fertilizers* [1999] 105 Taxman 490 (AP).

6. Consumption of raw materials in the pre-production stage is deductible if met after the business is set up—*CIT* v. *Incheck Tyres Ltd.* [1983] 141 ITR 937 (Cal.).

7. Where the assessee had set up two units, one manufacturing instrument on small-scale which had been temporarily closed down and other intending to manufacture mini-computers and micro-processor based systems on large-scale, as the two units did not form part and parcel of an indivisible business pre-operative expenditure in respect of mini-computer division which had not started functioning, could not be allowed as business expenditure—*Ashoke Marketing Ltd.* v. *CIT* [1994] 73 Taxman 126/208 ITR 941 (Cal.).

141.8-6 ***REPAIRS/RENOVATION*** - Such expenses are covered by sections 30 and 31. Section 37(1) is applicable if such expenses are inadmissible under sections 30 and 31—*CIT* v. *Kalyanji Mavji & Co.* [1980] 122 ITR 49 (SC), *S.B. Adityan* v. *First ITO* [1964] 52 ITR 453 (Mad.), *CIT* v. *ICI (India) (P.) Ltd.* [1983] 139 ITR 105 (Cal.), *Greaves Cotton & Crompton Parkinson Ltd.* v. *CIT* [1968] 70 ITR 181 (Bom.), *ITAT* v. *B. Hill & Co. (P.) Ltd.* [1983] 142 ITR 185 (All.). Any repairs expenditure of revenue nature, if not deductible under section 31, would be allowable as deduction under section 37—*CIT* v. *Datta Diary* [1998] 67 ITD 357 (Pune).

■ *General rule* - Expenditure is not necessarily capital even when structural repairs are carried out—*CIT* v. *I.C.I. (India) (P.) Ltd.* [1983] 139 ITR 105 (Cal.). Expenditure even if substantial, is not capital if it does not increase efficiency of asset—*C.R. Corera & Bros.* v. *CIT* [1963] 49 ITR 188 (Mad.). Expenditure on repairs which has resulted in substantial improvement of property, is capital expenditure—*Ratlam Bone Mills* v. *CIT* [1984] 147 ITR 148 (MP), *CIT* v. *Sri Rame Sugar Mills Ltd.* [1952] 21 ITR 191 (Mad.), *CIT* v. *Ballimal Navalkishore* [1979] 119 ITR 292 (Bom.), *Senapathy Synams Insulations (P.) Ltd.* v. *CIT* [2001] 117 Taxman 216 (Kar.).

The burden to prove that there had been repair and renovation would be on the assessee—*Premier Breweries Ltd.* v. *CIT* [1999] 104 Taxman 41/236 ITR 726 (Ker.).

■ *Examples of deductible/non-deductible expenses* - The following are held as deductible/non-deductible expenses—

1. If replacement of existing compound wall and rebuilding the same include removal of existing foundation and replacing it with new foundation, it results in effacing old asset and bringing into existence a totally new asset which gives enduring benefit. Consequently, such expenditure is a capital expenditure—*Senapathy Synams Insulations (P.) Ltd.* v. *CIT* [2001] 117 Taxman 216 (Kar.).

2. All expenditure on maintenance of a tea garden including expenditure on the maintenance of an area that has not reached maturity is deductible—*Income-tax Circulars, published by Directorate of Inspection* (RS & P), 1968 edition, page 192.

3. The expenditure incurred solely for repairs and modernizing the hotel and replacing the existing components of the building, furniture and fittings with a view to create a conductive and beautiful atmosphere is an expenditure incurred for the purpose of running of the business of a hotel—*CIT* v. *Ooty Dasaprakash* [2000] 110 Taxman 275 (Mad.). Similarly, expenditure on renovation of premises taken on lease would be allowable—*B & A Plantations and Industries Ltd.* v. *CIT* [2000] 242 ITR 22 (Gauhati), *CIT* v. *Kisenchand Chellaram (India) (P.) Ltd.* [1981] 130 ITR 385 (Mad.), *CIT* v. *Bharat Commercial Corporation* [1997] 226 ITR 242 (Pat.), *CIT* v. *Seshasayee Bros. (P.) Ltd.* [1982] 11 Taxman 18 (Mad.).

4. Expenditure by way of interior decoration with wall papers, partition walls, marble flooring provided in premises is in the nature of business expenditure for proper carrying on of business and, therefore, deductible—*B and A Plantations & Industries Ltd.* v. *CIT* [2001] 117 Taxman 323 (Gau.).

5. If expenditure is incurred for renovation of building/reconditioning of machinery to reactivate production which was temporarily suspended, and expenditure creates no new asset of an enduring benefit, it is allowable as revenue expenditure—*CIT* v. *Kalyanji Mavji & Co.* [1980] 122 ITR 49 (SC).

6. Expenditure incurred on replacement of thatched roof with asbestos sheets and barbed wire fence with compound wall [where the assessee obtained certain property for business] is deductible—*CIT* v. *B.V. Ramachandrappa & Sons* [1991] 191 ITR 34 (Kar.).

7. The expenditure incurred on making of lawns in the factory complex is deductible—*Prashant Khosla Pneumatics Ltd.* v. *ITO* [1992] 64 Taxman 287 (Delhi), *Steel Tubes of India (P.) Ltd.* v. *CIT* [1996] 130 CTR (MP) 547.

8. Expenditure for the replacement of wooden trolleys by stainless steel trolleys parts is deductible—*CIT* v. *Satyadev Chemical Ltd.* [1997] 226 ITR 95 (Guj.), *Standard Mills Co. Ltd.* v. *CIT* [1990] 181 ITR 233 (Bom.).

9. Expenditure on renovation of cinema building is of revenue nature—*CIT* v. *S. Zoraster & Co.* [1982] 133 ITR 559 (Raj.), *CIT* v. *Indian Metal & Metallurgical Corpn.* [1983] 141 ITR 40/[1990] 182 ITR 460 (Mad.), *CIT* v. *Bharat Cinema* [1980] 121 ITR 165 (*Punj. & Har.*).

10. The initial expenditure on first installation of fluorescent lights, including the expenditure on wiring and fittings, should be treated as capital expenditure as it creates an asset and all subsequent expenditure for replacement of the tubes should be treated as of a revenue nature, allowable *in toto—Circular No. 69 (XIX-3) [F.No. 27(31)-IT/51], dated November 27, 1951.*

11. Expenditure incurred by a textile mill on replacement of worn out electric motors would be allowable as revenue expenditure—*CIT* v. *Sree Narasimha Textiles (P.) Ltd.* [1999] 238 ITR 351 (Mad.), *CIT* v. *Sri Hari Mills Pvt. Ltd.* [1999] 105 Taxman 210/237 ITR 188 (Mad.).

12. Substantial repair charges on plant and machinery being necessary owing to long neglect of assets is deductible—*R.B. Bansilal Abirchand Spg. & Wvg. Mills* v. *CIT* [1957] 31 ITR 427 (Nag.).

13. Expenditure on repairs of building which does not amount to renovation is revenue expenditure—*Permali Wallace Ltd.* v. *CIT* [1985] 151 ITR 43 (MP).

14. Expenses incurred on premises (owned as well as leased) let out to tenants are admissible business deductions—*Usher's Wiltshire Brewery Ltd.* v. *Bruce* [1914] 6 TC 399 (HL).

15. Expenditure of Rs. 6,000 disbursed for being incurred on maintenance of Ram Mandir, was allowable under section 37(1)—*Atlas Cycle Industries Ltd.* v. *CIT* [1990] 181 ITR 18 (Punj. & Har.).

16. Expenditure incurred on guniting work carried on in business premises is deductible—*CIT* v. *Oxford University Press* [1977] 108 ITR 166 (Bom.), *CIT* v. *I.C.I. (India) (P.) Ltd.* [1983] 139 ITR 105 (Cal.).

17. Expenses incurred towards the deepening of an existing tubewell are in the nature of revenue expenditure—*Amrit Banaspati Co. Ltd.* v. *Dy. CIT* [2000] 111 Taxman 186 (Delhi) (Mag.).

18. Where a replacement of is made of a physically, commercially and functionally inseparable part of an entire asset, the expense incurred in relation to such transaction must be treated as an admissible revenue expenditure—*CIT* v. *Tea Estate (P.) Ltd.* [1992] 198 ITR 535 (Cal.).

19. Expenditure to repair damage to car in which the director of the assessee-company is travelling to the business premises, as a result of riot in the company's premises, is allowable as business expenditure—*CIT* v. *Southern Publications Ltd.* [1995] 211 ITR 397 (Mad.).

20. Expenditure incurred by the assessee on repairs of approach roads and resurfacing of kaccha roads inside its factory premises is allowable as revenue expenditure—*CIT* v. *Chemaux Ltd.* [1994] 74 Taxman 201 (Bom.), *CIT* v. *Himalaya Drug Co. (P.) Ltd.* [1998] 234 ITR 167 (All.).

21. Expenditure on repair to godown (godown used as creche for children of female workers was repaired and put to use as administrative office) is deductible—*Indian Ginning & Pressing Co. Ltd.* v. *CIT* [2002] 125 Taxman 546 (Guj.).

22. Expenditure incurred on cleaning of existing tubewell and altering pipes of pumps installed inside well to allowed as revenue expenditure—*Indian Ginning & Pressing Co. Ltd.* v. *CIT* [2002] 125 Taxman 546 (Guj.).

23. Expenditure incurred by an assessee on converting godown taken on lease into office premises by renovating it, providing interior decoration, replacement of existing roof with that of cement sheets, replacement of floor with that of marble, etc., is allowable as revenue expenditure—***CIT*** **v.** ***HEDE Consultancy (P.) Ltd.*** [2003] 127 Taxman 597 (Bom.).

24. Where the police bans the assessee's discotheque and the assessee utilises the said area as a Banquet Hall after making renovation and refurnishing, such expenses having been incurred simply to earn more profits cannot be termed as capital and are allowable as revenue expenditure—*Hotel Rajdoot (P.) Ltd.* v. *CIT* [1999] 104 Taxman 259 (Delhi) (Mag.).

25. Expenditure incurred by the assessee on repair of its cold storage whose chambers are destroyed due to fire, is allowable as revenue expenditure—*Ram Swarup Cold Storage Allied Ltd.* v. *ITO* [2002] 256 ITR 121 (Delhi - Trib.).

26. Contribution made by the assessee to the Government for building a new bridge in place of the old one which had become unserviceable, and which bridge is essential to provide access to the assessee's factory, is allowable as revenue expenditure—*CIT* v. *Coats Viyella India Ltd.* [2002] 253 ITR 667/124 Taxman 797 (Mad.).

27. Investment in the construction and repairs made by assessee after the execution of the agreement of sale in assessee's favour under the belief that assessee would own the property very soon, is not allowable as revenue expenditure—***Chimo Agencies Pvt. Ltd.*** v. ***CIT*** [2004] 267 ITR 64 (MP).

141.8-7 ***RENT OF BUILDING*** - Rent of the current year is covered by section 30. Section 37(1) is applicable in cases not covered by section 30.

▪ *General rule* - Where the expenditure incurred on rent is not allowable under section 30, it cannot be allowed under section 37—*Noshirwan & Co. (P.) Ltd.* v. *CIT* [1970] 77 ITR 822 (MP).

▪ *Examples of deductible/non-deductible expenses* - The following are held as deductible/non-deductible expenses—

1. Arrears of rent for earlier year paid by the assessee-lessee in subsequent year under a decree for overstaying in premises beyond period of agreement, are allowable as deduction in the assessee's hands in the year in which the assessee made provision for them following decree—*CIT* v. *Gurunathan* [1995] 211 ITR 174 (Mad.).

2. Where in connection with a lease agreement under which the assessee took on lease certain premises, the assessee agreed to pay certain commission to estate agent for period of lease, such commission was by way of additional rent and hence allowable as deduction—*Richardson Hindustan Ltd.* v. *CIT* [1988] 169 ITR 516 (Bom.).

3. Irrecoverable advance rent for a premises yet to be constructed is deductible as revenue expenditure—*CIT* v. *Globe Theatres Ltd.* [1950] 18 ITR 403 (Cal.).

4. Extra payment to lessor to obtain a lease of new building for business purpose is allowable—*CIT* v. *S.B. Ramakrishnan* [1969] 74 ITR 761 (Mad.).

5. Where the assessee claimed deduction in respect of additional ground rent payable to the Government on account of delay in removal of timber from the allotted forest area, in terms of agreement, even though liability was disputed in a civil suit still going on, additional ground rent liability could not be allowed in the year of accrual but only in the year in which the dispute was settled—*CIT* v. *Purshotham Gokuldas* [1999] 103 Taxman 460/237 ITR 115 (Ker.).

6. Where for excavation purposes the assessee took on lease a land on monthly rent for 15 years and the assessee was required to pay in advance rent for the entire lease period in form of guarantee deposit which was adjustable against the rent of each month, the advance rent paid by the assessee was not actually a yearly payment but a capital expenditure for achieving an enduring benefit over years and, therefore, would not be allowable as revenue expenditure—*Aditya Minerals (P.) Ltd.* v. *CIT* [1999] 106 Taxman 337/239 ITR 817 (SC).

7. Expenditure for hiring of a stall at India Paint Conference, for co-sponsoring International Conference on clean technologies, is allowable as deduction—***CIT*** v. ***E.I. Dupont India Ltd.*** [2007] 11 SOT 688/107 ITD 63 (Delhi).

141.8-8 ***ROYALTY*** - Royalty is a compensation payable to the owner of a right.

▪ *General rule* - Where payment of royalty is correlated to production, it may be a revenue expenditure—*Mewar Sugar Mills Ltd.* v. *CIT* [1973] 87 ITR 400 (SC).

▪ *Examples* - The following are examples of deductible/non-deductible expenses—

1. Royalty on net sales paid by the assessee-book publisher to a party to obtain recognition of its books by education department is a capital expenditure—*CIT* v. *Naya Sahitya* [1972] 84 ITR 567 (Delhi).

2. Royalty paid under a 5 year collaboration agreement for use of technical know-how to run an existing business more profitably would be allowable as revenue expenditure—*CIT* v. *Southern Pressing (P.) Ltd.* [2000] 242 ITR 67 (Mad.).

3. Royalty and dead rent paid under Mineral Concession Rules, 1960, will have to be allowed as deduction—*Circular No. 1-D (IV-53), dated January 20, 1966.*

4. In cases of Indian authors/writers where the amount receivable from royalties/writings are less than Rs. 25,000 and where detailed accounts regarding expenses incurred are not maintained, claims of expenses to the extent of 25 per cent of such amount or Rs. 5,000, whichever is less, may be allowed in the year of publication of a book or other publication including articles. The expenses to the extent mentioned above will be allowable without calling for any evidence in support of the claim. This circular will not, however, be available in cases of such authors/writers who are included in the terms of film artistes being story writers,

screenplay writers and dialogue writers if they are engaged in their professional capacity in the production of a cinematography film—*Letter F.No. 204/42/77-IT(A-II), dated September 28, 1977.*

5. Payment of enhanced royalty to owner of an estate forest for agreeing to grant a right to take and remove stock-in-trade, *i.e.*, sleepers and scantlings from logs of sal, for a sufficiently long period is a capital expenditure—*H. Dear & Co. (P.) Ltd.* v. *CIT* [1966] 60 ITR 546 (SC).

6. Where royalty paid by assessee to collaborator is based on sales, in return for services to be rendered by collaborator, and on ex-factory price for supply of information of day-to-day development in range of products, it is allowable as revenue expenditure—*CIT* v. *Gujarat Carbon Ltd.* [2002] 254 ITR 294/121 Taxman 526 (Guj.).

7. Expenses incurred for purchase of software are in the nature of rent or royalty and, therefore, have to be allowed as business expenditure—*ITC Classic Finance Ltd.* v. *CIT* [2000] 112 Taxman 155 (Cal.) (Mag.).

141.8-9 ***FORFEITURE OF SECURITY DEPOSIT*** - It covers forfeiture of deposit given as 'security' for the business purposes.

▪ *General rule* - Forfeiture of security deposited under a contract is deductible—*Thackers H.P. & Co.* v. *CIT* [1982] 134 ITR 21 (MP).

▪ *Examples* - The following are held as deductible/non-deductible expenses—

1. Where a security deposit is made to obtain agency and later due to reasons stated in agreement it becomes irrecoverable, irrecoverable deposit is not deductible as business expenditure—*CIT* v. *Motiram Nandram* [1940] 8 ITR 132 (PC).

2. Where for failure of the assessee-liquor supplier to lift agreed quantity of liquor the assessee's security deposit is forfeited and the assessee also had to pay for shortfall which it did not debit in its account books, it is only entitled to deduction to the extent of forfeiture of his security deposit only and not anything more—*CIT* v. *Kishangarh Madira Sangh* [1987] 167 ITR 393 (Raj.).

3. Where security deposit of the assessee is forfeited and the High Court orders its refund but refund is not made on account of State Government going in appeal against High Court's decision, such forfeited security deposit is not allowable as deduction—*CIT* v. *Tarlok Chand Desraj Singh & Co.* [1989] 45 Taxman 232/179 ITR 49 (Punj. & Har.).

141.8-10 **BORROWING** - It covers expenses incidental to borrowing—

▪ *General rule* - Expenditure incurred on raising a loan after setting up a business is a revenue expenditure—*India Cements Ltd.* v. *CIT* [1966] 60 ITR 52 (SC). In determining the nature of expenditure (revenue or capital) incurred in obtaining a loan, it is irrelevant to consider the purpose of the loan—*India Cements Ltd.* v. *CIT* (*supra*).

▪ *Examples* - The following are some of the examples of deductible/non-deductible expenses—

1. Where the assessee is formed for taking over another company's business and on the said acquisition, it pays part of purchase consideration by allotting shares and on balance of consideration outstanding it pays interest to other company, interest is deductible—*Bombay Steam Navigation Co. (1953) (P.) Ltd.* v. *CIT* [1965] 56 ITR 52 (SC).

2. Where the assessee, a running concern, incurred certain registration expenses in obtaining loan for setting up a new venture, such expenses are allowable as revenue expenditure—*CIT* v. *Oswal Spg. & Wvg. Mills Ltd.* [1986] 160 ITR 426 (Punj. & Har.).

3. Expenditure for stamp and registration charges for agreement with bank for overdraft facilities is allowable—*Ishwari Khetan Sugar Mills (P.) Ltd.* v. *CIT* [1967] 63 ITR 376 (All.).

4. Expenditure incurred on negotiating for overdraft facilities is an admissible deduction—*Jeewanlal (1929) Ltd.* v. *CIT* [1969] 74 ITR 753 (SC).

5. Commitment charge payable by a party on the unused portion of the loan which has not been drawn, has to be taken as an expenditure laid out wholly and exclusively for the purposes of the business and, therefore, permissible as a revenue deduction under section 37(1)—*Circular No. 2-P(XI-6) [F.No. 10/67/65-IT(A-I)], dated August 23, 1965, Circular No. 2P, dated August 23, 1965.*

6. Payment of bank guarantee commission and expenditure incurred on obtaining letter of credit for purchasing plant and machinery are capital expenditure—*CIT* v. *Vallabh Glass Works Ltd.* [1982] 137 ITR 389 (Guj.).

7. Interest on delayed payment of provident fund is an allowable deduction—***CIT*** v. ***Ishwari Khetan Sugar Mills (P.) Ltd.*** [2004] 191 CTR (All.) 184.

141.8-11 *ISSUE OF SHARES/DEBENTURES* - It covers expenses on issue of shares/debentures.

■ *General rule* - Expenditure for raising additional capital by issue of ordinary shares is a capital expenditure—*Vazir Sultan Tobacco Co. Ltd.* v. *CIT* [1988] 41 Taxman 7/174 ITR 689 (AP), *Brooke Bond India Ltd.* v. *CIT* [1997] 91 Taxman 26/225 ITR 798 (SC), *Metro General Credits Ltd.* v. *CIT* [1996] 221 ITR 99 (Mad.). Expenditure on issue of bonus shares is revenue expenditure—***CIT*** v. ***General Insurance*** [2006] 156 Taxman 96 (SC). Expenditure incurred after the commencement of business on raising debenture loan is an admissible deduction—*Premier Automobiles Ltd.* v. *CIT* [1971] 80 ITR 415 (Bom.). If, however, expenditure is incurred on raising debenture loan before the commencement of business, such expenditure is a capital expenditure.

■ *Examples* - The following are some of the examples of deductible/non-deductible expenses—

1. Where the expenditure was incurred for the purpose of changing the capital structure of the company to suit the requirements of the Foreign Exchange Regulation Act, 1973, by obtaining shares held by foreigners and transferring them to Indian citizens, thereby converting what is a non-resident company to a resident company, the expenditure is not deductible as a business expenditure—*CIT* v. *Commonwealth Trust Ltd.* [1987] 167 ITR 365 (Ker.).

2. Fee paid to Registrar of Companies for increasing authorised capital will result in an advantage of enduring nature and is a capital expenditure—*Mohan Meakin Breweries Ltd.* v. *CIT (No. 2)* [1979] 117 ITR 505 (HP). Likewise, fees paid to the registrar for expansion of the capital base of the company is directly related to the capital expenditure incurred by the company and is not deductible—*Punjab State Industrial Development Corpn. Ltd.* v. *CIT* [1997] 225 ITR 792/93 Taxman 5 (SC).

3. Expenditure incurred in connection with rights issue is a capital expenditure—*CIT* v. *Motor Industries Co. Ltd.* [1998] 97 Taxman 7/229 ITR 137 (Kar.).

4. Expenses incurred by the assessee in connection with the issue of bonus shares are expenditure of revenue nature—***CIT*** v. ***General Insurance Corpn.*** [2006] 156 Taxman 96 (SC).

5. Since convertible debentures have characteristic of equity shares such debentures cannot be termed as debt and, therefore, proportionate expenditure on such debentures is for augmentation of equity base of the company and as such, has to be treated as capital expenditure—*Banco Products (India) Ltd.* v. *CIT* [1999] 63 Taxman 370 (Ahd.), ***Sona Stearing Systems Ltd.*** v. ***CIT*** [2003] 129 Taxman 152 (Mag.).

6. Where a company issues debentures or bonds at a discount, the liability to pay discounted amount is an 'expenditure' allowable under section 37(1)—*Madras Industrial Investment Corpn. Ltd.* v. *CIT* [1997] 91 Taxman 340/225 ITR 802 (SC). Where the assessee-company issued debentures or bonds at a discount, the assessee is entitled to proportionate deduction of discount spread over the period for which debentures or bonds will remain outstanding. In such a case, the claim for deduction of the entire amount of discount in the year of issue itself cannot be allowed—*Madras Industrial Investment Corpn. Ltd.* v. *CIT* [1997] 91 Taxman 340/225 ITR 802 (SC). Similarly, premium payable on redemption of convertible secured debentures issued during the year has to be spread over the period of debentures—*Universal Cables Ltd.* v. *CIT* [2000] 111 Taxman 9/243 ITR 371 (Cal.), *National Engg. Industries Ltd.* v. *CIT* [1999] 106 Taxman 443 (Cal.). This rule is applicable even in the case of zero interest debentures. For instance, in ***CIT*** v. ***S.M. Holding & Finance (P.) Ltd.*** [2004] 134 Taxman 328 (Bom.) the assessee-company had issued zero interest unsecured convertible debentures of Rs. 100 each redeemable after 10 years at a premium of 100 per cent. Premium payable by it was Rs. 5,47,50,000 after expiry of 10 years. A deduction of Rs. 54,75,000 per annum was allowed as deduction. However, discount on issue of notified zero coupon bonds is deductible under section 36(1)(*iiia*) [*see* para 127A].

7. Expenditure incurred on stamp duty, registration fee, lawyer's fee, etc., in respect of the issue of debentures by a company to secure a loan, is admissible as revenue expenditure—*Premier Automobiles Ltd.* v. *CIT* [1971] 80 ITR 415 (Bom.).

141.8-12 *PAYMENT TO EMPLOYEES* - It covers expenses on payment of salary and allowances and providing perquisites. In order to claim deduction one must ensure that conditions of sections 40(*a*)(*iii*)/(*iv*), 40A(2)/(7)/(9) and 43B(*b*)/(*f*) are satisfied.

■ *General rule* - Merely because of the existence of an agreement between the employer and the employee, the Assessing Officer is not bound to treat the expenditure as wholly and exclusively for the purpose of business—*Swadeshi Cotton Mills Co. Ltd.* v. *CIT* [1967] 63 ITR 57 (SC). Quantum of remuneration to employees cannot be questioned, but the Assessing Officer can examine whether it is real and is paid for business purposes—*Bengal Enamel Works Ltd.* v. *CIT* [1970] 77 ITR 119 (SC). If expenditure on remuneration is incurred wholly and exclusively for purpose of business, it is not

for revenue to determine how much remuneration is justified—*CIT* v. *Raman & Raman Ltd.* [1969] 71 ITR 345 (Mad.). In applying test of commercial expediency to remuneration paid to an employee, the case has to be adjudged from the point of view of a businessman and not of income-tax department—*Aluminium Corpn. of India Ltd.* v. *CIT* [1972] 86 ITR 11 (SC), *J.K. Woollen Mfrs.* v. *CIT* [1969] 72 ITR 612 (SC).

The Apex Court in *Gordon Woodroffe Leather Mfg. Co.* v. *CIT* [1962] 44 ITR 551 has given the following three tests in allowing (or disallowing) payments to employees—

a. that the payment should have been made as a matter of practice which affected the quantum of salary;

b. that there was an expectation by the employee of getting a gratuity; and

c. that the sum of money was expended on the ground of commercial expediency and in order indirectly to facilitate the carrying on of the business of the assessee.

In the subsequent decision in *T. Sassoon J. David & Co. (P.) Ltd.* v. *CIT* [1979] 118 ITR 261/1 Taxman 485 the Apex Court held that these three tests have to be read disjunctively. Consequently, if a payment satisfies any of the three tests, the same would be admissible.

■ *Examples of deductible expenditure* - The following are held as deductible—

1. Contribution by the assessee to the employees' welfare trust and subsidy to House Building Society is deductible—*CIT* v. *Cheran Transport Corporation Ltd.* [2000] 241 ITR 137 (Mad.).

2. Contribution made by the assessee-company to State Housing Board for construction of tenements for its workers, ownership of which tenements remained with the Housing Board is deductible—*CIT* v. *Bombay Dyeing & Mfg. Co. Ltd.* [1996] 219 ITR 521 (SC).

3. Expenditure incurred in discharge of statutory obligation of constructing quarters for labourers (where the assessee met a part of cost of construction of Labour Welfare Fund Quarters, which were constructed at instance of the Government and ownership of quarters vested in the Government, and the assessee was paying rent for quarters to the Government) is deductible—*CIT* v. *Rungta Mines (P.) Ltd.* [1994] 205 ITR 335 (Cal.). Likewise, expenditure incurred by the assessee-company towards construction of workers' quarters under welfare scheme is allowable where ownership of the houses does not vest in the assessee—*CIT* v. *Mysore Cements Ltd.* [1990] 51 Taxman 219/183 ITR 367 (Kar.), *CIT* v. *Chetan Transport Corporation Ltd.* [2000] 241 ITR 137 (Mad.).

4. Where the assessee-company formulated a housing scheme for its employees, under which it provided loans to the employees for purchase of land and also incurred expenditure on laying colony roads, drains, water tanks etc., all of which were handed over to the local panchayat, the expenditure so incurred was not capital in nature—*CIT* v. *Premier Cotton Spinning Mills Ltd.* [1997] 223 ITR 440/93 Taxman 702 (Ker.).

5. Contribution made by company to death relief fund and to employee's housing society for construction of roads is deductible—*CIT* v. *E.I.D. Parry India Ltd.* [1999] 105 Taxman 153/240 ITR 253 (Mad.).

6. Expenses on supply of food to workers when they were residing in the mill premises and no other adequate facility was available for procuring food is deductible—*Harak Chand Flour Mills* v. *CIT* [1981] 6 Taxman 232 (All.).

7. Expenditure on repair and maintenance of quarters built for employees is allowable as deduction—*Jamshedpur Engg. & Machine Mfg. Co. Ltd.* v. *CIT* [1957] 32 ITR 41 (Pat.).

8. Laying of cement surface on the tennis court in the club for the benefit of employees can hardly be regarded as capital expenditure; money given by the assessee to the employees to enable them to form roads and erect street lights, etc., in a housing colony formed by them is also to be treated as money spent on the welfare of the employees—*CIT* v. *Madras Cements Ltd.* [2002] 254 ITR 423 (Mad.).

9. Expenditure incurred by the assessee on plantations in factory premises and residential quarters of company, with a view to making atmosphere pollution-free is allowable as revenue expenditure—*Hindustan Electro Graphites Ltd.* v. *CIT* [1996] 218 ITR 688 (MP).

10. Contribution made to club, which is situated within the employee's residential colony, with a view to maintain goodwill and create bonhomie is deductible—*Amrit Banaspati Co. Ltd.* v. *CIT* [2000] 111 Taxman 186 (Delhi) (Mag.).

11. Expenditure on management of temple in factory premises for recreation of employees (but expenditure on construction of employee inside factory will be capitalised and depreciation will be allowed on it) is deductible—*Atlas Cycle Industries Ltd.* v. *CIT* [1981] 6 Taxman 145 (Punj. & Har.).

12. Salary paid to *pujari* (where the assessee maintained a temple within mills premises and had employed a *pujari* in connection with the said temple and the said temple was not maintained for personal benefit of any person) is deductible—*Commercial Mills Co. Ltd.* v. *CIT* [1994] 72 Taxman 203 (Guj.).

13. Amounts transferred by the assessee-company to an educational trust set-up for education of children of its employees is deductible—*CIT* v. *Vazir Sultan Tobacco Co. (P.) Ltd.* [1987] Tax 87(3) 85 (AP).

14. Payment to school where children of its employees are getting education is deductible—*CIT* v. *Travancore Cochin Chemicals Ltd.* [2000] 109 Taxman 91 (Ker.).

15. Donation by the assessee to a trust set up to provide for education of children of employees, etc. can be allowed under section 37(1) if it is an 'expenditure' within meaning of section 37(1)—*Mysore Kirloskar Ltd.* v. *CIT* [1987] 166 ITR 836 (Kar.).

16. Donation paid by the assessee to local Panchayat for upgradation of the school into a high school, where the children of the assessee's employees would get preference in the matter of admission, will be allowable as deduction—*CIT* v. *India Radiators Ltd.* [1998] 149 CTR (Mad.) 400.

17. Reasonable salary paid to members of a Hindu undivided family for services rendered to family business on commercial consideration is deductible—*CIT* v. *Jainarain Jagannath* [1945] 13 ITR 410 (Pat.), *Bijoy Kumar Choudhary* v. *CIT* [1984] 148 ITR 146 (Ori.), *Sunderlal Nanalal (HUF)* v. *CIT* [1984] 16 Taxman 3 (Guj.).

Salary paid by a Hindu undivided family to its karta under a valid *bona fide* agreement of employment—*Jugal Kishore Baldeo Sahai* v. *CIT* [1967] 63 ITR 238 (SC).

18. Gratuity paid to widow of a director in accordance with company's articles of association is deductible—*CIT* v. *Seshasayee Bros. (P.) Ltd.* [1982] 11 Taxman 18 (Mad.).

19. Expenditure incurred for levelling land to be used as a playground by the assessee's workers is deductible—*Taksons (P.) Ltd.* v. *CIT* [1979] 2 Taxman 150 (Bom.).

20. Payment of gratuity to the transferee of the undertaking (where the assessee's one unit is closed and the same is transferred to another person who employs employees of the closed unit of the assessee with continuity of service and the assessee pays gratuity due to the employees to the transferee for being paid to them at the time of retirement) is deductible—*W.T. Suren & Co. Ltd.* v. *CIT* [1998] 97 Taxman 126 (SC).

21. Expenditure incurred on gifts made by the assessee-company on the occasion of marriages of relatives of employees is deductible—*CIT* v. *Bihar Alloy Steel Ltd.* [1995] 82 Taxman 26 (Pat.) (Mag.).

22. Presentation of wrist watches to the employees which was in the nature of an incentive to encourage the employees to attend work punctually, to keep them happy and to earn their goodwill towards the company is deductible— *CIT* v. *Hayward Waldia Refinery Ltd.* [1994] 209 ITR 159 (Cal.).

23. Expenditure incurred by the assessee on its anniversary celebrations, which included gifts to employees based on a fixed formula, that is, half-month's salary for every year of completed services, is allowable as an expenditure wholly and exclusively incurred for purposes of business—*CIT* v. *Aditya Mills Ltd.* [1994] 74 Taxman 50/209 ITR 933 (Raj.), *Karjan Co-operative Cotton Sales Ginning & Pressing Society* v. *CIT* [1993] 199 ITR 17 (Guj.) (FB).

24. Expenditure incurred on training of employees abroad is allowable—*Delhi Cloth & General Mills Co. Ltd.* v. *CIT* [1986] 158 ITR 64 (Delhi).

25. Contribution towards cost of erection of Government-owned Primary Health Centre near factory premises is admissible as a revenue expenditure—*CIT* v. *Rupsa Rice Mills* [1976] 104 ITR 249 (Ori.).

26. Hospital expenses incurred for treatment of director abroad are deductible expenditure—*Mehboob Productions (P.) Ltd.* v. *CIT* [1977] 106 ITR 758 (Bom.).

27. Contribution to a hospital for providing medical treatment to employees is a permissible deduction—*India United Mills Ltd.* v. *CIT* [1975] 98 ITR 426 (Bom.).

28. If step under section 25FF of Industrial Disputes Act is taken during the continuation of the business but before the actual transfer, then the amount expended by way of retrenchment compensation will be covered by section 37—*Ambala Cantt. Electric Supply Corpn. Ltd.* v. *CIT* [1982] 133 ITR 343 (Punj. & Har.).

29. Retrenchment compensation paid by the assessee prior to its takeover is allowable as deduction—*Karvales Ltd.* v. *CIT* [1992] 60 Taxman 483/197 ITR 95 (Ker.).

Retrenchment compensation payable at the time of closure of one or some of the *units* of a business is deductible—*see Bansidhar (P.) Ltd.* v. *CIT* [1981] 127 ITR 65 (Guj.), *K. Ravidranathan Nair* v. *CIT* [2001] 114

Taxman 53 (SC), ***CIT*** v. ***MGF India*** [2004] 187 CTR (Delhi) 511. Such compensation payable before the closure of *business* is also deductible. If, however, such compensation is payable at the time of closure of a *business*, it is not deductible—*Binani Printers (P.) Ltd.* v. *CIT* [1983] 143 ITR 338 (Cal.).

30. Amount transferred to a trust for the purposes of providing pension to widow of director who died in service is deductible—*CIT* v. *Indian Molasses Co. (P.) Ltd.* [1987] 166 ITR 740 (Cal.).

31. Compensation to the daughter of one of its employees who died abroad while on training is deductible—*CIT* v. *Laxmi Cement Distributors (P.) Ltd.* [1976] 104 ITR 711 (Guj.).

32. Salary paid to receiver appointed by a court is deductible—*Sachindra Mohan Ghosh* v. *CIT* ITC 396 (Pat.).

33. Remuneration paid to directors is allowable even if there is no provision for it in company's article of association—*Sagar Automotives (P.) Ltd.* v. *CIT* [1984] 148 ITR 492 (MP). Remuneration paid to director even if is paid in violation of section 314 of Companies Act is deductible—*Nilgiri Finance and Hire Purchase (P.) Ltd.* v. *CIT* [1995] 213 ITR 384 (Mad.).

34. High remuneration paid to an employee for attending to work outside the assessee's line of business, which though profitable required special organization, is deductible—*CIT* v. *Chari & Chari Ltd.* [1965] 57 ITR 400 (SC).

35. Merely because another employee would have been available on a lesser salary is not a ground for disallowance of salary paid—*D.N. Sinha (P.) Ltd.* v. *CIT* [1976] 102 ITR 491 (Cal.).

36. Claim for deduction of salary paid to an employee cannot be rejected on ground that for earning income, services of an employee are not required—***Bishambar Dayal*** v. ***ITO*** [2004] 2 SOT 104 (Jodh.).

37. Where it is found that recipient entity is a genuine one, that it has rendered service and that remuneration is not patently excessive, then it will not be proper for authorities to disallow amount as being unreasonable—*Ramanlal Kamdar* v. *CIT* [1976] 103 ITR 489 (Mad.).

38. Provision for payment of wages for weekly holiday under Bidi & Cigar Workers (Conditions of Employment) Act is deductible—*CIT* v. *Alim Beg Salim Bhai* [1987] 163 ITR 767 (MP).

39. Amount paid/payable to a former employee (where two former employees of the assessee-company having access to secret formula were retained in service even after their retirement to ensure that there would not be any competition from them by setting up rival ink manufacturing concern, since payment to such retired personnel was made only to protect company's existing asset for smooth running of its business without apprehending competition from its own retired personnel, the same would have to be allowed as revenue expenditure)—*CIT* v. *Joshi Formulas (P.) Ltd.* [1999] 104 Taxman 215 (Rajkot).

40. Where salary is paid to employees, who are in jail, only portion attributable to salary for leave earned is allowable—*J.K. Cotton Spg. & Wvg. Mills Co. Ltd.* v. *CIT* [1967] 64 ITR 444 (All.).

41. Reasonable remuneration paid by a company to its Registrar for performing duties in connection with the company's legal obligations to be discharged under the company law should be regarded as revenue expenditure provided the company is not itself maintaining a separate organization for the performance of such duties—*Letter : F.No. 10/25/63-IT(A-I), dated June 18, 1964.*

42. Where the assessee-company, whose mill is old and unbalanced and it never worked satisfactorily in the past, in addition to salary, started giving commission on profit to its general manager in order to create interest for accomplishment of task entrusted to him and the manager, in fact, has put in special efforts and improved business of the company, such commission is deductible—*J.K. Woollen Mfrs.* v. *CIT* [1969] 72 ITR 612 (SC).

43. Salary paid by an assessee-partner (being physically unfit) to his son to look after the assessee's interest in firm is deductible—*CIT* v. *Babu Ram* [1982] 10 Taxman 190 (Delhi).

44. Salary, bonus and travelling expenses paid by a partner assessee to his staff to look after his interest and to earn income from partnership is deductible—*CIT* v. *Ramniklal Kothari* [1969] 74 ITR 57 (SC).

45. Where remuneration paid is attributable to services rendered, and not to relationship of recipient with partner, it is allowable as business expenditure—*S. Palaniandi Mudaliyar & Sons* v. *CIT* [1975] 99 ITR 231 (Mad.).

46. Payment of lump sum amount to an employee barring his private practice is an allowable expenditure—*Champion Engg. Works Ltd.* v. *CIT* [1971] 81 ITR 273 (Bom.).

47. Loss caused by negligence of the assessee's servants in course of business operation is deductible—*Anamali Timber Trust Ltd.* v. *CIT* [1963] 47 ITR 814 (Ker.).

48. Expenditure on bringing back dead body of chairman of company who died while on tour abroad are to be allowed as deduction—*CIT* v. *Modipon Ltd. (No. 2)* [1999] 189 ITR 478 (All.).

49. Amount spent by the assessee on contributing dish antenna/amplifier for cable TV to staff recreation club at the mines situated at remote hilly area, is allowable as revenue expenditure— *Wolkem India Ltd.* v. *CIT* [1999] 65 TTJ (Jp.) 68/[2000] 108 Taxman 83 (Mag.).

50. Where on temporary closure of its business, the assessee incurs expenses on payment of gratuity, etc., to retrenched workers, such expenses are allowable as revenue expenditure—*CIT* v. *Master Stores* [2002] 75 TTJ (Cal.) 452.

51. Merely because sales during the year in question had come down compared with sales in earlier years, it cannot be reason for disallowing a part of remuneration paid by the assessee to his sons—*Onkar Nath Gupta* v. *ITO* [2002] 74 TTJ (Agra) 426.

52. Payments to workers due to closure of 4 out of 10 units in indivisible business are to be allowed as deduction under section 37—*K. Ravindranathan Nair* v. *CIT* [2001] 114 Taxman 53/247 ITR 178 (SC).

53. Provision made by the assessee for contribution towards the provident fund maintained by the Government of Tamil Nadu on account of Government employees sent on deputation to the assessee-corporation, is an allowable deduction in computing its income—***CIT* v. *Kattabomman Transport Corpn. Ltd.*** [2004] 268 ITR 507 (Mad.).

54. Foreign study expenses incurred by a company in respect of an employee cannot be disallowed simply because employee happens to be relative of a director. In the instant case, X was not only the daughter of one of the directors of the assessee-company but also an employee of the assessee-company. The assessee-company is on a better footing in the instant case. Not only that, X, on returning to India, continued to work for the assessee in compliance of the agreement she had entered into with it before leaving India. She has been further made as a director of the assessee-company. Therefore, the relation of X with one of the directors of the assessee-company as such need not disqualify her from being sent abroad for higher studies by the assessee-company—***J.B. Advani & Co. Ltd.*** v. ***CIT*** [2005] 1 SOT 830 (Mum.).

55. Where the assessee, a cine artist by profession, incurs certain expenditure towards medical treatment of wife of one X, who is a regular and *bona fide* employee of the assessee and who was otherwise unable to meet such an expenditure with his limited resources (even in absence of a contractual obligation on the assessee's part to incur the said expenditure), reimbursement of medical expenses incurred by the assessee's employee on his family member is allowable as deduction—***Ajay Singh Deol*** v. ***CIT*** [2004] 91 ITD 196 (Mum.).

56. Village welfare expenses incurred by the assessee towards the general village welfare in the vicinity of plant are allowable—***Gujarat Ambuja Cements Ltd.*** v. ***CIT*** [2005] 4 SOT 59 (Mum.).

57. Payment on account of membership fees for health club and also fees paid to another club for taking membership in the name of the corporate entity is allowable as business expenditure—***Sterlite Industries (India) Ltd.*** v. ***CIT*** [2006] 6 SOT 498 (Mum.).

58. Where giving bakshish by sugar factories to workers employed by harvesting and transport contractors had been a practice prevailing in State of Maharashtra for decades and such expenditure had been consistently allowed in the past not only in the case of assessee but also in the case of several other sugar factories, as these labourers were skilled workers and payment was for business purposes, bakshish so paid to them could not be disallowed—***CIT*** v. ***Samarth Sahakari Sakhar Karkhana Ltd.*** [2007] 294 ITR 540 (Bom.).

59. Where assessee-company incurred expenditure on installation of traffic signal near its office as its employees got struck in traffic jam repeatedly and got late for work, and handed over traffic lights to Traffic Police, expenditure so incurred was allowable—***Infosys Technologies Ltd.*** v. ***CIT*** [2007] 109 TTJ (Bang.) 631

■ *Examples of non-deductible expenses* - The following are held as non-deductible—

1. Where, after taking over of running business from a firm, a company pays in the first year itself work incentives to some members of the staff, and such incentives are disproportionately high when compared to the salaries paid to those members, and there is no scheme for making such payments and no such payments are made by the predecessor-firm, the Tribunal is justified in disallowing the amount paid as work incentives, as has not been expended wholly and exclusively for the purpose of the business of the company—*Jaipur Electro (P.) Ltd.* v. *CIT* [1997] 223 ITR 535 (Raj.).

2. Where there is no evidence that an alleged employee has rendered any services to the assessee, salary paid to him is not deductible—*Punjab Produce & Trading Co. Ltd.* v. *CIT* [1986] 159 ITR 376 (Cal.), *CIT* v. *Govindram Bros. (P.) Ltd.* [1983] 141 ITR 777 (Bom.), *Bally Jute Co. Ltd.* v. *CIT* [1986] 158 ITR 736 (Cal.).

3. Where in respect of two persons, who are the sole shareholders as well as sole directors of a private limited company, the company fixed two-thirds of profit as their remuneration, the remuneration paid is unreasonable—*Aspro Ltd.* v. *Commissioner of Taxes* [1936] 4 ITR 264 (PC).

4. Where A and his relative are holding half of the assessee-company's share capital and A is appointed as technical adviser even though he is not a trained personnel and is a doctor by profession, remuneration paid to him is disallowable—*Bengal Enamel Works Ltd.* v. *CIT* [1970] 77 ITR 119 (SC).

5. Expenditure incurred on by-pass surgery of a part-time advisor of the assessee-company, which had no link with salary or benefit of such advisor, would not be allowable as deduction—*CIT* v. *Tian House Service Ltd.* [2000] 109 Taxman 82/243 ITR 695 (Mad.).

6. Reserve in balance sheet to meet future holiday wages payable to workers under Factories Act, and retrenchment compensation payable under Industrial Disputes Act, are not allowable—*Chhaganlal Textile Mills (P.) Ltd.* v. *CIT* [1966] 62 ITR 274 (MP).

7. Payment for past services made on closure of business is not deductible—*J.K. Cotton Mfrs.* v. *CIT* [1952] 21 ITR 129 (All.).

8. Deduction of gratuity claims, whether by way of provision or otherwise, must be regulated only under section 40A(7) and section 37(1) will not apply—*Shree Sajjan Mills Ltd.* v. *CIT* [1985] 156 ITR 585 (SC).

9. Where loans advanced to the employees for construction of houses are written off by the assessee by debit to staff welfare account, loans so written off are not deductible—*Palani Andavar Mills Ltd.* v. *CIT* [1977] 110 ITR 742 (Mad.).

10. Where liability to pay retrenchment compensation arose only out of decision taken to close down business of company and not to keep alive its business activities, the expenditure cannot be regarded as the one incurred for the purpose of business—*P.N. Ganesan (P.) Ltd.* v. *CIT* [1990] 52 Taxman 461/[1992] 196 ITR 455 (Mad.). Retrenchment compensation payable at closure of business is not allowable as business expenditure—*M. Seshadri Iyengar & Sons* v. *CIT* [1985] 152 ITR 734 (Mad.).

11. Expenditure on construction of dam to ensure safety of workers is capital in nature—*CIT* v. *North Dhemo Coal Co. Ltd.* [1977] 106 ITR 592 (Cal.).

12. Pension paid by the assessee-company to the widow of holder of practically all its shares, who is also its managing director, is not allowable as deduction—*CIT* v. *Amalgamations Ltd.* [1995] 214 ITR 399 (Mad.).

13. Entertainment allowance paid to a director who is found to have done nothing to promote sales of the assessee is not allowable—*J. K. Agents (P.) Ltd.* v. *CIT* [1983] 142 ITR 126 (MP).

14. Liability arising from failure to deduct tax at source from salary of an employee, is not deductible—*Flour & Food Ltd.* v. *CIT* [1983] 140 ITR 648 (MP).

15. If increase in remuneration of employees is not justified by business considerations, it is not deductible—*Hotz Trust* v. *CIT* [1952] 21 ITR 149 (Punj.).

16. Increase of remuneration of a director of the assessee-company which is not shown to be due to business expediency, is not to be allowed as business expenditure—*J. R. Patel & Sons (P.) Ltd.* v. *CIT* [1964] 51 ITR 717 (Guj.).

17. Where as per agreement between the assessee-investment company's subsidiary companies and the directors of assessee-company, who are also directors of subsidiaries, and also other directors of subsidiaries, who are not the directors of the assessee-company, are entitled to remuneration and certain percentage of profits as commission but as subsidiaries cannot pay the entire remuneration in view of ceiling under provisions of section 198 of the Companies Act, 1956, the unpaid portion is paid by the assessee-company, the remuneration so paid by the assessee-company cannot be allowed as business expenditure—*CIT* v. *Amalgamations (P.) Ltd.* [1997] 92 Taxman 132/226 ITR 188 (SC).

18. Pension paid to wife of the departed Chairman of company as a mark of respect and not on commercial consideration will not be allowable as business expenditure—*Amalgamations Ltd.* v. *CIT* [1998] Tax LR 617 (Mad.).

19. Expenditure incurred on education of son of a director abroad cannot be treated as business expenditure merely because son subsequently takes part in business—***CIT*** v. ***R.K.K.R. Steels (P.) Ltd.*** [2003] 131 Taxman 830 (Mad.).

20. Expenditure incurred on education of relative of director who was not in assessee-company's employment, was not allowable—***Enkay (India) Rubber Co. (P.) Ltd.*** v. ***CIT*** [2003] 185 CTR (Delhi) 526.

21. Expenditure incurred for defending an employee from criminal proceeding/prosecution for activities which are violative of or in contravention of the provisions of law, is not allowable—***I.C.B. Ltd.*** v. ***ITO*** [2005] 93 ITD 418 (Mum.).

141.8-13 INTEREST† - It covers interest other than interest on borrowed capital covered by section 36(1)(*iii*).

■ *General rule* - Interest paid need not be a revenue outgoing—*Bombay Steam Navigation Co. (1953) (P.) Ltd.* v. *CIT* [1965] 56 ITR 52 (SC). If the principal is a permissible deduction, interest payable thereon would also be a permissible deduction—*Kamlapat Motilal* v. *CIT* [1976] 104 ITR 783 (All.). Where the borrowed fund has been utilised for non-business purposes, interest paid on it is to be disallowed—*CIT* v. *India Silk House* [1985] 152 ITR 79 (Mad.), *CIT* v. *Navbharat Enterprises (P.) Ltd.* [1999] 103 Taxman 36/238 ITR 754 (AP), *CIT* v. *Hindustan Conductors Pvt. Ltd.* [1999] 240 ITR 762 (Bom.).

■ *Examples of deductible expenditure* - The following are held as deductible—

1. Interest paid for delayed payment of tax (like UP sugarcane purchase tax, municipal tax) sales tax, a delayed payment of provident fund is an allowable deduction—*Balrampur Sugar Co. Ltd.* v. *CIT* [1982] 135 ITR 227 (Cal.), *Triveni Engg. Works Ltd.* v. *CIT* [1987] 167 ITR 742 (All.), *Russal Properties (P.) Ltd.* v. *CIT* [1981] 7 Taxman 187 (Cal.), *Mahalaxmi Sugar Mills Co.* v. *CIT* [1980] 123 ITR 429 (SC), *CIT* v. *Western Indian State Motors* [1988] 174 ITR 116 (Raj.), *Lachmandas Mohuradas* v. *CIT* [2002] 254 ITR 799 (SC).

2. Excess interest refunded to Income-tax Department (when excess interest, received by the assessee under section 214 which is taxed as his income in the year of receipt, is refunded to department, it is allowable as deduction in the year in which it is so refunded is deductible) is deductible—*CIT* v. *Syndicate Bank* [1986] 26 Taxman 546 (Kar.).

3. Interest paid on money taken against fixed deposits for paying estate duty is deductible—*CIT* v. *Amalgamations Ltd.* [1998] 232 ITR 608 (Mad.). Similarly, interest paid by the assessee-company on any borrowing for the purpose of discharging estate duty liability of the deceased who had controlling interest in company is deductible—*CIT* v. *Amalgamations Ltd.* [1995] 214 ITR 399 (Mad.).

4. Interest paid on outstanding balance of purchase consideration is deductible—*Bombay Steam Navigation Co. (1953) (P.) Ltd.* v. *CIT* [1965] 56 ITR 52 (SC), *Rahim Khatoon* v. *CIT* [1987] 167 ITR 697 (AP).

5. Expenditure on interest paid/payable on the unpaid purchase price of plant and machinery is deductible—Circular Letter F.No. 10/92/64-IT (A-I), dated September 13, 1965.

6. Interest on unpaid cost price of land and bank guarantee commission paid by the assessee (where the assessee acquires forest land in order to obtain regular supply of raw materials and later the State has nationalised the said land and not paid any compensation) is deductible—*CIT* v. *Gwalior Rayon Silk Mfg. (Wvg.) Co. Ltd.* [1999] 102 Taxman 433/237 ITR 253 (Bom.).

7. Interest paid by the assessee-dealer in liquor for delayed payment of instalment due to Government under a contract is deductible—*CIT* v. *K. Natarajan* [1990] 185 ITR 352 (Ker.), *CIT* v. *T.M. Chacko & Partners* [1978] 115 ITR 40 (Ker.).

8. Interest on deferred payment for purchase of machinery is allowable as a revenue expenditure—*CIT* v. *Sivakami Mills Ltd.* [1997] 227 ITR 465/95 Taxman 73 (SC).

9. Amount paid by way of interest on loans taken by the assessee from banks in order to pay off a part of loss is allowable—*Seth Banarsi Das Gupta* v. *CIT* [1977] 106 ITR 559 (All.).

10. Mere fact that business has changed hands will not disentitle the assessee to claim deduction of interest on borrowal—*CIT* v. *Naresh Chandra Bhargava* [1974] 97 ITR 572 (All.).

11. If there is an actual liability *in praesenti* to pay interest, deduction cannot be denied on the ground that the assessee was disputing the liability—*CIT* v. *Kesar Sugar Works Ltd.* [1999] 107 Taxman 226/239 ITR 398 (Bom.).

12. Interest payable by the assessee-corporation on compensation due to owners of transport undertaking which has been nationalised and vested in the assessee, is an allowable deduction—*CIT* v. *Cheran Transport (P.) Ltd.* [1986] 160 ITR 630 (Mad.).

13. Expenses incurred on borrowals for setting up a new factory, interconnected with existing business, is allowable—*Prem Spg. & Wvg. Mills Co. Ltd.* v. *CIT* [1975] 98 ITR 20 (All.).

14. Interest paid on money borrowed for expansion of existing business is deductible—*Ansal Properties & Industries (P.) Ltd.* v. *ITO* [1990] 37 TTJ (Delhi) 213.

15. Merely because a part of business had been closed while remaining business was carried on, interest paid on the amount borrowed for the entire business prior to part closure, cannot be disallowed—*ITO* v. *Ashakuty Coal Co. Ltd.* [1989] 33 TTJ (Cal.) 130.

†Interest on refund from Income-tax Department is taxable under the head 'Income from other sources'.

16. Interest on capital borrowed and invested in tax-free securities is allowable—*CIT* v. *Indian Bank Ltd.* [1965] 56 ITR 77 (SC).

17. Interest incurred by the assessee-partner for raising loan for business purposes of firm, is an allowable item of expenditure in computing the income of the assessee—*N. Sundareswaran* v. *CIT* [1969] 72 ITR 219 (Ker.), *CIT* v. *Gaya Prasad Khemani* [1992] 196 ITR 389 (Gauhati).

18. Where a partner effect a gift out of his capital account through book entries in the books of the firm, from the mere fact that there is no cash balance it cannot be held that the gift is invalid when there is no allegation that the gift is a sham and therefore, interest paid on such gifted amount by the firm is to be allowed—*Naunihal Thakar Das* v. *CIT* [1970] 77 ITR 332 (Punj. & Har.).

19. Interest paid by a firm in connection with liability taken over from the predecessor firm is deductible—*CIT* v. *N.D. Radha Kishan & Co.* [1983] 140 ITR 860 (Punj. & Har.).

20. Interest on loan taken to purchase plant and machinery is deductible if it pertains to the period after the plant and machinery is put to use.

■ *Instances of non-deductible expenses* - The following are held as non-deductible—

1. Interest paid under any provision of Income-tax Act, Wealth-tax Act or provision regulating fringe benefit tax for late payment or short payment of regular tax, advance tax, self-assessment tax, tax deductible at source, etc., is not deductible—*CIT* v. *Ashoka Mills Ltd.* [1996] 88 Taxman 184/218 ITR 526 (Guj.), *CIT* v. *Raipur Manufacturing Co. Ltd.* [1996] 135 CTR (Guj.) 248, *Saraspur Mills Ltd.* v. *CIT* [1997] 226 ITR 533 (Guj.). *Bharat Commerce & Industries Ltd.* v. *CIT* [1998] 230 ITR 733 (SC), *Federal Bank Ltd.* v. *CIT* [1989] 46 Taxman 271/180 ITR 37 (Ker.), *CIT* v. *Sunil & Co.* [1995] 127 CTR (Raj.) 244, *Orient General Industries Ltd.* v. *CIT* [1994] 209 ITR 490 (Cal.), *Bharat Commerce & Industries Ltd.* v. *CIT* [1998] 230 ITR 733 (SC).

2. The interest that is paid by the assessee on any sum borrowed by him for payment of income-tax (or interest on overdraft taken for payment of income-tax) is not deductible from his net income—*Mannalal Ratanlal* v. *CIT* [1965] 58 ITR 84 (Cal.), *East India Pharmaceutical Works Ltd.* v. *CIT* [1997] 91 Taxman 185/224 ITR 627 (SC). Interest paid by the assessee to department for allowing it to make payment of its taxes in instalments is not an allowable deduction under section 37(1)—*CIT* v. *Ghatkopar Estate & Finance Corpn. (P.) Ltd.* [1989] 42 Taxman 179/177 ITR 222 (Bom.). Where the assessee declared income under the Voluntary Disclosure Scheme and tax is paid in instalments with interest, interest paid is not deductible as business expenditure or as interest on borrowed capital—*Bharat Commerce & Industries Ltd.* v. *CIT* [1998] 230 ITR 733 (SC).

3. Payment of betterment charges is capital expenditure. Therefore, payment of interest on annual instalments of the betterment charges will have to be regarded as capital expenditure, because it has no direct nexus with the day-to-day running of the business of the assessee—*CIT* v. *Ahmedabad Mfg. & Calico Printing Co. Ltd.* [1995] 215 ITR 735 (Guj.).

4. Interest paid by an assessee on amounts received by it for sale of investments, after the transaction fell through, is not a business expenditure—*CIT* v. *Sundaram Fasteners Ltd.* [1984] 149 ITR 773 (Mad.).

5. Where the assessee-company, engaged in processing and exporting tobacco, took loans for developing certain land and on a part of the said land, tobacco seedlings are raised and upon the remaining land different crops like cotton, banana, etc., are raised, the assessee's claim for deduction of interest on loans can be allowed only in proportion to the amount spent on tobacco raising operations and not the entire interest amount—*CIT* v. *Navabharat Enterprises (P.) Ltd.* [1987] 165 ITR 603 (AP).

6. Where interest is paid to a trust whose juristic identity is under dispute, the claim for deduction is not allowable—*CIT* v. *B.P. Mines (P.) Ltd.* [1987] 168 ITR 246 (Ori.).

7. Gift by a partner out of his capital account is not valid and interest paid on such gifted amount is not admissible—*New India Colour Co.* v. *CIT* [1971] 80 ITR 206 (Delhi).

8. Deduction of interest paid on the money advanced to the directors of the assessee-company or firms in which they are substantially interested, is to be disallowed—*Saraya Sugar Mills (P.) Ltd.* v. *CIT* [1993] 201 ITR 711 (All.).

9. Interest paid by a trader on borrowings made to construct factory for manufacturing activities is not allowable as revenue expenditure—*Rainbow Dyestuff Ltd.* v. *CIT* [1995] 79 Taxman 31/213 ITR 560 (Guj.).

10. Interest liability of sister concern taken over by the assessee-firm is not allowable—*Premier Colonisers* v. *CIT* [1981] 132 ITR 514 (All.).

11. Interest paid on instalments of price of property purchased for business is not in all cases allowable—*CIT* v. *Sandesh Ltd.* [1965] 56 ITR 399 (Guj.).

12. Where the assessee-company made large borrowings from bank for investment on a new project, which is not interconnected with existing business, the interest on the said borrowing is not allowable—*Dey's Medical Stores Mfg. (P.) Ltd.* v. *CIT* [1986] 162 ITR 630 (Cal.).

13. Interest paid on loans borrowed for purchase of machinery and plant pertraining to the period till plant and machinery is put to use can be capitalised—*Sivakami Mills Ltd.* v. *CIT* [1979] 120 ITR 211 (Mad.).

14. If any payment is made for extra commercial consideration in the garb of interest, such payment cannot be allowed as deduction—*CIT* v. *Hindustan Conductors Pvt. Ltd.* [1999] 240 ITR 762 (Bom.).

15. Interest on loan taken to meet personal expenses is not deductible—*CIT* v. *Om Parkash Behl* [1981] 132 ITR 342 (Punj. & Har.).

141.8-14 COMPENSATION/DAMAGES - It covers compensation and damages.

■ *General rule* - If payment is for the purpose of business, it is generally allowed as deduction even if the payment of damages increases profits and reduces future expenses.

Expenditure incurred in order to remove the possibility of recurring disadvantage is an allowable deduction - *CIT* v. *Health & Co. (Calcutta) (P.) Ltd.* [1978] 114 ITR 605 (Cal.).

Damages paid by the assessee as a trader are allowable as deduction. However, where damages are paid by the assessee not as a trader or businessman but in some other capacity, such damages will not be allowed as business expenditure—*Annamalai Timber Trust Ltd.* v. *CIT* [1963] 47 ITR 814 (Ker.), *Pioneer Consolidated Co. of India Ltd.* v. *CIT* [1972] 85 ITR 410 (All.). For instance, damages paid due to negligence of the employee of the assessee is allowable as deduction.

Where the assessee is following the mercantile system of accounting, it would be entitled to deduction of liability to pay compensation in the year in which the liability is created in its books—*CIT* v. *Todi Tea Co. Ltd.* [1999] 105 Taxman 697/239 ITR 28 (Cal.), *CIT* v. *Kerala Transport Company* [1999] 239 ITR 183 (Ker.). However, where the assessee had clearly disputed its liability to pay liquidated damages for delay in supplying goods and there was no determination of damages payable by it by any adjudicatory forum nor had the assessee given up or waived its stand that it was not liable to payment of damages, such a liability could not be regarded as an accrued liability—*CIT* v. *Seshasayee Industries Ltd.* [1999] 156 CTR (Mad.) 452.

■ *Example of deductible expenses* - The following are held as deductible—

1. Damages for breach of contract for export of goods before declaration of export policy of the Government are deductible—*Hind Mercantile Corpn. Ltd.* v. *CIT* [1963] 49 ITR 23 (Mad.).

2. Compensation payable by the assessee-firm which has entered into certain export contracts but was enable to execute contracts due to high export duty levied by the Government is deductible—*CIT* v. *Sohanlal Kanwar & Sons* [1987] 164 ITR 129 (Raj.).

3. Damages paid to a worker in order to dismiss him in the interest of business are deductible—*Noble Ltd.* v. *Mitchel* [1926] 11 TC 372 (CA).

4. Compensation payable to an employee for loss of right of private business/practice is deductible—*Champion Engg. Works Ltd.* v. *CIT* [1971] 81 ITR 273 (Bom.).

5. Damages paid by a transport company to a person injured in an accident in unavoidable circumstances are deductible—*Renfrew Town Council* v. *IRC* [1934] 19 TC 13.

6. Compensation paid by the assessee for breach of contract would be allowable as deduction—*CIT* v. *Todi Tea Co. Ltd.* [1999] 105 Taxman 697/239 ITR 28 (Cal.). However, if compensation is paid for breach of contract to purchase a capital asset, it will not be allowed as deduction—*Swadeshi Cotton Mills Co. Ltd.* v. *CIT (No. 2)* [1967] 63 ITR 65 (SC).

7. Damages for failure to fulfil the contract in time are deductible—*Central Trading Agency* v. *CIT* [1965] 56 ITR 561 (All.).

8. Damages paid on account of breach of warranty are deductible—*CIT* v. *Prafulla Kumar Mallick* [1969] 73 ITR 119 (Ori.).

9. Damages on termination of agreement prematurely are deductible—*CIT* v. *J&S.P. Ltd.* [1984] 149 ITR 581 (Delhi).

10. Compensatory portion of damages payable under section 14B of Employees' Provident Funds Act (such damages are penal as well as compensatory in nature and only compensatory portion of damages paid under

the said section would be allowable as deduction)—*Standard Chemical Co. (P.) Ltd.* v. *CIT* [1998] 229 ITR 193 (All.), *CIT* v. *Simco Meters Ltd.* [1997] 142 CTR (Mad.) 456, *CIT* v. *Jam Manufacturing Co. Ltd.* [1999] 107 Taxman 573/240 ITR 167 (Bom.).

11. Where payment for termination of sole distributionship is made not for purposes of bringing into existence any asset or advantage but to get rid of a commercially disadvantageous business agreement, the payment is an allowable deduction under section 37(1)—*CIT* v. *Motor Industries Co. Ltd.* [1997] 93 Taxman 157/223 ITR 112 (Kar.).

12. Compensation paid to sole selling agents on termination of agency in accordance with the provisions of the Companies Act, 1956 is an allowable deduction—*CIT* v. *Sales Magnesite (P.) Ltd.* [1995] 214 ITR 1/81 Taxman 334 (Bom.).

13. Where there is only one other partner who retires and the assessee in a partnership firm and the other partner pays compensation to him ostensibly for use of his assets in business, the same will be allowed as deduction—*CIT* v. *Delhi Printing Works* [1981] 132 ITR 554 (Delhi).

14. Payment made for getting premises vacated (where the assessee-company engaged in business of letting out premises, paid a sum to a party to get vacant possession of its premises which it let out to another party subsequently on higher rent) is deductible—*CIT* v. *Auto Distributors Ltd.* [1994] 210 ITR 222 (Cal.).

15. Compensation paid by the assessee, a manufacturer of rayon yarn, to weavers for non-supply of rayon at concessional rate is allowable as deduction—*South India Viscoses Ltd.* v. *CIT* [1982] 135 ITR 206 (Mad.), *CIT* v. *Rajaram Bandekar* [1994] 208 ITR 503/76 Taxman 156 (Bom.).

16. Where on transfer of seat of management of the assessee-company, compensation is paid for its directors in UK, such payment is an allowable expenditure—*Indian Copper Corpn. Ltd.* v. *CIT* [1960] 38 ITR 544 (Pat.).

17. Compensation paid to outgoing directors, who were not found desirable in the interests of the assessee-company is deductible—*CIT* v. *Superintendence & Co. of India (P.) Ltd.* [1980] 125 ITR 327 (Cal.).

18. Amount paid by the assessee to its general manager for premature termination of his employment consequent on the transfer of its banking business to another bank is deductible—*CIT* v. *Bharat Nidhi Ltd.* [1966] 60 ITR 520 (Punj.).

19. Compensatory payment made by assessee to Government as per Government directions to help people affected by the assessee's polluting industrial unit, is allowable as deduction—***CIT*** v. ***Deversons Industries Ltd.*** [2007] 104 ITD 171 (Ahd.).

20. Where assessee closed one of three units and closed unit was part of the same business activity, compensation paid at time of closure of unit is an allowable expenditure—***CIT*** v. ***Medley Pharmaceuticals Ltd.*** [2007] 109 TTJ (Mum.) 328

▪ *Examples of non-deductible expenses* - The following are held as non-deductible—

1. As opined by the Supreme Court in *Organo Chemical Industries* v. *Union of India* AIR 1979 SC 1803, the damages imposed by section 14B of the Employees Provident and Miscellaneous Provisions Act include a punitive sum quantified according to the circumstances of the case and the levy under this provision is penal in nature and also to act as a deterrent. Therefore, damages so paid cannot be allowed as deduction under section 37(1)—*Rohtak Textiles Mills Ltd.* v. *CIT* [1997] 226 ITR 485 (Delhi). Where, due to delayed payment of provident fund contributions necessitated by financial stringency, the assessee had to pay damages levied by the concerned authorities, the payment was as a result of infraction of law and is hence not deductible—*CIT* v. *Bharath Plywood & Timber Products (P.) Ltd.* [1997] 137 CTR (Ker.) 520.

2. Where compensation is paid for breach of contract to purchase capital assets, the payment of compensation is on capital account—*Swadeshi Cotton Mills Co. Ltd.* v. *CIT* (No. 2) [1967] 63 ITR 65 (SC), *Dalmia Dadri Cement Ltd.* v. *CIT* [1973] 90 ITR 297 (Punj. & Har.).

3. Where compensation paid to retiring directors is not made in terms of a contract or under compulsion of statute or as an inducement to resign, compensation so paid is not deductible—*Travancore Tea Estates Co. Ltd.* v. *CIT* [1985] 154 ITR 745 (Ker.).

4. Compensation and notice pay paid by the assessee-company to its workers on closure of its manufacturing unit pursuant to award of Industrial Tribunal under section 25FFF of Industrial Disputes Act, 1947, could not be said to be expenditure incurred for carrying on business or laid down wholly or exclusively for purpose of business and, hence, would not be allowable as revenue expenditure—*Coimbatore Premier Corpn. (P.) Ltd.* v. *CIT* [1999] 103 Taxman 539 (Mad.).

141.8-15 COMMISSION - It covers commission. In case of commission payable to employees, one must ensure that the conditions of section 43B are satisfied—

■ *General rule* - Commission payable for business purposes is deductible. However, the mere existence of an agreement to pay commission does not bind the Assessing Officer to allow the deduction—*Lachminaryan Madan Lal* v. *CIT* [1972] 86 ITR 439 (SC). Therefore, payment of commission on account of extra commercial consideration where recipient of commission has no extra technical qualification is to be disallowed—*Anand Jyoti Printers (P.) Ltd.* v. *CIT* [1987] 165 ITR 771 (MP), *Indian Press Exchange Ltd.* v. *CIT* [1982] 138 ITR 594 (Cal.). If commission is paid not in connection with any work done by the payee for the assessee, expenditure is not deductible—*Vijayakumar Mills Ltd.* v. *CIT* [1963] 50 ITR 332 (Mad.). But, where commission is paid in the course of business on one of the many transactions for a short period, it is a revenue expenditure—*CIT* v. *P.V. Rangaiah Sons & Co.* [1973] 88 ITR 42 (AP).

■ *Examples of deductible expenditure* - The following are held as deductible—

1. Guarantee commission paid to brokers, shareholders managing directors for giving personal guarantee to obtain a credit facility is deductible—*L.H. Sugar Factories & Oil Mills (P.) Ltd.* v. *CIT* [1979] 118 ITR 985 (All.).

2. Guarantee commission paid by the assessee for securing guarantee on the strength of which it can purchase relevant capital assets on payment by instalments is not an expenditure in the nature of capital expenditure. Guarantee commission given to the bank is revenue expenditure irrespective of the nature of expenditure—*CIT* v. *Madras Cement Ltd.* [2002] 254 ITR 423 (Mad.). Guarantee commission to bankers for guaranteeing the instalments payable on account of import of plant is deductible—*Sivakami Mills Ltd.* v. *CIT* [1979] 120 ITR 211 (Mad.).

3. Guarantee commission paid for giving a guarantee to Commercial Taxes department for obtaining stay of disputed sales tax is deductible—*CIT* v. *Rukmani Mills Ltd.* [1982] 133 ITR 154 (Mad.).

4. Commission paid to agent for undertaking responsibility for payment and standing guarantee for the other customers of the assessee is an allowable deduction—*J.K. Steel & Industries Ltd.* v. *CIT* [1978] 112 ITR 285 (Cal.).

5. Commission paid at a percentage of profits to general manager is deductible—*J.K. Woollen Mfrs.* v. *CIT* [1969] 72 ITR 612 (SC).

6. Commission paid to selling agents is deductible—*Madura Knitting Co.* v. *CIT* [1956] 30 ITR 764 (Mad.), *CIT* v. *Swadeshi Mining & Mfg. Co. Ltd.* [1979] 118 ITR 975 (Cal.).

7. Where selling agents have undertaken obligations like responsibility for all payments for sales and fulfilment of contractual obligations by customers even in respect of sales not made through them, commission paid to them on all sales whether made through them or not is deductible—*Aluminium Corpn. of India Ltd.* v. *CIT* [1972] 86 ITR 11 (SC).

8. Commission paid at a higher rate in order to attract first customer in a new region is deductible—*CIT* v. *Bharat Collieries Ltd.* [1968] 68 ITR 42 (Pat.).

9. Payment of commission to transferor of business for letting the assessee-transferee to execute unfinished contracts is a revenue expenditure—*CIT* v. *Desmet (India) (P.) Ltd.* [1982] 138 ITR 382 (Bom.).

10. Commission paid by the assessee to employees on net profits is deductible out of profits actually distributed and not out of profits estimated by the Assessing Officer—*Hanuman Glass Works* v. *CIT* [1962] 46 ITR 268 (All.), *L. Sheo Narain Lal, In re* [1954] 26 ITR 249 (All.).

11. Commission paid for procuring contracts is business expenditure—*CIT* v. *Hewitt Robins (New York)* [1983] 141 ITR 278 (Cal.).

12. Commission paid to person for negotiating in respect of sale of machinery with buyer is allowable—*Swastic Textile Co. (P.) Ltd.* v. *CIT* [1984] 150 ITR 155 (Guj.).

13. Where the Tribunal took notice of trade practice of payment of secret commission to parties and then allowed deduction to the assessee even though the assessee could produce neither receipt for payment of secret commission and brokerage nor name and address of payees concerned to enable verification of payment by the Assessing Officer, the Tribunal was justified in allowing the deduction—*CIT* v. *A.S.K. Rathinasamy Nadar* [1994] 75 Taxman 638/[1995] 212 ITR 527 (Mad.).

14. Commission paid for exploiting colliery is allowable—*CIT* v. *Kolhia Hirdagarh Co. Ltd.* [1949] 17 ITR 545 (Bom.).

■ *Examples of non-deductible expenses* - The following are held as non-deductible—

1. Commission paid on shares borrowed for pledging them as security against income-tax demands is not allowable—*CIT* v. *Dalmia Dadri Cement Ltd.* [1980] 125 ITR 510 (Delhi).

2. Where the assessee-company purchased a going concern with all its assets and liabilities, including pending contracts subject to payment of commission to the seller on all pending contracts, the commission so paid is not allowable—*Western Mechanical Industries (P.) Ltd.* v. *CIT* [1977] 110 ITR 703 (Bom.).

3. Where the Tribunal had found as a fact that the assessee had failed to establish that the secret commission is expended by it for the purpose indicated by it, commission is not allowable—*Fresh Dyes and Chemicals (I) (P.) Ltd.* v. *CIT* [1993] 201 ITR 253/71 Taxman 165 (SC).

4. Commission paid to a sole selling agent where the agency is found to be not genuine is not to be allowed—*Precision Instrument Mfg. Co.* v. *CIT* [1982] 137 ITR 5 (Delhi).

5. Commission payable to banks for furnishing guarantees regarding deferred payments for import of plant and machinery is in the nature of a capital expenditure and cannot be allowed as deduction in computing the total income under the Income-tax Act. The Board have, however, no objection to permit such expenditure to be added to the cost of the plant and machinery and to allow depreciation thereon at the usual prescribed rates—*Letter : F. No. 7/33/62-IT(A-I), dated August 28, 1963.*

141.8-16 *TECHNICAL KNOW-HOW* - Capital expenditure on acquiring technical know-how is deductible according to the provisions of section 35AB or 32. The discussion given below is applicable if such expenditure is not covered by sections 35AB and 32.

■ *General rule* - Where the assessee claimed deduction of royalty paid under a technical know-how agreement as revenue expenditure and the Tribunal and the High Court, after analysing the technical know-how agreement had concluded that the assessee set up a new business and the foreign company not only furnished the technical know-how to manufacture products but also rendered valuable service in setting up factory itself and as such the assessee acquired enduring benefit, disallowance of part of royalty paid for the same as capital expenditure is justified even though the payment is required to be made on a certain percentage rate of gross turnover.

The question as to whether a particular payment made by an assessee under the terms of the agreement forms a part of the capital expenditure or revenue expenditure would depend upon several factors, namely,whether the assessee has obtained a completely new plan with a complete new process and completely new technology for manufacture of the product or the payment is made for the technical know-how which is for the betterment of the product in question which is already being produced; whether the improvisation made is the part and parcel of the existing business or a new business is set up with the so-called technical know-how for which payments are made, whether on expiry of the period of agreement, the assessee is required to give back the plans and designs which are obtained, though the assessee can manufacture the product in the factory that has been set up with the collaboration of the foreign firm; the cumulative effect on a construction of the various terms and conditions of the agreement : whether the assessee derives benefits coming to its capital for which the payment is made—*Jonas Woodhead & Sons (India) Ltd.* v. *CIT* [1997] 91 Taxman 1/224 ITR 342 (SC).

The Delhi High Court in ***Shriram Pistons & Rings Ltd.* v. *CIT*** [2008] 171 Taxman 81 held that technical know-how payments would be revenue in nature, unless there is absolute transfer of any right therein so that:

a. the licensee has a unhindered/free hand to sub-license with no prior permission of the licensor;

b. the licensee is not obliged to treat the same as confidential;

c. the agreement does not provide for any exit clause.

To say so in many words, the Court held that in case the assessee's rights were hedged in with all sorts of conditions, then that would clearly make it a case of right to use the technology and not sale of the technical know-how, no matter the kind of nomenclature used in the agreement.

Where under an agreement for supply of technical know-how foreign company has not sold any information, process or invention to the assessee Indian company and no advantage of enduring nature has been obtained by Indian company, the amount paid by the Indian company under collaboration agreement is revenue expenditure—*CIT* v. *Indian Oxygen Ltd.* [1996] 218 ITR 337 (SC).

▪ *Year in which deductible* - Where collaboration agreement under which royalty payable by the assessee-company is subject to approval by the Government of India, royalty payable would accrue only in the year in which such approval is granted and not in the year in which the agreement was entered into—*CIT* v. *John Fowler (India) Ltd.* [1999] 105 Taxman 447/239 ITR 312 (Bom.).

▪ *Examples of deductible expenditure* - The following are held as deductible—

1. Expenditure on the mere use of technical knowledge and information for the running of the business during the period of agreement or the user of patents or trade marks is deductible—*CIT* v. *Steel Plant (P.) Ltd.* [1984] 149 ITR 294 (Bom.), *Electro Medicals* v. *CIT* [1987] 163 ITR 807 (MP), *CIT* v. *Associated Electrical Industries (India) (P.) Ltd.* [1975] 101 ITR 844 (Cal.).

2. Where the assessee-company, engaged in the business of manufacturing certain products entered into 5 years continuing technical collaboration agreement with a foreign company with a view to improving its products, and payment is made in five equal instalments, only instalment so paid under relevant year is deductible—*Veljan Hydrair (P.) Ltd.* v. *CIT* [1988] 38 Taxman 111 (AP).

3. Expenditure on acquiring non-exclusive and non-transferable right to use technical information (where a company incurred certain expenditure to obtain benefit of research and development made by the foreign collaborating company and the technical information given to the Indian company was non-exclusive and non-transferable, it was not a case of out and out-sale of technical know-how. The assessee-company was merely given a non-exclusive and non-transferable right to use technical information) is deductible—*CIT* v. *Wavin (India) Ltd.* [1999] 236 ITR 314 (SC).

4. Expenditure to get right to use licence for limited period (where the assessee-company, manufacturing tyres, entered into an agreement with a foreign company for technical know-how for manufacture of radial tyres and the assessee got the right to use the licence for a fixed period of 8 years) is deductible—*Goodyear India Ltd.* v. *ITO* [2000] 73 ITD 189/68 TTJ (Delhi) (TM) 300.

5. Expenditure incurred for the acquisition of technical know-how for better production of the assessee's product and no asset is acquired by payment is deductible—*CIT* v. *South India Exports Co. Ltd.* [2000] 242 ITR 150 (Mad.).

6. Amount paid by the assessee in the form of equity shares for technical know-how obtained for improving manufacture of articles is allowable as revenue expenditure when the know-how acquired does not belong to a new line of activity which the assessee is going to start—*CIT* v. *Sudarshan Chemical Industries (P.) Ltd.* [1986] 159 ITR 629 (Bom.), *CIT* v. *Borosil Glass Works Ltd.* [1986] 161 ITR 286 (Bom.).

7. Technical assistance fees paid by the assessee in setting up new divisions of existing business is allowable—*CIT* v. *Hindustan Machine Tools (No. 2)* [1989] 43 Taxman 153/175 ITR 216 (Kar.), *Permali Wallace Ltd.* v. *CIT* [1985] 151 ITR 43 (MP), *CIT* v. *Super Steels* [1989] 45 Taxman 327/178 ITR 637 (Punj. & Har.).

8. Payments made by the assessee-company to a foreign company in accordance with collaboration agreement to provide technical know-how but not to furnish any secret or patented process to assessee or to allow the assessee to use, collaborators' trade mark or name, are to be treated as revenue expenditure—*Gannon Norton Metal Diamond Dies Ltd.* v. *CIT* [1987] 163 ITR 606 (Bom.).

9. Where under an agreement within the foreign firm, the assessee obtains technical know-how, sub-cultures, etc., on 'once for all' payment for increasing yield of penicillin in its existing plant with a proviso to keep the said know-how confidential, the payment made will constitute a revenue expenditure—*Alembic Chemical Works Co. Ltd.* v. *CIT* [1989] 177 ITR 377/43 Taxman 312 (SC).

10. Where the payment is made to a nominee of a collaborating company as part of the price for the acquisition of technical know-how, such payment is allowable as a revenue expenditure—*CIT* v. *British India Corpn. Ltd.* [1987] 30 Taxman 546P/165 ITR 51 (SC).

11. The mere fact that the assessee is entitled to use the know-how even after the expiry of the period of the agreement, cannot lead to the conclusion that the assessee has acquired a benefit of an enduring character—*CIT* v. *Tata Engineering & Locomotive Co. (P.) Ltd.* [1980] 123 ITR 538 (Bom.).

12. Where under an agreement with a foreign company the assessee is granted an exclusive licence to use patents and designs for 10 years with an option to extend or renew the agreement and the assessee is not to disclose the documents to the third parties, the payment made by the assessee to foreign company is to be treated as a revenue expenditure—*CIT* v. *I.A.E.C. (Pumps) Ltd.* [1998] 232 ITR 316 (SC).

13. Payment made to a foreign collaborator as a contribution (measured as percentage of sales turnover) towards the cost of research carried on by the foreign company is deductible—*CIT* v. *Waving India Ltd.* [1983] 143 ITR 281 (Mad.).

14. Fee paid by the assessee for use of manufacturing know-how and for necessary training of the personnel outside India, to a foreign company is deductible - *Hindustan Ciba Geigy Ltd.* v. *CIT* [1999] 152 CTR (Bom.) 15.

15. Initial membership fee paid by the assessee-company supplying technical know-how to various concerns, for obtaining supply of mathematical models which could be used for rational designing of vapour liquid contracting systems is deductible - *CIT* v. *Engineers India Ltd.* [1999] 239 ITR 237 (Delhi).

16. Payment made by the assessee by way of lump sum amount to person to undertake research for the assessee to enable the assessee to manufacture a component of an item manufactured by the assessee, is to be treated as revenue expenditure—*Crescent Capacitors* v. *CIT* [1984] 149 ITR 285 (Delhi).

17. Payment made under know-how agreement to use technical know-how and trademark is allowable as revenue expenditure and merely because the agreements provided that the assessee shall be entitled to retain technical know-how, designs, drawings, etc., even after expiry of the agreements, it will not alter the nature of the transaction—*Praga Tools Ltd.* v. *CIT* [1980] 123 ITR 773 (AP).

18. Amount paid by the assessee-manufacturer for elimination of competition, acquisition of know-how with regard to agronomical research, soil conditions, and sales in particular area, is allowable as revenue expenditure—*Coromandel Fertilizers Ltd.* v. *CIT* [1984] 148 ITR 546 (AP).

19. Payment under a collaboration agreement to secure information and knowledge with reference to latest technical developments regarding manufacture of PVC resins and compounds is a revenue expenditure—*CIT* v. *Chemicals & Plastics (I) Ltd.* [1989] 45 Taxman 79/179 ITR 269 (Mad.).

20. Where there is no out and out sale of the designs, drawings, technical information or technical know-how by the foreign companies to the assessee, royalty and commissions paid by the assessee to foreign company are allowable as revenue expenditure—*CIT* v. *Hindustan Motors Ltd.* [1991] 192 ITR 619 (Cal.).

21. Where the assessee acquired know-how, drawings, etc., but no machines for the manufacture of a product which it is already manufacturing, the amount paid for acquiring know-how is allowable as revenue expenditure—*CIT* v. *Buckau Wolf New India Engg. Works Ltd.* [1986] 157 ITR 751 (Bom.).

22. Expenditure incurred by the assessee-company engaged in manufacture of electronic equipment towards acquisition of design and drawing for manufacture of power line carrying communication equipments, is a revenue expenditure—*CIT* v. *BPL Systems & Projects Ltd.* [1997] 227 ITR 779 (Ker.).

23. Expenditure by way of royalty for obtaining access to technical knowledge of collaborator for limited duration is allowable as revenue expenditure—***Eicher Motor Ltd.*** v. ***CIT*** [2004] 1 SOT 1 (Indore).

24. Payment made for permission to use a party's trademark for a limited period of ten years is allowable as revenue expenditure—***BPL Refrigeration Ltd.*** v. ***CIT*** [2004] 91 ITD 203 (Bang.).

■ *Examples of expenses not deductible* - The following are held as not deductible†—

1. Where at its inception the assessee enters into a collaboration agreement with a non-resident holding half of its shareholding and the agreement is to be terminated if the said shareholding fell below a fixed limit, the amount paid by the assessee to non-resident company under collaboration agreement for use of technical know-how which the assessee is entitled to use even after termination of agreement, is not deductible as a revenue expenditure—*CIT* v. *Warner Hindusthan Ltd.* [1986] 160 ITR 217 (AP).

2. Acquisition of knowledge in respect of the new product, although allied in nature to the products that are already being manufactured by the assessee, will amount to the acquisition of an advantage or an asset for the extension of the assessee's business—*Hylam Ltd.* v. *CIT* [1973] 87 ITR 310 (AP).

3. Payment made by the assessee for an expert opinion of a foreign firm for starting a foundry which is not used when the foundry is set up is disallowable as a capital expenditure—*CIT* v. *S.L.M. Maneklal Industries Ltd.* [1977] 107 ITR 133 (Guj.).

4. Where a business is taken over by the assessee as going concern, the amount paid towards training of officers taken over by the assessee is not allowable—*CIT* v. *Bharat Earth Movers Ltd.* [1985] 155 ITR 321 (Kar.).

5. Royalty paid by the assessee under technical know-how agreement for right to use trademark and technical know-how exclusively is not allowable as revenue expenditure—*CIT* v. *Polyformalin (P.) Ltd.* [1986] 161 ITR 36 (Ker.).

6. Where under the terms of collaboration agreement, the assessee acquires ownership of know-how and data for use by it in future without any limit of time, payment for such know-how is to be treated as a capital expenditure—*Ram Kumar Pharmaceutical Works* v. *CIT* [1979] 119 ITR 33 (All.).

†In these cases, one can claim depreciation under section 32 if the relevant conditions are satisfied.

7. Where under an agreement the assessee made a payment to its foreign collaborator for documents such as manufacturing drawings, processing documents, designs, charts, plans and other literature as specified in said agreements, expenditure incurred by the assessee is to be treated as capital expenditure—*Scientific Engg. House (P.) Ltd.* v. *CIT* [1985] 23 Taxman 66 (SC).

8. Where a foreign company agrees to assist the assessee in construction of works and in manufacturing and selling additional products, royalty paid by the assessee to the foreign company can be treated as partly capital and partly revenue expenditure—*M.R. Electronic Components Ltd.* v. *CIT* [1982] 136 ITR 305 (Mad.).

141.8-17 ***LITIGATION EXPENSES*** - It covers expenses on litigation —

▪ *General rule* - If the assessee incurs expenses in his character as a trader and the liability falls on him as a trader, and the transaction in respect of which proceedings are taken out arises out of and is incidental to the assessee's business, then litigation expenses are deductible—*Modi Industries Ltd.* v. *CIT* [1977] 110 ITR 855 (All.). If however, expenditure by the assessee is incurred for any purpose which is an offence or which is prohibited by any law, it cannot be deemed to have been incurred for the purpose of business or profession and no deduction is permissible in respect of such expenditure.

The following points should also be kept in view —

1. No distinction should be made between civil litigation and criminal litigation—*CIT* v. *Dhanrajgirji Raja Narasingirji* [1973] 91 ITR 544 (SC).

2. Question whether the litigation expenses are of capital or revenue nature, depends on whether the expenses are incurred by the assessee for the purpose of creating, curing or completing the assessee's title to capital or whether it is for the purpose of protecting its business ; if it is the former then the expenses incurred must be considered as capital expenditure ; litigation expenses incurred to protect business are revenue expenditure—*Dalmia Jain & Co. Ltd.* v. *CIT* [1971] 81 ITR 754 (SC), *Dalmia Dairy Industries Ltd.* v. *CIT* [1999] 104 Taxman 544 (Delhi).

3. It is not open to the department to prescribe what expenditure an assessee should incur and in what circumstances he should incur that expenditure. Every businessman knows his interest best. The fact that he does not leave the carriage of the case in the hands of the prosecuting agency of the Government is no ground for disallowing the expenditure—*CIT* v. *Dhanrajgirji Raja Narasingirji* [1973] 91 ITR 544 (SC).

4. Where a person purchases assets with the knowledge of a defect in title and where he subsequently incurs expenditure for perfecting his title, such expenditure is capital in nature. Where, however, the assessee (having acquired assets) has been carrying on business with them and receives claim by some interested person, the expenditure then incurred would have a protective element or a defensive character and such expenditure would be allowed as deduction.

▪ *Example of deductible expenditure* - The following are held as deductible—

1. Litigation expenses incurred to defend a suit filed by a shareholder where, if relief was granted, it would have affected the carrying on of the assessee's business, are deductible—*Premier Construction Co. Ltd.* v. *CIT* [1966] 62 ITR 176 (Bom.).

2. Legal expenses on defending the employee against criminal prosecution in the interest of the business are allowable—*CIT* v. *National Rayon Corpn. Ltd.* [1985] 155 ITR 413 (Bom.), *Ananda Marga Pracharaka Sangha* v. *CIT* [1994] 76 Taxman 88 (Cal.).

3. Legal expenses incurred on defending the managing director, who represented the assessee company in a firm, are deductible—*CIT* v. *Ahmedabad Controlled Iron & Steel Reg. Stockholders Association (P.) Ltd.* [1975] 99 ITR 567 (Guj.).

4. Litigation expenses incurred for launching a prosecution against a director are deductible—*Iron Traders (P.) Ltd.* v. *CIT* [1974] 97 ITR 606 (Delhi).

5. Expenditure incurred in a civil proceeding to resist a measure (legislative or executive) which imposes restrictions on carrying on of the business is deductible—*Sree Meenakshi Mills Ltd.* v. *CIT* [1967] 63 ITR 207 (SC).

Litigation expenses in protecting the trade or business are deductible—*Dalmia Jain & Co. Ltd.* v. *CIT* [1971] 81 ITR 754 (SC), *State of Tamil Nadu* v. *C.H. Simpson* [1992] 197 ITR 237 (Mad.).

7. Expenditure incurred for the preservation or protection of the asset is deductible—*CIT* v. *R.B. Bansilal Abirchand Firm* [1971] 79 ITR 104 (Bom.), *Mahabir Parshad & Sons* v. *CIT* [1945] 13 ITR 340 (Lahore), *Transport*

Co. (P.) Ltd. v. *CIT* [1962] 46 ITR 1009 (Mad.), *CIT* v. *O.P.N. Arunachala Nadar* [1983] 141 ITR 620 (Mad.), *Ebrahim Aboobaker* v. *CIT* [1971] 81 ITR 664 (Bom.), *CIT* v. *Muir Mills Co. Ltd.* [1984] 148 ITR 418 (All.) [however, litigation expenses in connection with the acquisition of a capital asset are not deductible] - *Plastic Products Ltd.* v. *CIT* [1966] 62 ITR 209 (All.).

8. Litigation expenses incurred by the assessee in successfully defending himself against the alleged offence of infringement of patent rights are deductible—*CIT* v. *Rohtas Industries Ltd.* [1968] 68 ITR 174 (Pat.), *Kangra Valley State Co. Ltd.* v. *CIT* [1935] 3 ITR 324 (Lahore).

9. Litigation expenses incurred for terminating inconvenient business relationship are deductible—*G. Scammel & Nephew Ltd.* v. *Rowles* [1940] 8 ITR (Suppl.) 41 (CA).

10. Legal expenses incurred by a company in altering the articles of association to convert it from private company to public company in accordance with section 43A of the Companies Act are deductible—*CIT* v. *Utkal Machineries Ltd.* [1981] 6 Taxman 288 (Ori.).

11. Legal expenses incurred in connection with the renewal of lease should be allowed as an admissible deduction for purposes of income-tax provided that the renewal of the lease is for a period of less than fifty years—*Circular : No. 22 [R. Disc. No. 27 (53)-IT/43], dated June 23, 1943.*

12. Professional charges paid to solicitors for effecting amalgamation of a company for smooth and efficient conduct of the assessee's business are deductible—*CIT* v. *Bombay Dyeing & Mfg. Co. Ltd.* [1996] 85 Taxman 396 (SC).

13. Legal charges for obtaining a loan from a financial institution are deductible—*Orissa Cement Ltd.* v. *CIT* [1969] 73 ITR 14 (Delhi).

14. Money paid to a consultant for preparation of budget forms, etc., is allowable—*CIT* v. *Sandur Manganese & Iron Ore (P.) Ltd.* [1967] 63 ITR 120 (Mys.).

15. Litigation expenses incurred by a director in order to defend the validity of his election to the directorship are deductible—*CIT* v. *Purshottamdas Thakurdas* [1946] 14 ITR 305 (Bom.).

16. Expenditure incurred for income-tax proceedings is an allowable expenditure—*Binodiram Balchand* v. *CIT* [1963] 48 ITR 548 (MP), *R.B. Bansilal Abirchand Spg. & Wvg. Mills* v. *CIT* [1971] 81 ITR 34 (Bom.) (FB), *Addl. CIT* v. *India United Mills Ltd.* [1983] 141 ITR 399 (Bom.), *CIT* v. *Khalsa Nirbhai Transport Co. (P.) Ltd.* [1971] 82 ITR 741 (Punj. & Har.).

17. Litigation expenses regardless of the result of legal proceedings are deductible—*CIT* v. *H. Hirjee* [1953] 23 ITR 427 (SC).

18. Litigation expenses even in connection with proceedings for concealment of income are deductible—*Modi Sugar Mills Ltd.* v. *CIT* [1973] 90 ITR 201 (All.). The Delhi Bench of the Tribunal in *CIT* v. *Nestle India Ltd.* [2002] 125 Taxman 135 held that the preparation of return is part of business activity and hence any expenditure in that regard is admissible. The Rajasthan High Court in *Associated Stone Industries (Kotah) Ltd.* v. *CIT* [2002] 123 Taxman 643 held that fees paid to Chartered Accountants for preparation and filing of return cannot be considered as an expenditure laid out wholly and exclusively for purpose of business or earning income.

19. Professional fee in regard to wealth-tax proceedings is deductible—*Century Spg. & Mfg. Co. Ltd.* v. *CIT* [1979] 116 ITR 301 (Bom.).

20. Expenditure which is incurred in opposing coercive governmental action with the object of saving taxation and safeguarding business is deductible—*CIT* v. *Birla Cotton Spg. & Wvg. Mills Ltd./CIT* v. *Birla Bros. (P.) Ltd.* [1971] 82 ITR 166 (SC).

21. Litigation expenses incurred on resisting the Government's order for appointment of a special officer to manage the assessee's affairs are deductible—*CIT* v. *Bennett Coleman & Co. Ltd.* [1979] 116 ITR 297 (Bom.).

22. Expenditure incurred by a company in connection with investigation into its affairs by a Government Commission is an allowable deduction—*South Asia Industries (P.) Ltd.* v. *CIT* [1981] 132 ITR 144 (Delhi).

23. Legal expenses incurred by the successor to business on a suit initiated by the predecessor are deductible—*CIT* v. *T. Veerabhadra Rao, K. Koteswara Rao & Co.* [1985] 155 ITR 152 (SC).

24. Litigation expenses incurred by a union of motor lorry owners to object grant of permits to other carriers to ply buses on routes allotted to the assessee are deductible—*CIT* v. *K.M.O.U. Ltd.* [1972] 86 ITR 343 (All.).

25. Legal expenses incurred by the assessee to resist the petitions filed to declare him as insolvent are deductible—*Seth Champalal Ramswarup* v. *CIT* [1964] 52 ITR 201 (All.).

26. Legal expenses incurred by the assessee in connection with a suit filed a restrict others from using the assessee's trademark are deductible—*Central India Spg., Wvg. & Mfg. Co. Ltd.* v. *CIT* [1943] 11 ITR 266 (Nag.).

27. Litigation expenses arising out of a contract of loan, in money-lending business are deductible—*CIT* v. *Maharajadhiraja Sir Kameshwar Singh of Darbhanga* [1942] 10 ITR 214 (PC).

28. Law charges incurred by an assessee in respect of property held by it as stock-in-trade are deductible—*CIT* v. *Karnani Finance Enterprises Ltd.* [1996] 87 Taxman 229 (Cal.).

29. Expenditure incurred by a company in defending itself in a petition filed by a shareholder for its winding up is an admissible deduction—*All India Reporter Ltd.* v. *CIT* [1963] 49 ITR 196 (Bom.), *CIT* v. *Jagatjit Distilling & Allied Industries Ltd.* [1961] 41 ITR 328 (Punj.).

30. Legal expenses incurred by a firm to defend a suit filed for dissolution of the firm by one of the partners, with the High Court ultimately directing that the partner who brought the suit should retire from the firm, are allowable as deduction—*CIT* v. *Card Board Products* [1998] 96 Taxman 282 (Pat.).

31. Legal expenses incurred by a partner for dissolution of a firm, rendition of accounts, and also alleging mismanagement of the affairs of firm, are deductible—*Bilasrai Juharmal (HUF)* v. *CIT* [1983] 141 ITR 915 (Bom.).

32. Legal expenses incurred for getting an agreement declared as void and compensation paid in this connection are revenue in nature— *Western India Oil Distributing Co. Ltd.* v. *CIT* [1970] 77 ITR 140 (Bom.).

33. Fee paid for legal advice in connection with the purchase of land for expansion of the assessee's manufacturing activity where purchase did not materialise, is a revenue expenditure—*Hindustan Milkfood Mfrs. Ltd.* v. *CIT* [1989] 45 Taxman 392/179 ITR 302 (Punj. & Har.).

34. Litigation expenses on a suit filed by the shareholder regarding allotment of new shares are allowable—*Kalinga Tubes Ltd.* v. *CIT* [1974] 96 ITR 20 (Ori.).

35. Where the assessee paid advance to acquire certain premises but the transaction did not materialise, the fees paid to the advocate to recover that advance is allowable as revenue expenditure—*CIT* v. *Gujarat Steel Tubes Ltd.* [2002] 123 Taxman 994/258 ITR 235 (Guj.).

36. Where the assessee-company pays certain amount to a solicitor company to secure opinion on RBI Circulars in connection with investment to be made by NRIs, registration of shares in NRI's names, etc., the Assessing Officer was not justified in disallowing such amount holding that registration of shares in NRI's name or in name of somebody else, will not affect running of business and is in no way connected with the assessee's business—*Escorts Ltd.* v. *IAC* [2001] 79 ITD 291 (Delhi).

37. Payment made towards professional charges for providing services for enhancement of bank limits, is deductible—*Media Video Ltd.* v. *CIT* [2002] 122 Taxman 28 (Delhi) (Mag.).

38. Where the assessee pays advance to acquire certain premises but the transaction does not materialise, the fees paid to the advocate to recover that advance is allowable as a revenue expenditure—*CIT* v. *Gujarat Steel Tubes Ltd.* [2002] 123 Taxman 994/258 ITR 235 (Guj.).

■ *Examples of expenses not deductible* - The following are held as not deductible —

1. Litigation expenses to defend a suit by a partner for share of profits are not deductible—*Rayalu Ayyar & Co.* v. *CIT* [1937] 5 ITR 727 (Mad.).

2. Money spent by a partner in a suit against another partner for rendition of accounts is not an allowable deduction—*Raghunath Prasad* v. *CIT* [1955] 28 ITR 45 (All.).

3. Litigation expenses in connection with a suit for performance of an agreement to sell land is capital expenditure—*Rajasthan Construction Co. (P.) Ltd.* v. *CIT* [1984] 148 ITR 61 (Bom.).

4. Litigation expenses incurred by a smaller HUF prior to the date of partition in connection with the partition suit, by which the business assets are allotted to the HUF, cannot be allowed—*CIT* v. *Mahadoo Prosad Shyamsunder* [1993] 203 ITR 168 (Cal.).

5. Legal expenses incurred by the assessee for calling a general body meeting of its subsidiary company under section 186 of Companies Act are not deductible—*United Breweries Ltd.* v. *CIT* [1986] 162 ITR 527 (Kar.).

6. Legal expenditure incurred by the assessee-company due to litigation between the two groups of directors of the assessee is not allowable as a business expenditure—*Albert David Ltd.* v.*CIT* [1981] 131 ITR 192 (Cal.).

7. Expenditure on litigation incurred in connection with acquisition of a capital asset is capital expenditure—*Life Insurance Corpn. of India* v. *CIT* [1987] 167 ITR 740 (Bom.).

8. Litigation expenses incurred after the assessee's business has been banned by the Government are not allowable—*Grain Chamber Ltd.* v. *CIT* [1962] 46 ITR 217 (All.).

9. Expenditure to defend monopoly rights enjoyed by the assessee under an instrument of assignment of lease, is a capital expenditure—*Bikaner Gypsum Ltd.* v. *CIT* [1969] 73 ITR 778 (Raj.).

10. Expenditure on defending suit for recovery of possession of property held by the assessee are not allowable—*CIT* v. *Malayalam Plantations (India) Ltd.* [1988] 169 ITR 237 (Ker.).

11. Legal expenses for resisting appointment of the Government inspector to report on affairs of the assessee-company, are not deductible—*Harinagar Sugar Mills Ltd.* v. *CIT* [1979] 117 ITR 945 (Bom.).

12. Legal expenses incurred by the assessee in the process of completing and perfecting its title to shares of a company acquired by it are capital expenses—*Jaya Hind Industries (P.) Ltd.* v. *CIT* [1986] 161 ITR 842 (Bom.).

13. Expenditure in connection with disputes as to the title of the business is not allowable—*N. Selvarajulu Chetty & Co. (India)* v. *CIT* [1965] 56 ITR 29 (Mad.).

14. Legal expenses to defend a suit filed by the shareholders for restraining the assessee from declaring dividend *in specie* rather than in cash are not deductible—*Buland Sugar Co. Ltd.* v. *CIT* [1981] 130 ITR 434 (Delhi).

15. Individual liabilities in civil or criminal case of an individual member of the HUF are not deductible—*Mahanth Sah Thakur Dayal Sah* v. *CIT* 6 ITC 188 (Pat.).

16. Expenses incurred by the company to resist application to court by shareholders under section 153C of Indian Companies Act, 1913 questioning appointment of directors are not allowable—*CIT* v. *Shiwalik Talkies Ltd.* [1967] 63 ITR 83 (Punj.).

17. Expenses incurred by newspaper company in defending an editor and a printer in the proceedings for contempt of court are not allowable—*Amrita Bazar Patrika, In re* [1937] 5 ITR 648 (Cal.).

18. Legal expenses in connection with writ petition filed by the assessee against the Government orders under the Sugar Control Order should be allowed as business expenditure—*CIT* v. *Shree Krishna Gyanoday Sugar Ltd.* [1990] 186 ITR 541 (Cal.).

19. Brokerage, underwriting commission, and legal charges in connection with issue of shares are capital expenditure—*Hindustan Gas & Industries Ltd.* v. *CIT* [1979] 117 ITR 549 (Cal.).

20. Contribution towards a suit relating to patents not ensuring for benefit of the assessee is not allowable—*CIT* v. *Ciba of India Ltd.* [1968] 69 ITR 692 (SC).

21. Litigation expenses incurred on defending directors and employees which are proved as relatable to extra-commercial considerations are not deductible—*Swadeshi Cotton Mills Co. Ltd.* v. *CIT* [1975] 100 ITR 59 (All.) (FB).

22. Payment made on behalf of the deceased director of company to settle a case of misfeasance against him, is not deductible—*Executors of Sardar Narain Singh, In re* [1943] 11 ITR 478 (Lahore).

23. Expenses incurred in defending the title on the basis of mortgages not obtained in the course of a money-lending business are not deductible—*Seth Kaluram Kankaria, In re* [1947] 15 ITR 209 (All.).

24. Litigation expenditure is capital expenditure when expenditure incurred is in connection with an acquisition of a business asset, demanding a specific performance of contract—***Sankranti Agarbathi Co.*** v. ***CIT*** [2003] 128 Taxman 290 (Kar.).

25. Litigation expenses in connection with recovery of a debt which is not a trading debt are not allowable—*Jokhiram Ramchandra* v. *CIT* [1966] 61 ITR 693 (Bom.).

141.8-18 ***PENALTY/PENAL INTEREST*** - It covers payment on account of penalty/penal interest.

▪ *General rule* - If an assessee is penalised under one Act, he cannot claim that the amount is deductible against his income under another Act, because that will be frustrating the entire object of imposition of penalty. If the assessee resorts to unlawful means to augment his profits or reduce his loss, then the expenditure incurred for these unlawful activities cannot be allowed to be deducted whether the business is lawful or otherwise. Even if the entire business of the assessee is illegal and income is sought to be taxed by the Assessing Officer, the expenditure in the illegal activities is not deductible after the insertion of *Explanation* to section 37(1) by the Finance (No. 2) Act, 1998. Even if the assessee has to pay fine or penalty because of an inadvertant infraction of law which does not involve any moral obliquity, the result will be the same. Even in such cases, deduction will not be permitted of the amounts paid as penalty or fine or of the value of the goods confiscated by the statutory authority as expenditure incurred wholly and exclusively for the purposes of

carrying on the trade. It has been consistently held by the English Courts that fines or penalties payable for violation of law cannot be permitted as deduction under the Income-tax Act. That will be against public policy. Even though the need for making such payments arises out of trading operation, the payments are not wholly and exclusively for the purpose of the trade. One can carry on his trade without violation of law. In fact, section 37 presumes that the trade will be carried on lawfully.

Therefore, the expenditure which can be deducted in connection with the business carried on by the assessee is the expenditure which can properly be regarded as such. The penalties paid for violating the law in the course of the conduct of business cannot be regarded as deductible expenditure, as the assessee is expected to carry on business in accordance with law and not in violation of the law. Penalty incurred by the assessee for the violation of the applicable statute, unless the true nature of that penalty is compensatory, is not to be regarded as deductible item of expenditure—*CIT* v. *Rane Brake Linings Ltd.* [2001] 115 Taxman 367 (Mad.).

The following points should also be kept in view —

1. Penalty which is compensatory in nature and is paid for breach of a contract or statute (not being one which is treated as an offence or prohibited by any law) is deductible.

2. Penalty or interest or fine under direct taxes is not deductible. For example interest levied on the assessee for delay in filing return will not be allowable as a business expenditure—*Bharat Commerce & Industries Ltd.* v. *CIT* [1998] 230 ITR 733/98 Taxman 151 (SC).

3. One of the important tests to determine whether the levy is compensatory or penal in nature is whether for the non-compliance of the provisions any criminal liability or prosecution is provided. If any criminal liability or prosecution is provided, the levy is surely penal in nature—***CIT* v. *Catholic Syrian Bank Ltd.*** [2003] 130 Taxman 447 (Ker.).

▪ *Example of deductible/non-deductible expenses* - The following are held as deductible/non-deductible—

1. Penalty under the Central Sales Tax Act [for instance, suppose failure to utilise goods for specified purposes after purchasing goods at concessional sales tax of 1 per cent (as against normal rate of 4 per cent) attracts penalty at a rate higher than the concessional rate of 3 per cent (say 3.75 per cent), then penalty of 3 per cent is for breach of contract to utilise goods for specific purpose and is deductible, while 0.75 per cent is for breach of statutory provision and is not deductible. As a general rule, penalty for breach of a contract is deductible, while penalty for breach of legal provision is not deductible]—*Malwa Vanaspati & Chemical Co.* v. *CIT* [1997] 225 ITR 383 (SC), *Simplex Structural Works* v. *CIT* [1983] 140 ITR 782 (MP).

2. Levy authorised by section 36(3) of the Bombay Sales Tax Act is composite in nature, being partly compensatory and partly penal in character and the proportion between the two is required to be determined and apportioned, before allowing compensatory part of it as deduction—*CIT* v. *Bharat Television (P.) Ltd.* [1996] 218 ITR 173/86 Taxman 56 (AP). However, interest on arrears or on outstanding balance of sales tax is compensatory in nature and would be allowable as deduction in computing profits of a business—*Lachmandas Mathuradas* v. *CIT* [2002] 122 Taxman 828 (SC).

3. The penalty payable for non-payment of the sales tax within the prescribed time, is not deductible as business expenditure under section 37—*CIT* v. *Bharat Steel Tubes Ltd.* [1996] 86 Taxman 358 (Delhi), *CIT* v. *Bharat Berrel & Drum Mfg. Co. (P.) Ltd.* [1990] 49 Taxman 149/182 ITR 21 (Bom.), *CIT* v. *Rajdev Kirana Stores* [1990] 181 ITR 285 (MP).

4. Where it was found from the judgment of the Tribunal that the penalty that was imposed was not on account of any delayed payment of Central Sales Tax but was for contravention of the provisions of the Central Sales Tax Act and there was nothing on the record to show that the amount of penalty had a compensatory element in it, penalty levied on the assessee under the Central Sales Tax Act could not be allowed as a deduction while computing the income of the assessee—*Swadeshi Cotton Mills Co. Ltd.* v. *CIT* [1998] 233 ITR 199 (SC).

5. Where the assessee pays a certain penalty to the State Electricity Board on account of late delivery of goods, under a contractual obligation, the loss is incidental to business, and hence it is deductible—*CIT* v. *Indo Asian Switch Gears (P.) Ltd.* [1996] 222 ITR 772/[1997] 92 Taxman 86 (Punj. & Har.).

6. Damages paid for breach of contract due to change in Government policy are deductible—*Hind Mercantile Corpn. Ltd.* v. *CIT* [1963] 49 ITR 23 (Mad.).

7. Damages paid for failure to comply with the agreement to sell the land are capital expenditure—*New Central Jute Mills Ltd.* v. *CIT* [1982] 136 ITR 742 (Cal.).

Similarly, damages paid for non-fulfilment of contract for purchase of capital asset are in the nature of capital expenditure—*CIT* v. *Ramakrishna Engineering Industries (Coimbatore) Ltd.* [1995] 215 ITR 723/84 Taxman 510 (Mad.).

8. Penalty paid by the assessee-contractor for non-completion of contract within a stipulated time is allowable—*CIT* v. *R.D. Sharma & Co.* [1982] 137 ITR 333 (Bom.).

9. Liquidated damages payable in consequence of contractual liability would be allowable as business expenditure—*G.L. Rexroth Industries Ltd.* v. *Dy. CIT* [1997] 59 TTJ (Ahd.) 757/[1958] 96 Taxman 279 (Mag.).

10. Amount paid under section 14B of the Employees' Provident Fund Act as damages for default in making payment of provident fund contributions is penal in character and is not allowable as business expenditure—*CIT* v. *A. Albuquerque & Sons* [1992] 198 ITR 609 (Kar.), *Swadeshi Cotton Mills Co. Ltd.* v. *CIT* [1989] 180 ITR 651 (All.), *Rohtak Textile Mills Ltd.* v. *CIT* [1997] 226 ITR 485 (Delhi).

11. Loss suffered by the assessee on account of a stipulation contained in the contract to lift a particular quantity of a commodity is allowable as a trading loss—*Madira Kraya Vikraya Sangh* v. *CIT* [1993] 69 Taxman 556/203 ITR 530 (Raj.).

12. Where there is allotment of quota for import of foreign cotton by federation and the assessee did not import the allotted quantity, the payment of guarantee amount for bales not imported is not in the nature of penalty and is therefore allowable—*CIT* v. *Surya Prabha Mills (P.) Ltd.* [1980] 123 ITR 654 (Mad.).

13. Amount paid for shortfall in export performance is an allowable deduction—*CIT* v. *Rajkumar Mills Ltd.* [1982] 135 ITR 811 (MP).

14. Payment made for not importing certain goods as it was not profitable in view of commercial expediency is an allowable business expenditure—*CIT* v. *Maneklal Harilal Spg. & Mfg. Co. Ltd.* [1983] 141 ITR 129 (Guj.), *CIT* v. *Lakshmi Mills Co. Ltd.* [1982] 135 ITR 203 (Mad.).

15. Penalty or fine paid by the assessee to customs authorities in lieu of confiscation of certain goods imported by the assessee without a valid import licence, is not deductible—*Rohit Pulp & Paper Mills Ltd.* v. *CIT* [1995] 79 Taxman 168 (Bom.), *CIT* v. *Jamiyarai Rajpal* [1998] 232 ITR 437 (MP).

16. Where the assessee is allowed to cut blazes in trees for collecting resin, penalty paid by it forcutting bigger blazes than what is permitted will be deductible but penalty paid for cutting blazes on trees not allotted to him, will not be deductible—*Khushal Singh Subhash Chander* v. *CIT* [1997] 228 ITR 608 (HP).

17. Penalty payable under section 24(4)(*a*) and 24(4)(*b*) of the Banking Regulation Act, 1949 cannot be treated as a deductible expenditure for purpose of section 37—***CIT*** v. ***Syndicate Bank*** [2003] 127 Taxman 287 (Kar.)

18. Where the assessee, without getting approval from the Bombay Municipal Corporation (BMC), added two rooms to existing structure of its factory at a certain cost and capitalized cost in books of account, amount paid by the assessee to BMC to regularize construction being in nature of penalty, is not allowable—***Radhaballabh Silk Mills (P.) Ltd.*** v. ***CIT*** [2007] 12 SOT 423 (Mum.).

141.8-19 TAXES - It covers payment of taxes.

■ *General rule* - Any tax (other than income-tax, wealth-tax, fringe benefits tax, securities transaction tax†, surtax, dividend tax, gift-tax) is deductible if it is paid/payable while carrying on abusiness and profession and conditions of section 43B are satisfied.

■ *Examples of deductible expenditure* - The following are held as deductible—

1. Municipal property tax chargeable under the local tax law of Japan is deductible—*Mitsui Steamship Co. Ltd.* v. *CIT* [1975] 99 ITR 7 (SC).

2. Municipal taxes paid by a running concern on plot purchased by it for business purposes is deductible even if the building is not constructed—*CIT* v. *Suri Sons* [1989] 177 ITR 406 (Punj. & Har.).

3. Purchase tax on goods purchased but not sold during the year is deductible—*CIT* v. *Marwell Sea Foods* [1987] 166 ITR 624 (Ker.).

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†However, rebate under section 88E is available in respect of securities transaction tax.

4. Tax paid by the tea companies on their tea gardens under the U.P. Large Land Holding Tax Act, 1957 is deductible—*Dehra Dun Tea Co. Ltd.* v. *CIT* [1973] 88 ITR 197 (SC).

5. Amount paid in respect of urban land and building tax imposed by the U.P. Government is deductible—*Mohan Meakin Breweries Ltd.* v. *CIT* [1979] 2 Taxman 63 (HP).

6. Road and Public Works Cess under the Bengal Cess Act and Educational Cess under the Bengal (Rural) Primary Education Act is deductible—*Jaipuria Samla Amalgamated Collieries Ltd.* v. *CIT* [1971] 82 ITR 580 (SC).

7. Amount paid under section 5C of Rajasthan Sales Tax Act to the extent it represents difference between full rate of sales tax and concessional rate is deductible—*CIT* v. *Sutlej Cotton Mills Ltd.* [1992] 194 ITR 66 (Cal.).

8. Building tax paid under Kerala Building Tax Act, 1975, is an expenditure of capital nature—*Continental Tourist Home* v. *CIT* [1999] 151 CTR (Ker.) 479.

9. Professional tax paid by a person carrying on business or trade is deductible—Circular No. 16, dated September 18, 1969.

10. Quarterly motor vehicle tax paid by the assessee transporter in respect of buses which were transferred by it during the relevant previous year if such tax was not recovered by it from the transferee—*CIT* v. *P.S.S. Transport (P.) Ltd.* [1995] 78 Taxman 372/213 ITR 771 (Mad.).

11. Tax paid by the assessee who acquired a running transport business from a transport company with outstanding tax arrears is deductible—*CIT* v. *Shriram Prayagdas & Mahadeo Prasad* [1982] 10 Taxman 297 (MP).

■ *Examples of expenses not deductible* - The following are held as not deductible —

1. Where the assessee claimed deduction of betterment charges, being contribution made towards cost of Town Planning Scheme and betterment charges provided general improvement of the area and, accordingly, enhanced value of land and resulted in providing better facilities for carrying out business of the assessee, betterment charges paid by the assessee are not allowable as revenue expenditure—*Arvind Mills Ltd.* v. *CIT* [1992] 63 Taxman 493/197 ITR 422 (SC).

2. Amount of taxes paid by the assessee-shipping company at foreign ports which is based on a percentage of freight, cannot be allowed as deduction under section 37, since it cannot be said that it is paid for earning profit—*CIT* v. *Kerala Lines Ltd.* [1993] 201 ITR 106 (Mad.).

3. Amount spent in discharging income-tax liabilities of business purchased is a capital expenditure—*Dashmesh Transport Co. (P.) Ltd.* v. *CIT* [1980] 125 ITR 681 (Punj. & Har.).

4. Payment made to obtain exemption from income-tax is not deductible—*Bhor Industries Ltd.* v. *CIT* [1963] 48 ITR 376 (Bom.).

5. Tax paid by the assessee after it has earned income in a foreign country to the foreign Government cannot be regarded as expenditure incurred for the purpose of earning profit and would, thus, not be allowable as a business deduction—*South India Shipping Corpn.* v. *CIT* [1999] 240 ITR 24 (Mad.).

141.8-20 ***TOUR EXPENSES*** - It covers travel (including foreign tour) expenses —

■ *General rule* - Expenses on travel for business purpose is generally treated as revenue expenditure. If, however, such expenditure is incurred for initiation of a new business, then it is treated as capital expenditure and, consequently, it is not deductible. Likewise, tour expenses incurred to purchase a capital asset is capital expenditure. It is part of "actual cost" of asset and consequently it is not deductible under section 37(1).

■ *Instances of deductible/non-deductible expenses* - The following are held as deductible/non-deductible—

1. Expenditure incurred, in connection with an exploratory mission or a visit intended to finalise the collaboration agreement, in the form of travelling expenses, has to be treated as revenue expenditure where royalty payment for know-how under the agreement has already been allowed as revenue expenditure—*Antifriction Bearings Corporation Ltd.* v. *CIT* [1978] 114 ITR 335 (Bom.).

2. A tour undertaken for the purpose of a preliminary survey of new methods of manufacturing, designing or processing and of new machinery with a view to purchase them, even if not immediately but at a later stage, would be one for the purpose of bringing into existence a capital asset and such expenditure would, therefore, be capital expenditure—*Ambica Mills Ltd.* v. *CIT* [1964] 54 ITR 167 (Guj.). Expenditure in connection with

foreign tour undertaken for initiation of new business is not allowable—*CIT* v. *Flour & Food Ltd.* [1988] 170 ITR 469 (MP).

3. Where the managing director and the chairman of the assessee-company went on a foreign tour not only in connection with the assessee's existing business but also in connection with a new venture to be undertaken by the assessee, that part of expenditure incurred on a foreign tour which related to a new venture is to be disallowed as capital expenditure—*Vazir Sultan Tobacco Co. Ltd.* v. *CIT* [1987] 35 Taxman 406/175 ITR 55 (AP).

4. Expenses on travel of foreign expert to help the assessee in setting up a new plant are capital in nature and hence not allowable as revenue expenditure—*Ciba of India Ltd.* v. *CIT* [1993] 70 Taxman 505/202 ITR 1 (Bom.).

5. The amount spent by the assessee on the visit of its general manager to foreign country in connection with an agreement for obtaining know-how from foreign company is allowable as revenue expenditure—*CIT* v. *Buckau Wolf New India Engineering Works Ltd.* [1986] 157 ITR 751 (Bom.).

6. Where the assessee-owner of a printing press, attended an International Printers' Conference in a foreign country as the delegate of State Printers' Association, it was *held* that the expenditure incurred on the foreign tour could not be characterised as a capital expenditure—*CIT* v. *S. Krishna Rao* [1970] 76 ITR 664 (AP).

7. Where the assessee, a surgeon, spent money on tour abroad to study the latest techniques in surgery, it was *held* that the expenditure was allowable as revenue expenditure—*Dr. P. Vadamalayan* v. *CIT* [1960] 40 ITR 501 (Mad.), *CIT* v. *Dr. M.S. Shroff* [1971] 80 ITR 687 (Delhi).

8. Expenditure incurred on foreign tour of wife of a director who accompanies him, is not allowable, where there is no evidence that her visit was necessary in order to facilitate negotiations at top level with foreign corporations—*CIT* v. *Sahibag Entrepreneurs (P.) Ltd.* 1995 Tax LR 133 (Guj.). Where the object of foreign tour undertaken by the assessee's wife is to attend the assessee for his personal comforts or the object of expenditure is two fold, *viz.*, for the purpose of business and to attend to personal comforts of her husband, the expenditure will not qualify for deduction as business expenditure—*D.B. Madan* v. *CIT* [2002] 125 Taxman 324 (Mad.).

9. The expenses incurred for availing of the services of an attendant by a businessman on his tour abroad for treatment would be only to satisfy or meet the personal need and in that context, it is really immaterial whether the person concerned avails himself of the services of his wife or that of a stranger and the tour expenses of such an attendant would not be allowable—*CIT* v. *T.S. Hajee Moosa & Co.* [1985] 153 ITR 422 (Mad.), *Bombay Mineral Supply Co. (P.) Ltd.* v. *CIT* [1985] 153 ITR 437 (Guj.) (App.).

10. Travelling expenses for procuring loan for construction of a cinema theatre are allowable—*CIT* v. *Shah Theatres (P.) Ltd.* [1988] 36 Taxman 335/169 ITR 499 (Raj.).

11. Where the managing director of a running business incurs foreign tour expenses to inspect and to take trial run of capital equipment, the expenses are deductible—*Bralco Metal Industries (P.) Ltd.* v. *CIT* [1994] 74 Taxman 132/206 ITR 477 (Bom.).

12. Expenditure incurred on foreign trips of directors to advance business of the assessee is allowable—*Delhi Cloth & General Mills Co. Ltd.* v. *CIT* [1986] 158 ITR 64 (Delhi).

13. Expenditure incurred by the assessee-company on the foreign tour of Chairman to attend the meeting of the International Chamber of Commerce would be deductible—*CIT* v. *Delhi Cloth & General Mills Co.* [1999] 240 ITR 9 (Delhi).

14. Where to facilitate the business of the assessee and to strengthen cordial relations between the two companies, the assessee invited the chairman and the managing director of the English holding company along with their spouses, travelling expenses relating to spouses were also to be allowed on the ground of commercial expediency—*CIT* v. *Sundaram Clayton Ltd.* [1999] 105 Taxman 545/240 ITR 271 (Mad.).

15. Where the material on record clearly shows that the partner of the assessee-firm is on a tour abroad in connection with the business of assessee, merely because no business can be transacted during that time, is not sufficient to disallow the travelling expenses—***ITO*** v. ***Dhiman Systems*** [2005] 147 Taxman 37 (Asr.)(Mag.).

16. Where the assessee-company's CMD visited Mauritius at the invitation of CII along with his wife, the expenditure incurred on his wife's visit is allowable—***Hero Honda Motors Ltd.*** v. ***CIT*** [2005] 3 SOT 572 (Delhi).

17. Where the assessee-company's director has contacted various prospective suppliers abroad with whom the assessee has business dealings in subsequent years, the expenditure on foreign travel cannot be disallowed - ***CIT* v. *Mercury Metals (P.) Ltd.*** [2005] 1 SOT 435 (Ahd.).

18. With regard to expenses incurred by the members of a delegation going abroad for exploring new markets for Indian products and similar export promotional activities, all reasonable expenditure incurred by the

members of the delegations should be allowed in the assessment of the members concerned—*Circular No. 2(40)/66-EAC, dated January 16/17, 1967, issued by the Ministry of Commerce.*

19. The question of admissibility of expenditure on visits to foreign countries should not be approached from the point of view as to whether such visits result immediately in the earning of profits. All that the law requires is that the expenditure should not be in the nature of capital expenditure or personal expenditure of the assessee, and should be wholly and exclusively laid out for the purposes of the business—*Circular : No. 4 [C. No. 27(3)-IT/50], dated June 19, 1950.*

141.8-21 ***DONATION/CONTRIBUTION*** - It covers expenses by way of donations/contributions to others—

- *General rule* - If the case of an assessee is that what is given by him, though termed as donation is not a donation but business expenditure and if he satisfies authorities in that regard, there is no bar in allowing deduction in respect of such payment under section 37(1)—*Voltas Ltd.* v. *CIT* [1994] 207 ITR 47 (Bom.). If, therefore, the taxpayer is able to establish a nexus between the donation and the business, it would be *held* to be for the purpose of the business and allowable under section 37(1)—*CIT* v. *Kuber Singh Bhagwandas* [1979] 118 ITR 379 (MP)(FB), *Delhi Cloth & General Mills Co. Ltd.* v. *CIT* [1986] 158 ITR 64 (Delhi), *CIT* v. *Kaira Distt. Co-op. Milk Producer's Union Ltd.* [2001] 114 Taxman 215 (Guj.). The law is well-settled that for the purpose of income-tax, any contribution made or expenditure incurred by the assessee which is directly connected or related to the carrying on of the assessee's business or which results in a benefit to the assessee's business, has to be regarded as an allowable deduction under section 37(1)—*Krishna Sahakari Sakhar Karkhana Ltd.* v. *CIT* [2000] 112 Taxman 246 (Bom.), *R.B. Narain Singh Sugar Mills (P.) Ltd.* v. *CIT* [1980] 4 Taxman 519 (Delhi).

If an assessee makes contribution to a public welfare fund which is directly connected with or related to the carrying on of his business or which results in benefit to his business, it has to be regarded as an allowable deduction under section 37(1). The onus of proof that a particular expenditure is laid out or expended for the purpose of his business is on the assessee. Since the party claims entitlement of deduction, it is for it to produce the necessary evidence to show that the payment made by it was with a view to secure benefit to its business—*CIT* v. *Industrial Development Corporation of Orissa Ltd.* [2001] 115 Taxman 626 (Ori.).

- *Examples of deductible expenditure* - The following are held as deductible—

1. Contribution to a public welfare fund which is directly connected with or related to the carrying on of the business or which results in benefit to the business is deductible—*CIT* v. *Industrial Development Corporation of Orissa Ltd.* [2001] 115 Taxman 626 (Ori.).

2. Contribution to a trade syndicate with a view to preventing uneconomic competition is deductible—*CIT* v. *Darbhanga Sugar Co. Ltd.* [1957] 32 ITR 64 (Pat.).

3. Contribution to a trade association for indemnity and to insure its members against loss is deductible—*Thomas* v. *Richard Evans & Co. Ltd.* [1972] 11 TC 790 (HL).

4. Contribution paid by the assessee to raise subsidy for mills participating in a scheme to supply a certain quantity of controlled cloth to the Government is deductible—*CIT* v. *Rajkumar Mills Ltd.* [1982] 135 ITR 811 (MP).

5. Contribution paid to club, which was situated within the employees' residential colony, with a view to maintain goodwill and create bonhomie, as a welfare measure towards employees will be allowable—*Amrit Banaspati Co. Ltd.* v. *CIT* [2000] 111 Taxman 186 (Delhi) (Mag.).

6. Contribution made by the company to Death Relief Fund and to Employees' Housing Society for construction of roads, would be allowable as deduction—*CIT* v. *E.I.D. Parry India Ltd.* [1999] 105 Taxman 153/240 ITR 253 (Mad.).

7. Premium paid by the assessee-company to Maharashtra Industrial Development Corporation under agreement for temporary water supply connection is deductible—*CIT* v. *National Machinery Mfrs. Ltd.* [1991] 191 ITR 483 (Bom.).

8. Donation/contribution made by the assessee to any relief funds, such as Chief Minister's Drought Relief Fund or a District Welfare Fund established by District Collector for benefit of public with a view to securing benefit to the assessee's business (cannot be regarded as payment opposed to public policy) irrespective of the fact that

the contribution is voluntary or at instance of authorities concerned is deductible—*Sri Venkata Satyanarayana Rice Mill Contractors Co* v. *CIT* [1996] 89 Taxman 92 (SC), *CIT* v. *Kuber Singh Bhagwandas* [1979] 118 ITR 379 (MP), ***CIT*** v. ***Katlabomman Transport Corpn. Ltd.*** [2004] 268 ITR 507 (Mad.).

9. Statutory contribution made by the assessee-co-operative society manufacturing sugar to Education Fund under section 68 of the Maharashtra Co-operative Society Act is deductible—*Krishna Sahakari Sakhar Karkhana Ltd.* v. *CIT* [1998] 229 ITR 577 (Bom.), *Krishna Sahakari Sakhar Karkhana Ltd.* v. *CIT* [2000] 112 Taxman 246 (Bom.).

10. Contribution made by the assessee marketing society to District Welfare Fund for the purpose of getting goodwill of District Collector is deductible—*CIT* v. *Kanyakumari Distt. Co-op. Supply & Marketing Society Ltd.* 1996 Tax LR 949 (Mad.).

11. Expenditure in regard to contribution made by the assessee-company to State Electricity Board towards laying of additional circuit line in order to meet increased demand to company is deductible—*Mafatlal Fine Spg. & Wvg. Co. Ltd.* v. *CIT* [1993] 69 Taxman 385 (Bom.).

12. Contribution given under a development scheme for construction of road around factory building for facilitating the transport of sugarcane to the factory and the flow of manufactured sugar out of the factory is deductible—*L.H. Sugar Factory & Oil Mills (P.) Ltd.* v. *CIT* [1980] 4 Taxman 5 (SC).

13. Contribution for repairs to approach road to the assessee's factory even though the road belonged to the Government is deductible—*CIT* v. *Hindustan Motors Ltd.* [1968] 68 ITR 301 (Cal.).

14. Expenditure or a contribution by way of reimbursement for black topping of a road already laid out is deductible—*CIT* v. *Tractors & Farm Equipments Ltd.* [1982] 133 ITR 147 (Mad.).

15. Contribution to railways for the construction of an overbridge across an accident prone strip of the railway track close to the assessee's factory, the residential area of its workers and a school is deductible—*Panyam Cements & Mineral Industries Ltd.* v. *CIT* [1979] 117 ITR 770 (AP).

16. Contribution made by a sugar mill under a statutory obligation towards construction of the Government owned roads which would facilitate supply of sugarcane to factories is deductible—*Lakshmiji Sugar Mills Co. (P.) Ltd.* v. *CIT* [1971] 82 ITR 376 (SC).

17. Contribution made by the assessee to the Government for building a new bridge in place of the old one which has become unserviceable and which is essential to provide access to the assessee's factory, is allowable as revenue expenditure—*CIT* v. *Coats Viyella India Ltd.* [2002] 253 ITR 667/124 Taxman 797 (Mad.).

18. Contribution made to the State Co-operative Federal Education Fund, as per the provisions of section 69 of the Gujarat Rajya Co-operative Society Act, 1961, is allowable as business expenditure—***Mehsana District Co-operative Milk Producers Union Ltd.*** v. ***CIT*** [2003] 132 Taxman 40 (Guj.).

19. Contribution to a political party is deductible under section 80GGB or 80GGC.

20. Contribution by a company towards construction of a building of a chamber of commerce is deductible—***CIT*** v. ***Chemical & Plastic India*** [2007] 165 Taxman 158 (Mad.).

21. Admission fee and contribution to infrastructure development fund paid by an assessee to become a member of particular stock exchange is deductible—***CIT*** v. ***S. Venkatasubramaniam*** [2007] 165 Taxman 163 (Mad.).

■ *Examples of non-deductible expenses* - The following are held as not deductible —

1. Contribution to the Refugee Relief Fund to provide flood relief in an area where the assessee-company has its office cannot be allowed as business expenditure—*Voltas Ltd.* v. *CIT* [1993] 71 Taxman 230/[1994] 207 ITR 47 (Bom.).

2. Contribution to an association, which does not serve any business purpose, is not deductible—*Iron Traders (P.) Ltd.* v. *CIT* [1974] 97 ITR 606 (Delhi).

3. Payment which is opposed to public policy is not deductible—*CIT* v. *Kodandarama & Co.* [1983] 144 ITR 395 (AP).

4. Contribution to Insurance Fund cannot be considered as an admissible deduction—*CIT* v. *Thanthai Periyar Transport Corporation* 1997 Tax LR 514 (Mad.).

141.8-22 *DEVALUATION LOSS* - It covers additional liability on account of devaluation of currency —

■ *General rule* - Additional liability arising out of devaluation can be taken to be of the same character as the original receipt or the original liability and it cannot be taken to be having a different

character—*Lakshmi Card Clothing Mfg. Co. (P.) Ltd.* v. *CIT* [1984] 149 ITR 716 (Mad.). The question of deduction of increased liability due to devaluation on loan repayment has to be decided on a finding whether the amount of loan is utilised by the assessee as fixed capital or working capital—*Groz-Beckert Saboo Ltd.* v. *CIT* [1986] 160 ITR 743 (Punj. & Har.). It is for working capital, it is deductible. Conversely, if it is for fixed capital it is not deductible under section 37(1). The taxpayer can take the help of section 43A.

▪ *Examples* - The following are some of the examples of deductible/non-deductible expenses —

1. Devaluation loss due to transfer of provident fund kept in India to Singapore is an allowable deduction—*United India Fire & General Insurance Co. Ltd.* v. *CIT* [1983] 144 ITR 638 (Mad.).

2. Where after declaration of dividend due to fluctuation in the rate of exchange, the assessee had to remit an extra amount for payment of dividends, the said extra amount is deductible as business expenditure—*CIT* v. *Calcutta Electric Supply Corpn. Ltd.* [1987] 166 ITR 797 (Cal.).

3. Where loss is incurred by the assessee-company due to fluctuation of exchange rates in remittances of profit from India to its U.K. office, it is allowable—*Goodricke Groups Ltd. (No. 2)* v. *CIT* [1993] 201 ITR 266 (Cal.).

4. Where surplus profits are remitted by the assessee to its head office in U.K. for the purpose of distribution by way of dividends, loss arising from such remittance due to fluctuations in rates of exchange, should be regarded as a loss incurred by the assessee in carrying on its business—*Goodricke Group Ltd. (No.1)* v. *CIT* [1993] 201 ITR 261 (Cal.).

5. Fluctuations in rate of foreign exchange resulting in gain or loss while repaying instalments of foreign loan will not alter cost incurred for purchase of asset for computing depreciation—*CIT* v. *Tata Iron and Steel Co. Ltd.* [1998] 231 ITR 285/98 Taxman 459 (SC).

141.8-23 PAYMENT TO WARD OFF COMPETITION - It covers payment to a rival to ward off competition —

▪ *General rule* - Payment made to a rival to ward off competition in the business would constitute capital expenditure only if the object of making that payment is to derive an enduring advantage by eliminating competition over some length of time—*CIT* v. *Coal Shipment (P.) Ltd.* [1971] 82 ITR 902 (SC).

▪ *Examples of deductible/non-deductible expenses* - The following are a few examples of deductible/non-deductible expenses —

1. If payment is made for warding off competition and to acquire competitioner's business, the same is capital expenditure—*Blaze & Central (P.) Ltd.* v. *CIT* [1979] 120 ITR 33 (Mad.).

2. Amount paid by the assessee to a competitor for not competing with him in securing a contract of purchasing stock-in-trade is capital expenditure—*Behari Lal Beni Parshad* v. *CIT* [1959] 35 ITR 576 (Punj.).

3. Where the object of a payment is freedom from competition from a payee party for rest of period of business activities of the assessee, such payment is a capital expenditure—*Chelpark Co. Ltd.* v. *CIT* [1991] 56 Taxman 29/191 ITR 249 (Mad.).

4. Amounts paid to rival forest contractors to persuade them not to bid at auction of forest coupe is a business expenditure—*V. Damodaran* v. *CIT* [1967] 64 ITR 26 (Ker.).

5. Where non-compete fee paid by assessee gives enduring benefit to assessee in its business, payment of such fee falls within capital field which is not an allowable expenditure—***Asianet Communications (P.) Ltd.*** v. ***CIT*** [2006] 7 SOT 496 (Chennai).

141.8-24 ADVERTISEMENT - It covers advertisement expenses —

▪ *General expenses* - Advertisement expenses of revenue nature are deductible under section 37(1) if other conditions are satisfied. By virtue of section 37(2B), expenditure incurred by an assessee on advertisement in any souvenir, brochure, tract, pamphlet or the like published by a political party is not deductible.

▪ *Examples of deductible expenses* - A few examples of deductible expenses are given below —

1. Expenditure incurred in connection with annual day celebrations is an allowable expenditure—*CIT* v. *Mehsana Distt. Co-operative Milk Producers Union Ltd.* [1994] 207 ITR 140 (Guj.).

2. Expenditure on commemorative brochure is allowable—*CIT* v. *Tata Iron & Steel Co. Ltd.* [1977] 106 ITR 363 (Bom.).

3. Where the assessee-company deriving income from manufacture of tea, distributed tea samples and complimentary tea to shareholders, directors and friends at an annual general meeting of the company, it is deductible—*CIT* v. *Tirrihannah Co. Ltd.* [1992] 195 ITR 393 (Cal.).

4. Expenditure on organising football/sports tournament is allowable—*Sarda Plywood Industries Ltd.* v. *CIT* [1999] 238 ITR 354 (Cal.), *CIT* v. *Delhi Cloth & General Mills Co.* [1999] 240 ITR 9 (Delhi).

5. Expenditure on canvassing customers for one's product is deductible—*R.S. Munshi Gulab Singh & Sons* v. *CIT* [1946] 14 ITR 66 (Lahore).

6. Expenditure on advertisements in souvenir published by charitable institutions is a deductible expenditure—*British Electrical & Pumps (P.) Ltd.* v. *CIT* [1977] 106 ITR 620 (Cal.).

7. Expenditure incurred by the assessee-company for giving silver medals to shareholders and silver wall plaques to directors on the eve of silver jubilee celebrations of the assessee is allowable—*Andhra Sugars Ltd.* v. *CIT* [1988] 171 ITR 209 (AP).

8. Expenditure incurred by a film distributor on silver jubilee celebration of a film, is deductible—*Amarjothi Pictures* v. *CIT* [1968] 69 ITR 755 (Mad.).

9. Amount spent by the assessee in connection with the inaugural function of its new project cannot be said to be in the nature of capital expenditure merely on the ground that it is incurred prior to commencement of business—*CIT* v. *Aluminium Industries Ltd.* 1995 Tax LR 462/80 Taxman 243/214 ITR 541 (Ker.). Expenditure on inauguration of factory by the Prime Minister is allowable - *CIT* v. *Hindusthan Aluminium Corporation Ltd.* [1989] 176 ITR 206 (Cal.)

10. Where the assessee-company is a manufacturer of automobiles, expenses incurred by it in relation to seminar organized by Association of India Automotive Manufacturers, on providing lunch, are admissible as deduction—***Escorts Ltd. Corpn. Finance*** v. ***CIT*** [2004] 3 SOT 202 (Delhi).

11. Assessee can claim entire deferred revenue expenditure on advertisement in the year in which it is incurred even though assessee has spread it over five years—***Amar Raja Batteries Ltd.*** v. ***CIT*** [2004] 91 ITD 280 (Hyd.).

141.8-25 ***MINING*** - Section 35E is applicable in respect of expenditure on prospecting, etc., for certain minerals. If conditions of section 35E are not satisfied, then deduction is available under section 37(1), if conditions of section 37(1) are satisfied.

▪ *General rule* - Payment for winning and extracting mineral from land is capital expenditure ; but for acquiring material already won is revenue expenditure—*R.B. Seth Moolchand Suganchand* v. *CIT* [1972] 86 ITR 647 (SC), *Gujarat Mineral Development Corporation Ltd.* v. *CIT* [1983] 143 ITR 822 (Guj.).

Payment made to extract stones from land, which are not the assessee's stock-in-trade in a business sense but a capital asset from which after extraction it converted the stones into its stock-in-trade, on long-term basis is a capital expenditure—*Pingle Industries Ltd.* v. *CIT* [1960] 40 ITR 67 (SC). However, in *Gotan Lime Syndicate* v. *CIT* [1966] 59 ITR 718 (SC), it was held that annual payment of royalty or dead rent for excavation of limestone under mining lease is a revenue expenditure.

Prima facie, it appears that there is a conflict in the decisions of Supreme Court delivered by co-ordinate benches in *Pingle Industries Ltd.* v. *CIT* [1960] 40 ITR 67 and *Gotan Lime Syndicate* v. *CIT* [1966] 59 ITR 718 (SC).

▪ *Examples of deductible/non-deductible expenses* - The following are held as deductible/non-deductible —

1. Where under two lease agreements the assessee is given right to win, raise and remove stones from quarries specified in agreements for three years in consideration of certain amount to be paid in two instalments, expenditure incurred for obtaining the right under the contract is capital expenditure—*Motwani & Co.* v. *CIT* [1988] 170 ITR 97 (Ori.).

2. Amount spent by the assessee, carrying on business of extracting mica from mica mines taken on lease, for concreting walls and roof underground in the course of carrying out orders of mining authorities, so as to

safeguard against rainwater going into mines, is of capital nature—*CIT* v. *Karuna Mica Co.* [1987] 167 ITR 292 (Pat.).

3. Expenditure on prospecting is in nature of revenue expenditure—*Hindustan Aluminium Corpn. Ltd.* v. *CIT* [1986] 159 ITR 673 (Cal.).

4. Amount paid for obtaining lease for extracting iron ore and compensation paid for failure to restore land for cultivation are capital expenditure—*Chintalapudi Ranganayakulu* v. *CIT* [1964] 51 ITR 276 (AP).

5. Expenditure on removal of overburden in open cast mining is revenue expenditure—*CIT* v. *Katras Jharia Coal Co. Ltd.* [1979] 118 ITR 6 (Cal.), *CIT* v. *Rajendra Trading Co. (P.) Ltd.* [1984] 146 ITR 637 (Cal.).

6. Stowing expenses incurred in coal mining business is allowable as revenue expenditure—*CIT* v. *Kirkend Coal Co.* [1970] 77 ITR 530 (SC).

7. Expenditure on digging trenches around coal mine to protect mine from fire is an allowable revenue expenditure—*CIT* v. *Tara Prasad Lodha* [1975] 99 ITR 173 (Pat.).

8. Expenditure on internal development of mines is allowable as revenue expenditure—*CIT* v. *Indian Copper Corpn. Ltd.* [1986] 161 ITR 327 (Pat.), *CIT* v. *Indian Copper Corpn. Ltd.* [1986] 162 ITR 905 (Pat.).

9. Expenditure incurred by the assessee in mining business on earth cutting to reach the reef, is revenue expenditure—*CIT* v. *J.A. Trivedi Bros.* [1979] 117 ITR 983 (Bom.).

10. Where royalty is payable on the basis of quantum of extraction of stone, subject to a certain minimum amount, the excess over minimum amount is not capital expenditure—*Associated Stone Industries (Kotah) Ltd.* v. *CIT* [1971] 82 ITR 896 (SC).

11. Annual payment of royalty/dead rent for excavation of limestone under the mining lease is a revenue expenditure—*Gotan Lime Syndicate* v. *CIT* [1966] 59 ITR 718 (SC).

12. Royalty paid by the assessee-company for quarrying stone is a revenue expenditure—*CIT* v. *Associated Stone Industries (Kotah) Ltd.* [1981] 130 ITR 868 (Raj.).

13. Protection fee paid to obtain monopoly right of mining is capital expenditure—*Assam Bengal Cement Co. Ltd.* v. *CIT* [1955] 27 ITR 34 (SC).

14. Amount paid for right to collect saltpetre is not capital expenditure—*CIT* v. *Bhojraj Harichand* [1946] 14 ITR 277 (Lahore).

15. Expenditure on taking lease of land for excavating manganese ore is capital expenditure—*Aditya Minerals (P.) Ltd.* v. *CIT* [1987] 167 ITR 774 (AP).

16. Lease rent payable to Government for five-year lease of quarries for excavating slabs which are not available on surface is not revenue expenditure—*CIT* v. *Southern India Mining & Slab Co.* [1988] 171 ITR 193 (AP).

17. Lease money paid for removing crude saltpetre is revenue expenditure—*Nand Lal Bhoj Raj, In re* [1946] 14 ITR 181 (Lahore).

18. Tender money for obtaining right to work mines is capital expenditure—*CIT* v. *Ramlal & Sons* [1965] 57 ITR 742 (Raj.) (FB).

19. Payment made to acquire right to work in mines and extract ore is capital expenditure—*N. Peer Sahib* v. *CIT* [1964] 54 ITR 681 (Mys.).

20. Salami paid for obtaining lease right to obtain clay from earth for 10 years is a capital expenditure—*Sri Krishna Tiles & Potteries Madras (P.) Ltd.* v. *CIT* [1988] 173 ITR 311 (Mad.).

21. Expenditure incurred by the assessee, whose business is not of mining, on acquisition of mining leases, which the assessee did not operate at all, will be capital expenditure—*Salgaonkar Mining Industries* v. *CIT* [1997] 228 ITR 183 (Bom.).

22. Expenditure incurred towards stamp duty for securing renewal of mining lease with the Government would be allowable as revenue expenditure—*CIT* v. *Panyam Cements & Mineral Industries Ltd.* [1997] 228 ITR 212 (AP).

23. Where the assessee holding mining leases from State Government had not incurred any expenditure towards restoration of lands to their original condition, estimated liability for restoration charges cannot be allowed as deduction—*New India Mining Corporation (P.) Ltd.* v. *CIT* [2000] 243 ITR 640/111 Taxman 632 (SC). However, in ***Udaipur Mineral Development Syndicate (P.) Ltd.*** v. ***CIT*** [2003] 129 Taxman 728 (Raj.), under terms of agreement, the assessee-lessee was required to restore surface land so used by it to its original condition. The Rajasthan High Court held that the very moment the assessee dug pits, liability did arise and it was entitled for deduction of expenses which it was supposed to incur for filling those pits, as it was following mercantile system of accounting.

24. Site development expenses incurred by the assessee-company relating to soil trips, levelling, labour charges, etc., are allowable and cannot be treated as a capital expenditure—***CIT*** v. ***Supreme Rayons (P.) Ltd.*** [2005] 95 TTJ (Jodh.) 182.

25. Quarry development expenses incurred by an assessee cement manufacturer in the first year of its business are allowable as a revenue expenditure—***Gujarat Ambuja Cements Ltd.*** v. ***CIT*** [2005] 4 SOT 59 (Mum.).

141.8-26 ***BRICKS MANUFACTURER*** - It covers expenses incurred by a brick manufacturer.

■ *General rule* - If a person as a manufacturer of bricks purchases land or takes it on a long lease for starting a concern and digs earth out of the land so acquired, the purchase price or the premium paid for the lease can safely be regarded to be a part of his fixed capital. If an owner of an already established kiln were to enter into forward contracts or agreements to procure earth, the price paid to acquire it would be an item in the profit and loss account only if it were lying in a loose state—*Benarsidas Jagannath, In re* [1947] 15 ITR 185 (Lahore).

■ *Examples of deductible/non-deductible expenses* - The following are held as deductible/non-deductible —

1. If right acquired is not merely to dig and remove earth but also an interest in land, payment made to lessor is capital expenditure, more so in a long-term lease—*Ford & Macdonald Ltd.* v. *CIT* [1964] 54 ITR 133 (All.).

2. Lease amount paid where the lease of land is taken for 7 years for manufacturing bricks, is capital expenditure—*United Commercial Corpn.* v. *CIT* [1970] 78 ITR 800 (All.).

3. Where the assessee takes lease of a land for excavation of earth for manufacture of bricks and the land is to revert back to the lessor after expiry of seven years, lease rent is allowable as a revenue expenditure—*Shanker Dass Sethi & Sons* v. *CIT* [1986] 157 ITR 770 (Delhi).

4. Cost of land purchased for extracting earth for brick kiln is capital expenditure—*Ganeshi Lal Bhattawala, In re* [1938] 6 ITR 489 (All.).

141.8-27 ***SHARING OF PROFIT*** - It covers payments based upon profits.

■ *General rule* - Where the payments made under a profit-sharing scheme are *bona fide* and not merely a device to reduce tax liability and the sums have actually been paid to the employees, the amounts may be treated to have been expended wholly and exclusively for the purposes of the employer's business—*Circular : No. 64(XI-2) [F. No. 27(10)-IT-51], dated October 27, 1951.*

■ *Examples of deductible expenses* - The following are some of instances of deductible expenses —

1. Where cost of borrowing is a portion of profits, and borrowing is necessary for earning the profits, the payment of share of profit is deductible—*Dharamvir Dhir* v. *CIT* [1961] 42 ITR 7 (SC).

2. Remuneration based on profits does not amount to division of profits and is deductible — *CIT* v. *Bombay Burma Trading Corpn. Ltd.* [1941] 9 ITR 155 (Rangoon).

3. Share in profits in lieu of interest on borrowings is a permissible deduction—*Jamshedpur Motor Accessories Stores* v. *CIT* [1974] 95 ITR 664 (Pat.).

4. Where the outgoing partners reserved the right to claim the share in profits in respect of certain forward contracts entered into by the old firm, such payment will be an allowable deduction to the new firm—*V.N.V. Devarajulu Chetty & Co.* v. *CIT* [1950] 18 ITR 357 (Mad.).

5. Payment made with reference to profits, for obtaining a concession or a profit-earning apparatus, is deductible—*CIT* v. *Travancore Sugars & Chemicals Ltd.* [1973] 88 ITR 1 (SC).

6. Where purchaser of a running business agrees to pay percentage of profits to vendor, without any limit and for indefinite period and the payment has no relation to any capital sum, it is revenue and not capital expenditure—*Travancore Sugars & Chemicals Ltd.* v. *CIT* [1966] 62 ITR 566 (SC).

■ *Examples of non-deductible expenses* - The following are held as non-deductible —

1. Where in lieu of technical information and services to be provided by the foreign company, the assessee agreed to give the latter a share in net profits and payment of net profits is adjusted against cost of shares of the assessee which the foreign company has agreed to take, the payment of net profits by the assessee to the foreign company is not to be allowed as a revenue expenditure—*CIT* v. *Belpahar Refractories Ltd.* [1977] 109 ITR 667 (Ori.).

2. Where the payment represents sharing/application of profits, it is not deductible — *R.M.G. Sundararamier Radhakrishnier & Co.* v. *CIT* [1952] 21 ITR 184 (Mad.).

141.8-28 ***OTHER EXPENSES*** - The following are some of the instances of deductible/non-deductible expenses —

■ GIFTS

❑ If an assessee society as a corporate body decides to give presents to its members to commemorate silver jubilee celebrations, the expenditure on such presents is allowable—*Karjan Co-operative Cotton Sales Ginning & Pressing Society* v. *CIT* [1993] 199 ITR 17 (Guj.) (FB).

❑ Cost price of raw material received free of charge under agreement with the Government with matching contribution by the assessee is deductible—*CIT* v. *Kaira Distt. Co-op. Milk Producer Union* [2001] 114 Taxman 215 (Guj.).

❑ Expenditure on presentation of gifts to officers of collaborator company is an allowable deduction—*CIT* v. *S.L.M. Maneklal Industries Ltd.* [1977] 107 ITR 133 (Guj.).

❑ Expenses incurred by the assessee on occasion of marriage of daughter of chairman of a company with which he had business relations and on personal gifts on festive occasions to others, would not be allowable as business expenditure—*CIT* v. *Jeevandas Laljee & Sons* [1999] 106 Taxman 139 (Mad.).

❑ Expenditure on Diwali gifts is allowable as business expenditure—***CIT*** v. ***Anil Alums (P.) Ltd.*** [2005] 98 TTJ (Asr.) 56.

❑ Amount spent on distribution of gift articles to dealers by assessee—***CIT*** v. ***Avery Cycle Inds. Ltd. (Punj. & Har.)*** [2006] 157 Taxman 382.

■ KEYMAN INSURANCE PREMIUM

❑ Premium paid by a firm in respect of life of one of its partners, assured under Keyman Insurance Policy—***P.G. Electronics*** v. ***ITO*** [2007] 15 SOT 79 (Delhi) (SMC) (URO).

■ FOREST LEASE

❑ Payment made for acquiring the right to cut and fell standing timber is capital expenditure—*Hood Barrs* v. *Inland Revenue Commissioners* [1958] 34 ITR 238 (HL).

❑ Payment of enhanced royalty to owner of an estate forest for agreeing to grant a right to take and remove stock-in-trade, *i.e.*, sleepers and scantlings from logs of sal, for a sufficiently long period is a capital expenditure—*H. Dear & Co. (P.) Ltd.* v. *CIT* [1966] 60 ITR 546 (SC).

■ CONSULTANCY FEES

❑ Fee paid to an expert for inspection of machinery is an allowable deduction —*CIT* v. *Vallabh Glass Works Ltd.* [1982] 137 ITR 389 (Guj.).

❑ Where the object of the entire exercise for which the services of a consultancy firm are availed of by the assessee, is for rationalisation of its administration and modernisation of its machinery with a view to derive maximum benefit out of the existing resources, payments made to such consultancy firm are allowable as revenue expenditure—*CIT* v. *Abbott Laboratories (I) (P.) Ltd.* [1993] 69 Taxman 214/202 ITR 818 (Bom.).

❑ Consultancy fee paid for the benefit of increasing manufacturing efficiency is allowable—*CIT* v. *Praga Tools Ltd.* [1986] 157 ITR 282 (AP).

❑ Consultancy fee for preparation of report relating to diversification of new venture is to be disallowed—*Vazir Sultan Tobacco Co.* v. *CIT* [1987] 35 Taxman 406 (AP).

❑ Fee paid by the assessee for use of manufacturing know-how and for necessary training of the personnel outside India, to foreign company would be allowable as deduction—*Hindustan Ciba Geigy Ltd.* v. *CIT* [1999] 152 CTR (Bom.) 15.

❑ Payments made to consultancy firms for making feasibility studies to identify projects that may be taken up advantageously and for preliminary study regarding availability of limestone deposits, would be allowable as

revenue expenditure when study taken up by the assessee was for utilisation of surplus funds and it had not resulted in setting up of new business—*CIT* v. *Coromandal Fertilizers* [1999] 105 Taxman 490 (AP).

❑ Payments made by the assessee-company to obtain the report of consultants for improving efficiency of business would be allowable as a revenue expenditure—*CIT* v. *Crompton Engineering Co. Ltd.* [2000] 242 ITR 317 (Mad.).

❑ Expenses incurred to obtain letters of administration are capital expenditure—*Indermani Jatia* v. *CIT* [1962] 46 ITR 1156 (All.).

■ HIRING EXPENSES

❑ Where the assessee-pharmaceutical company installed computers at its business premises on hire basis, the expenditure incurred in connection with their installation is allowable as a revenue expenditure—*CIT* v. *Alembic Chemical Works Ltd.* [1994] 206 ITR 170/76 Taxman 515 (Guj.).

❑ Lump sum payment of a non-refundable amount made by the assessee, apart from the monthly rent, as consideration for grant of charter of a vessel is to be treated as a capital expenditure—*J.K. Chemicals Ltd.* v. *CIT* [1994] 74 Taxman 154/207 ITR 725 (Bom.).

■ AUDIT

Expenses incurred on special audit under section 142(2A) would be allowable taking into account volume of work done—*Pradeep Maheshwari* v. *CIT* [1999] 105 Taxman 351 (Ker.).

■ BETTERMENT CHARGES

Betterment charges paid to a municipality constitutes capital expenditure—*CIT* v. *O.L. of A'bad Mfg. & Calico Ptg. Co. Ltd.* 1999 Tax LR 615 (Guj.), *Vikram Mills Ltd.* v. *CIT* [1999] 107 Taxman 344 (Guj.).

■ PUJA EXPENSES

❑ As the expenses incurred on the occasion of Diwali and mahurat are in the nature of business expenditure, it has been decided not to lay down any monetary limits for the purpose of their allowance—*Letter : F. No. 13A/20/68-IT(A-II), dated October 3, 1968.*

❑ Where the assessee maintains a temple within the mills premises and has employed a pujari in connection with the said temple and the said temple is not maintained for personal benefit of any person, the salary paid by the assessee to the pujari is allowable as business expenditure—*Commercial Mills Co. Ltd.* v. *CIT* [1994] 72 Taxman 203/204 ITR 505 (Guj.).

❑ Customary puja expenditure at the time of opening the assessee's books of account is an allowable deduction—*Brijraman Das & Sons* v. *CIT* [1983] 142 ITR 509 (All.).

■ TRADE MARK

❑ Expenditure on registration of trade mark is allowable as a revenue expenditure— *CIT* v. *Finley Mills Ltd.* [1951] 20 ITR 475 (SC), *Erode Transport (P.) Ltd.* v. *CIT* [1969] 71 ITR 283 (Mad.). Application fees for getting an existing trade mark registered is a revenue expenditure—*CIT* v. *Century Spg., Wvg. & Mfg. Co. Ltd.* [1947] 15 ITR 105 (Bom.).

■ RESEARCH EXPENSES

Contribution to the cost of research in the assessee's line of manufacture, is a revenue expenditure—*CIT* v. *Wavin India Ltd.* [1983] 143 ITR 281 (Mad.).

■ ENTERTAINMENT EXPENDITURE

❑ Expenditure by a race club on hot drinks served on the race days to stewards, secretary, donors of cups, other VIPs and officials of the club is allowable as revenue expenditure—*Royal Calcutta Turf Club* v. *CIT* [1991] 57 Taxman 185/188 ITR 352 (Cal.).

❑ Expenditure incurred by the assessee-club on members invited from other clubs at the time of conducting turf invitation cup, which was found to have no connection with the assessee's business, was not deductible—*Madras Race Club* v. *CIT* [1994] 210 ITR 680 (Mad.).

❑ Entrance fee paid by the assessee-company for getting membership of sports club is allowable as a revenue expenditure—*Gujarat State Export Corporation Limited* v. *CIT* [1994] 209 ITR 649 (Guj.).

❑ The expenditure by way of membership fee of the Indian Institute of Foreign Trade can be said to be wholly and exclusively incurred for the purpose of business of the members— *Letter : F No. 9/54/64-IT (A-I), dated September 2, 1964* and *Letter : F. No. 9/56/66-IT (A-I), dated January 17, 1967.*

❑ The expenditure by way of membership fee of the Indian Institute of Packaging can be said to be wholly and exclusively incurred for the purpose of business of the members. Therefore, such expenditure may be

allowed as an admissible deduction, under section 37(1), in the hands of the payers in computing their total income from business — *Letter : F. No. 9/23/67-IT(A-I), dated July 6, 1967.*

■ WAIVER OF RECEIVABLE AMOUNT

❑ Liability which has stood obliterated by mutual consent is not deductible—*CIT* v. *S.K.G. Sugar Ltd.* [1974] 96 ITR 194 (Pat.).

❑ A voluntary gesture on the part of an assessee to waive interest, which is admittedly payable to him by a third party and which is assessable under 'other sources' cannot be treated as an admissible expenditure—*M.N. Kanagasabai Chettiar* v. *CIT* [1970] 75 ITR 672 (Mad.).

■ PROFESSION

❑ Expenditure on upkeep of professional dress by a barrister is not deductible— *Mallalieu* v. *Drummond* (H.M. Inspector of Taxes) 57 TC 330 (HL).

■ HOLDING - SUBSIDIARY COMPANY

❑ It is now well-settled that a parent company cannot be allowed to claim deduction in respect of a loss or expenditure incurred by it for the purpose of a subsidiary company—*CIT* v. *Amalgamation (P.) Ltd.* [1977] 108 ITR 895 (Mad.).

❑ Loss of wholly-owned subsidiary company is not deductible in the hands of the parent company—*Odhams Press Ltd.* v. *Cook* [1941] 9 ITR (Suppl.) 92 (HL).

■ CLUB EXPENSES

❑ A race club is entitled to deduction of expenditure on maintenance of a club house and kiosks—*Royal Western India Turf Club Ltd.* v. *CIT* [1970] 78 ITR 548 (Bom.).

❑ Where the assessee-club bears losses of another club and rendering assistance to other clubs is an object contemplated in its memorandum, such losses are allowable—*Bangalore Race Club* v. *CIT* [1970] 77 ITR 435 (Mys.).

■ ELECTRICITY

❑ Cost of installing a service connection by an electricity supply company is a capital expenditure—*Monghyr Electric Supply Co. Ltd.* v. *CIT* [1954] 26 ITR 15 (Pat.).

❑ Connection charges paid to the State Electricity Board would be allowable—*Amrit Banaspati Co. Ltd.* v. *CIT* [2000] 111 Taxman 186 (Delhi) (Mag.).

❑ Expenditure on installation of electrical work in new production office would be capital expenditure—*Goodyear India Ltd.* v. *ITO* [2000] 113 Taxman 89 (Mag.)/66 TTJ (Delhi) 164.

■ SHIFTING EXPENSES

Expenses incurred on shifting the factory would be deductible as revenue expenditure—*CIT* v. *L.M. Van Moppes Diamond Tools India Ltd.* [1999] 151 CTR (Mad.) 435.

■ INSURANCE COMPANIES

❑ Payment of bonus to policyholders to induce them to renew their policies with the assessee-insurer, is expenditure laid out for the business—*Union Co-operative Insurance Society* v. *CIT* [1967] 66 ITR 360 (SC).

❑ Bonus paid to the policyholders for renewing policies is not a contingent liability—*Union Co-operative Insurance Society* v. *CIT* [1967] 66 ITR 360 (SC).

❑ Distribution of profits of an insurance company among policyholders is not a deductible expenditure—*Bharat Insurance Co. Ltd.* v. *CIT* [1934] 2 ITR 63 (PC).

■ DEALER IN SHARES

Where the assessee-company, a dealer in shares has purchased shares, purchase price of shares has to be treated as a business expenditure—*CIT* v. *Jai Hind Investment Industries (P.) Ltd.* [1993] 202 ITR 316 (Cal.).

■ TEA COMPANY

Expenditure incurred by the assessee-tea company on replacement of parts of an old CTC machine in order to maintain good cutting of green tea leaves and for maintaining manufacture of quality tea, is an allowable revenue expenditure—*CIT* v. *Rameshwar Prosad Kejriwal & Sons (P.) Ltd.* [1994] 76 Taxman 124 (Cal.).

■ PARTNERSHIP FIRM

❑ Amount paid by a partner to another person for looking after his interests in the firm is allowable—*CIT* v. *Baburam* [1982] 138 ITR 311 (Delhi).

❑ Relinquishment of interest and title in property by retiring partner in assets of the assessee-firm, in lieu of a consideration, would result in acquisition of assets by the assessee-firm and the consideration paid would be a capital expenditure only—*CIT* v. *Sangam Enterprises* [1999] 106 Taxman 234/240 ITR 13 (AP).

❑ Where the assessee-partner appoints a third person to be a whole-time worker of the firm in which he is a partner and gives all his remuneration to that person, the same is allowable to the assessee as a business expenditure—*CIT* v. *K.L. Raizada* [1973] 87 ITR 151 (All.).

❑ Motor car expenses incurred by the assessee-partner are deductible from his share income from the firm—*Matubai Chunilal Patel* v. *CIT* [1967] 66 ITR 408 (Guj.).

❑ Where the partnership deed does not prohibit withdrawal of capital and a partner withdraws capital and gifts it and the donee deposits the gifted amount in the firm, such a gift is valid and interest paid on such a deposit cannot be disallowed—*CIT* v. *Mahatta Construction Co.* [1989] 178 ITR 427 (Gauhati).

❑ Expenses incurred by a firm on auditing of the partner's share income are not deductible—*Amna Bai Hajee Issa* v. *CIT* [1964] 51 ITR 835 (Mad.).

❑ Interest paid by the assessee on the debit balance in a firm in which he is a partner cannot be allowed as a deduction where withdrawals are made by the assessee for personal expenses—*Baldev Ramnarayan* v. *CIT* [1988] 174 ITR 680 (Kar.).

❑ Payment made to purchase interest of a partner in a firm is a capital expenditure—*R. Guruswamy Naidu* v. *CIT* [1952] 21 ITR 188 (Mad.).

❑ Amount paid by the assessee-firm to outgoing partners for relinquishing their interest/rights in goodwill of firm is a capital expenditure—*CIT* v. *Puran Das Ranchoddas & Sons* [1988] 169 ITR 480 (AP).

■ HUF

❑ A HUF is allowed to deduct salaries paid to members of family if payment is made as a matter of commercial or business expediency ; but service must be to family—*Jitmal Bhuramal* v. *CIT* [1962] 44 ITR 887 (SC).

❑ HUF has no inherent incapacity to carry on business and expenses incurred by it on consideration of commercial expediency are deductible—*Shankerlal H. Dave* v. *CIT* [1980] 124 ITR 733 (Guj.).

❑ Remuneration to karta for managing business of HUF paid under an agreement between members of HUF is deductible from income of HUF ; such agreement entered into by adult members on behalf of minors is not invalid—*Jugal Kishore Baldeo Sahai* v. *CIT* [1967] 63 ITR 238 (SC).

❑ Amount paid to karta as remuneration cannot be allowed in the absence of agreement to pay such remuneration—*N. Veeraiah Reddiar & Bros.* v. *CIT* [1967] 64 ITR 474 (Ker.). Payments of remuneration to karta even under an implied agreement which is not in writing is allowable—*S.P. Chandrakanth* v. *CIT* [1984] 148 ITR 714 (Kar.), *CIT* v. *Raghunandan Saran* [1977] 108 ITR 818 (All.).

■ PAYMENT UNDER SECTION 80G

❑ There may be a circumstance where an expenditure falls within the category of wholly and exclusively for the purposes of the business or profession and also under section 80G and in that case option remains with the assessee to claim expenditure under either of aforesaid sections but where there is no direct nexus to prove that it is wholly and exclusively for the purpose of business or profession, then it cannot be claimed under section 37(1)—*Jaswant Trading Co.* v. *CIT* [1995] 212 ITR 24 (Raj.).

■ RESERVES

❑ Transfer of amount to reserve under section 205(2A) of the Companies Act would not amount to diversion of income by overriding title, nor would the amount so transferred be deductible under section 37(1)—*Seshasayee Paper & Boards Ltd.* v. *CIT* [1998] 145 CTR (Mad.) 498.

❑ Contingency reserve, development reserve and tariff and dividend control reserve made out of profits by electricity supply company to comply with the terms of the Electricity (Supply) Act, 1948 cannot be allowed as deduction—*Vellore Electric Corpn. Ltd.* v. *CIT* [1997] 93 Taxman 401/227 ITR 557 (SC).

❑ Contingency reserve created by the assessee rural electricity society, at 1/2 per cent of the original cost of the fixed assets, in accordance with clause (*iv*) of the Sixth Schedule to the Electricity Supply Act, 1948 and invested in the manner prescribed by the Co-operative Societies Act, is allowable as deduction—*CIT* v. *Kotputli Rural Electric Co-operative Society Ltd.* [2002] 255 ITR 563/123 Taxman 797 (Raj.).

■ SOFTWARE EXPENSES

❑ Software by its own nature is a thing which requires ongoing expenses for its upgradation, therefore, one-time expenditure on same cannot give benefit of enduring nature to an assessee and, thus, same is to be allowed as a revenue expenditure—***Sumitomo Corpn. India (P.) Ltd.*** v. ***CIT*** [2005] 1 SOT 91 (Delhi). Expenditure on software and its upgradation is allowable—***Naveen Projects Ltd.*** v. ***CIT*** [2005] 1 SOT 232 (Delhi).

❑ The Madras High Court in ***CIT*** v. ***Southern Roadways Ltd.*** [2006] 155 Taxman 493 held that computer upgrade is meant to improve the efficiency of the computers with a view to keep pace with the changing technology with the result that the expenditure did not yield any enduring benefit. The Court in this regard explained that enduring benefit would suggest lasting and not everlasting or permanent advantage. In other words, there must be sufficient degree of durability.

❑ Software programme once developed by the assessee cannot be said to be of enduring benefit and expenses incurred in developing such software programme will be allowable as revenue expenditure—*Business Information Processing Services* v. *CIT* [1999] 106 Taxman 116 (Jp.).

❑ Expenditure incurred for purchase of software (as such expenditure is in nature of rent or royalty) is allowable—*ITC Classic Finance Ltd.* v. *CIT* [2000] 112 Taxman 155 (Cal.) (Mag.).

❑ Expenditure on software, which had become obsolete, written off by assessee, is allowable as revenue expenditure—***CIT*** v. ***Citicrop Overseas Softwares Ltd.*** [2004] 85 TTJ (Mum.) 87.

❑ Where software expenses incurred by the assessee consist of payments made towards anti-virus programme meant for efficient working of computer and upgradation of software, payments so made are not incurred to acquire enduring benefit or an asset and, therefore, has to be treated as revenue expenditure—***Ajitkumar C. Kamdar*** v. ***CIT*** [2005] 1 SOT 183 (Mum.).

❑ In case of company dealing in computers and computer software, write off of obsolete and slow moving items is allowable in full—***Digital Equipment India Ltd.*** v. ***CIT*** [2006] 103 TTJ (Bang.) 329.

❑ Expenditure incurred by software developer on updation of existing software is allowable as revenue expenditure—*Spectrum Business Support Ltd.* v. *CIT* [2007] 13 SOT 89 (Mum.).

❑ Where software is in nature of license and not in nature of new software, expenses thereon have to be treated as revenue in nature—***CIT*** v. ***Jasper Investments Ltd.*** [2007] 109 TTJ (Mum.) 530.

❑ The Delhi High Court in ***CIT*** v. ***G.E. Capital Services Ltd.*** [2007] 164 Taxman 46, held that expenditure incurred on MS office software which is not customized software and which software requires frequent upgradation is an allowable business expenditure whereas according to it only customized software can have an enduring value.

■ DEFERRED REVENUE EXPENDITURE

❑ When any expenditure is treated as a 'deferred revenue expenditure', it presupposes that concerned expenditure, creating benefit in revenue field, is a revenue expenditure but considering its enduring benefits as well as fact that it does not result in creation of any new asset or advantage of enduring nature in capital field, the same is required to be treated distinctly from capital expenditure.

The treatment given to such expenditure in the P&L A/c by an assessee is in keeping with sound accounting policies and does operate as an estoppel when claiming deduction of the whole expenditure as revenue expenditure. For instance, advertisement expenditure on launching a new product and treated as "deferred revenue expenditure" is still a revenue expenditure. The action of the revenue authorities in treating the same as capital expenditure and disallowing the claim for deduction of the entire amount in the first year is not proper—***CIT*** v. ***Modi Olivetti Ltd.*** [2004] 84 TTJ (Delhi) 1038, ***CIT*** v. ***Jai Parabolic Sugars Ltd.*** [2008] 172 Taxman 258 (Delhi).

❑ Mere fact that expenditure which was otherwise revenue expenditure had been treated as deferred revenue expenditure in books of company cannot for that reason alone be disallowed in computing total income—***Borosil Glass Works Ltd.*** v. ***CIT*** [2004] 3 SOT 940 (Mum.).

❑ Expenditure incurred on marketing of newly-launched products is revenue expenditure even though it is treated as deferred revenue expenditure by the assessee in its books—***CIT*** v. ***Medicamen Biotech Ltd.*** [2005] 1 SOT 347 (Delhi).

■ PROVISION FOR UNEXPIRED WARRANTY

❑ Provision made by an assessee at 2 per cent of sale price for post-sales customer services in nature of claims within warranty period, is allowable as deduction—*Infosys Technologies Ltd.* v. *CIT* [2007] 109 TTJ (Bang.) 631.

❑ Where provision made by an assessee towards unexpired warranty was not based on actual quantification and actual expenditure incurred was much less than provision made, making it clear that liability of excess amount did not accrue, the Assessing Officer was held as justified in disallowing excess amount as contingent liability—***Srinivasa Computers Ltd.*** v. ***CIT*** [2007] 107 ITD 357 (Chennai).

❑ It had been held in ***CIT*** v. ***Vinitec Corpn. (P.) Ltd.*** [2005] 146 Taxman 313/278 ITR 337 (Delhi) that where the warranty clause is a part of the sale document and it imposes a liability on the assessee to discharge its

obligation for the period of warranty, the liability could be capable of being construed in definite terms and, therefore, could be deducted while working out the profits and gains of business.

■ OTHERS

❑ Where the assessee-undertaking had vested with the State Government and while the assessee's appeal against such an acquisition was pending it had incurred expenses on running the establishment, such expenses would be allowable as business expenditure—*CIT* v. *Vellore Electric Corporation Ltd.* [2000] 243 ITR 529/113 Taxman 236 (Mad.).

❑ Expenses incurred in respect of an abandoned project up to the date of abandonment would be allowable in the year in which the project was abandoned—*CIT* v. *Seshasayee Paper & Boards Ltd.* [2000] 243 ITR 421 (Mad.).

❑ Payment made towards professional charges for providing services for enhancement of bank limits is deductible. The payment made to brokers for the purposes of considering the viability of private placement of shares with financial institution is deductible. The expenditure incurred for professional charges for preparing offered documents, registration/approval from RBI, designing printing of application form and interests warrants is deductible—*Media Video Ltd.* v. *CIT* [2002] 122 Taxman 28 (Mag.).

❑ Expenditure incurred by author for attending seminar to generate knowledge which is a part of input of book, is to be allowed—*G.S. Ramaswamy* v. *CIT* [2002] 125 Taxman 461 (Mad.).

❑ Where assessee, a chartered accountant, while carrying out his profession, proceeded to USA for doing MBA since there is a nexus of CA degree of assessee with MBA degree, expenditure in question is to be allowed as business expenditure—***ITO*** v. ***Apurva P. Patel*** [2006] 7 SOT 755 (Mum.).

❑ Expenditure incurred by assessee for obtaining ISO-9002 certificate is allowable—***CIT*** v. ***Upper India Steel Mfg. & Engg. Co.*** [2006] 150 Taxman 51 (Chd.) (Mag.); ***CIT*** v. ***Tirupati Microtech (P.) Ltd.*** [2008] 112 ITD 328 (Jodh.).

❑ Provision made by assessee-car manufacturer for warranty is allowable—***Honda Siel Cars India Ltd.*** v. ***CIT*** [2006] 157 Taxman 76 (Delhi) (Mag.), ***Hero Briggs & Stratton Auto Ltd.*** v. ***CIT*** [2007] 161 Taxman 128 (Mag.). Provision for after-sales service as per warranty, based on ascertained liability, is deductible—***CIT*** v. ***Indian Transformers Ltd.*** [2004] 270 ITR 259 (Ker.), ***CIT*** v. ***Vinitec Corpn. (P.) Ltd.*** [2005] 146 Taxman 313 (Delhi)—***CIT*** v. ***Sony India (P.) Ltd.*** [2005] 4 SOT 30 (Delhi).

❑ Where there was no finding that the replantation of tea bushes is made in virgin or already abandoned area and in fact expenditure is on replacement of bushes that had died or become permanently useless, expenditure incurred by the assessee on replantation is to be allowed—*CIT* v. *J.N. Sarma* [1998] 100 Taxman 612/[1999] 235 ITR 170 (Gau.).

❑ Where the assessee, a manufacturer of tea, incurs expenditure on maintenance of nursery which is used for replacement of dead plants within plantation area, the expenditure incurred by the assessee is revenue expenditure—***CIT*** v. ***Tasah Tea Ltd.*** [2003] 129 Taxman 647/262 ITR 388 (Cal.).

❑ Travel expenditure incurred by the assessee foreign company to send technicians to India to study requirements for marketing rubber gaskets are deductible as revenue expenditure—*CIT* v. *Vaccum Concrete (Overseas) Co. Inc.* [2000] 245 ITR 863/[2002] 120 Taxman 340 (Mad.).

❑ Where Government laid down a mandatory condition for milk producing co-operative societies to undertake technical training programme for villagers which would help milk production as well as profit of such societies, expenditure incurred on training is to be allowed as business expenditure—***CIT*** v. ***Churu Zila Sahakari Dugdh Utpadak Sangh Ltd.*** [2004] 1 SOT 127 (Jodh.).

❑ Any payment in violation of RBI directions is not allowable as deduction under section 37(1)—***ANZ Grindlays Bank (I)*** v. ***CIT*** [2004] 88 ITD 53 (Delhi).

❑ Amount paid to Electricity Board on account of allegation of theft of electricity is deductible—***Adhunik Chemicals Pvt. Ltd.*** v. ***CIT*** [2004] 3 SOT 875 (Delhi) (SMC-I).

❑ Where assessee-firm engaged in business of legal profession incurred expenses towards education of its partner abroad, since there is a direct nexus between type of education procured by partner and nature of assessee's business, expenses incurred by assessee were definitely in nature of revenue expenses, which were to be allowed—***CIT*** v. ***P.C. Hathi*** [2004] 1 SOT 119 (Ahd.) (SMC).

❑ Hospitality expenses incurred by assessee-advocate in exploring possibility of foreign association are allowable so long as they are not personal in nature—***Sudipto Sarkar*** v. ***CIT*** [2004] 139 Taxman 23 (Kol.) (Mag.).

❑ Assessee is entitled to set off interest earned on deposits out of public issue money against the expenses incurred for public issue—***Neha Proteins Ltd.*** v. ***CIT*** [2004] 83 TTJ (Jodh.) 236.

❑ Where interest was earned on deposit with bank under a mandatory situation in connection with issue of shares, such interest is to be set off against share issue expenses—***J.M. Shares & Stock Brokers Ltd.*** v. ***CIT*** [2004] 83 TTJ (Mum.) 1052.

❑ Payments made as secret commission/mamools by assessee-contractor to Government officials to secure contracts, being on account of illegal gratification and also opposed to public policy, cannot be allowed in view of *Explanation* to section 37(1)—***ITO*** v. ***M.S. Kumaraswamy*** [2004] 84 TTJ (Chennai) 916.

❑ Stamp duty for term loan and professional fee for term loan, are allowable as revenue expenditure—***Shri Rama Multi Tech Ltd.*** v. ***CIT*** [2005] 92 TTJ (Ahd.) 568.

❑ Financial charges, legal and professional charges and upfront fees incurred in connection with obtaining loan, are allowable expenses—***Shri Rama Multi Tech Ltd.*** v. ***CIT*** [2005] 92 TTJ (Ahd.) 568.

❑ Expenditure incurred by the assessee on payment of one-time non-refundable fee for membership of OTC Exchange of India is allowable as revenue expenditure—***Neset Holdings (P.) Ltd.*** v. ***CIT*** [2006] 151 Taxman 309 (Delhi).

❑ Where personnel of the assessee-company went to Bhuj and Bhavnagar to facilitate relief work during aftermath of earthquake, aircraft expenditure incurred by the assessee on said visits is an allowable expenditure—***CIT*** v. ***Jindal Steel & Power Ltd.*** [2007] 16 SOT 509 (Delhi).

❑ Provision for holiday incentive scheme for the benefit of dealers available on the basis of achieving targets is deductible—***CIT*** v. ***Honda Siel Power Products*** [2007] 165 Taxman 577 (Delhi).

❑ Refundable deposits placed by an assessee with a stock exchange does not constitute expenditure and cannot be allowed as deduction under section 37(1)—***CIT*** v. ***Khandwala Finance Ltd.*** [2008] 22 SOT 1 (Mum.).

❑ The assessee purchased running business of a firm along with its goodwill and paid certain amount to partners of that firm for not carrying on same line of business for five years. The expenditure incurred by assessee is revenue in nature and, hence, allowable. Since expenditure is incurred for a period of 5 years, it is to be allowed over a period of 5 years and not in a lump sum in the relevant assessment year—***Premier Opticals (P.) Ltd.*** v. ***CIT*** [2008] 170 Taxman 167 (ITAT).

■ BOARD'S CIRCULARS

❑ Keyman insurance premium is deductible - Circular No. 762, dated February 18, 1998

❑ Revenue expenses incurred by the industrial undertakings in connection with the maintenance of the Industrial Home Guard Units may be treated as deductible expenses under section 37(1)—Letter : F. No. 10/80/64-IT(A-I), dated February 26, 1965.

❑ Interest charged by the Government for delay in payment of tax is in the nature of a personal liability which cannot be allowed as a deduction in the computation of the taxable income—*Source :* Relevant extracts from the minutes of 15th meeting of CDTAC held on August 6, 1970.

❑ Any expenditure on labour welfare work, not of capital nature - actually incurred during the previous year - should be allowed in entirety as deduction in income-tax assessments, irrespective of the actual amount of profits for that year available for meeting the expenditure—Circular : No. 3 [R. Disc. No. 27(50)-IT/46], dated March 26, 1946.

❑ Out of the financial assistance to be given by the employers in connection with the setting up of consumers' co-operative stores for industrial workers, the managerial subsidy to meet the establishment cost, such as salaries and rent charges on a tapering basis for three years, may be treated as being of the nature of expenditure for the welfare of the industrial workers of the employer concerned and can be permitted to be deducted in computing the taxable income of the employer—*Letter : F. No. 10/16/63-IT(A-I), dated May 14, 1963.*

❑ The contributions to a fund set up under subsidised industrial housing scheme cannot be regarded as an admissible deduction under section 37(1) of the Act—Letter : F. No. 10/8/63-IT(A-I), dated October 14, 1963.

❑ Where laga contribution is made at the customary rate prevalent in the market, such contribution should be allowed in full in the assessment of the member-contributors—Circular : No. 5-P(XIV-I), dated September 28, 1963.

❑ Professional tax paid by a person carrying on a business or trade can be allowed to him as a deduction under section 37(1)—Circular : No. 16 [F. No. 9/38/69-IT(A-II)], dated September 18, 1969.

❑ Rebate or bonus (which is in the nature of deferred discount) passed on by the consumer co-operative stores to their members on the value of the purchases made by them during a year should be allowed as a deduction in computing the business income of such a society—Circular : No. 117 [F. No. 201/5/73-IT(A-II)], dated August 22, 1973.

❑ It is open to the subscriber either to claim the entire amount paid under the OYT scheme in the year in which the payment is made or proportionately in the years for which the advance payment of rent is made.

Where the installation of telephone is in the previous year subsequent to the previous year in which the deposit is made, the deduction for the payment should be allowed in the year of payment irrespective of the fact whether the telephone has been installed or not—Instruction : No. 943 [F. No. 204/15/76-IT(A-II)], dated April 2, 1976.

❑ Amount paid by an assessee for obtaining a new telephone connection under the "Tatkal Telephone Deposit Scheme", can be allowed as revenue expenditure in the year of payment. The refund of the said amount, if any, will be taxed under section 41(1)—*Circular : No. 671, dated October 27, 1963.*

❑ Since the deposit of Rs. 10,000 for a telex connection does not earn any interest when the telex machine is installed, at that stage, this amount may be treated as a revenue expenditure allowable as a deduction, if the assessee makes such a claim. However, when the amount is returned by the postal authorities when the telex connection is finally closed, the refund of Rs. 10,000 shall be treated as an income of the assessee of the year in which the amount is refunded—*Circular : No. 420 [F. No. 204/10/83-IT(A-II)], dated June 4, 1985.*

❑ The contributions made by the members to the 'cycle export pool' *vide* rule 5(*c*) of the scheme, will be admissible as a deduction under section 37(1) of the Act in their assessments. The subsidies received from the pool by the members will be treated as taxable income in their hands—*Letter : F. No. 27(24)-IT/59, dated May 19, 1959.*

❑ ARP expenditure incurred by insurance companies should be treated on the same principles as laid down in the Board's Circular No. 42, dated August 22, 1942—*Circular : No. 36 [R. Disc. No. 54(13)-IT/43], dated November 24, 1943.*

❑ The outlay incurred by factories on approved camouflage measures should, like expenditure on other air raid precautions measures, be treated as revenue expenditure for the purpose of income-tax—*Circular : No. 48 [C. No. 19(22)-IT/42], dated October 16, 1942.*

❑ In view of the statutory obligation cast on the employers under the provisions of the Apprentices Act, 1961, recurring expenses incurred on imparting of the basic training to the apprentices under the said Act will be allowable as a deduction under section 37(1).

❑ As regards expenses for imparting of practical training under Practical Training Stipends Scheme and Programme of Apprenticeship Training (PAT), these expenses will not be covered within the meaning of section 37(1), as no statutory obligation is cast on the employer under these two training schemes—*Circular : No. 192 [F. No. 204/39/75-IT(A-II)], dated March 10, 1973.*

❑ All expenditure on the maintenance of a tea garden, including expenditure on the maintenance of an area that has not reached maturity, is an item of revenue expenditure and as such is allowable as deduction for the purposes of computing the income of a tea estate under the Income-tax Act — *Source :* Income-tax Circulars published by Directorate of Inspection (RS & P), 1968 Edition, page 192.

❑ Expenditure *qua* telephones and conveyance laid out wholly and exclusively by small newspaper agencies for the purposes of the business can be allowed as deduction but any expenditure in the nature of personal expenses of such assessees is not admissible as a deduction.

In determining the non-business part of such expenditure, the Assessing Officers need not go into meticulous details regarding each item and the officers should adopt a reasonable approach in this respect having regard to the circumstances of the newspaper business—*Letter : F. No. 35/5/65-IT(A-I), dated July 1, 1965.*

❑ Harvesting and transportation expenses incurred by the Co-operative sugar mills for procuring sugarcane from farmers, who are members of such Co-operative Sugar Mills and who are bound under an agreement to supply the sugarcane exclusively to the concerned sugar mill is deductible—**Circular No. 6/2007**, dated October 11, 2007.

Amounts expressly disallowed under the Act

142. Sections 40, 40A and 43B enumerate deductions expressly disallowed while computing taxable income of an assessee. Provisions of these sections are discussed in paras 143 to 155. Besides these provisions, no deduction is permissible in respect of any expenditure or allowance under sections 28 to 44C in respect of income referred to in sections 115A, 115AB, 115AC, 115AD, 115BBA and 115D.

Amount not deductible under section 40(*a*)

143. In the case of any assessee, the following expenses are expressly disallowed under section 40(*a*)—

143.1 ***Interest, royalty, fees for technical services payable outside India or payable to a non-resident [Sec. 40(a)(i)]*** - If the following three conditions are satisfied the assessee (*i.e.*, the payer) is supposed to deduct tax at source (TDS) under section 195—

Condition one	The amount paid is interest, royalty, fees for technical services or other sum.
Condition two	The aforesaid amount is chargeable to tax under the Act in the hands of the recipient.
Condition three	The aforesaid amount is paid/payable (*a*) outside India to any person; or (*b*) in India to a non-resident.

If the above three conditions are satisfied, the assessee (the payer) is supposed to deduct tax at source and deposit the same with the Government within the time-limit specified by section 200(1) [generally this time-limit is seven days from the end of the month in which tax is deducted. In some cases, time-limit is different (for detailed discussion, refer to para 428.4)].

▪ *TDS defaults* - TDS defaults may be broadly grouped in the following categories—

Default one	Tax is deductible at source but the assessee has not deducted it.
Default two	Tax is deducted during the current year. Under section 200(1) it should be deposited during the current year but the assessee (*i.e.*, the payer) has not deposited during the current year.
Default three	Tax is deducted during the current year, it is deposited in the current year but after the due date specified under section 200(1).
Default four	Tax is deducted during the current year. The last date of deposit, as per section 200(1), falls in the next financial year. Tax is actually deposited by the assessee (*i.e.*, the payer) in the next financial year after the due date.

▪ *Consequences in the case of above defaults* - The expenditure (*i.e.*, interest, royalty, technical fees, etc.) is not deductible while calculating income of the assessee (*i.e.*, payer) under section 40(*a*)(*i*), in the case of *Default one, Default two* and *Default four.* However, this disallowance is not applicable (or the expenditure is deductible) in the case of *Default three.*

▪ *Consequences if tax is deposited subsequently* - If the above expenditure is not allowed in the current year, deduction will be available while computing the business income of a subsequent previous year in which such tax will be paid (*i.e.*, in the year in which tax deducted by the assessee will be paid to the Government).

▪ *Judicial rulings* - If royalty is paid to a non-resident (tax is deductible but not deducted at source), it is not allowed as deduction. Likewise, if technical know-how is purchased from a non-resident, tax is deductible but not deducted at source, depreciation on such technical know-how is not deductible—***Suaco Carbprettors (I) Ltd.*** v. ***CIT*** [2005] 3 SOT 798 (Mum.). Conversely, where legal fees paid to solicitors in UK is not chargeable to tax under Act in India, assessee is under no obligation to deduct tax at source under section 195 from payment and, therefore, it cannot be disallowed by invoking section 40(*a*)(*i*)—***IMP Power Ltd.*** v. ***ITO*** [2006] 9 SOT 156 (Mum.).

▪ Section 40(*a*)(*i*) is applicable also in respect of payments made on capital account and makes no distinction between revenue expenditure or capital expenditure and in fact it covers both—***Spaco Carburettors (I) Ltd.*** v. ***CIT*** [2005] 3 SOT 798 (Mum.).

▪ No disallowance of payments under section 40(*a*)(*i*) can be made for non-deduction of tax at source therefrom where such payments to non-resident are not taxable in the hands of recipient in view of the provision of the Income-tax Act or Avoidance of Double Taxation Agreement—***NQA Quality Systems Registrar Ltd.*** v. ***CIT*** [2005] 2 SOT 249 (Delhi).

Provisions illustrated - Consider the following cases pertaining to payment of interest, royalty, technical fees or any other sum to a non-resident which are subject to the provisions of tax deduction at source under section 195 (in all cases liability is incurred during the previous year 2008-09) -

Date on which tax is supposed to be deducted	Actual date of tax deduction	When tax should be deposited under section 200(1)	Date of deposit of TDS	Previous year in which it is deductible
June 26, 2008	June 26, 2008	July 7, 2008	September 1, 2008 (*i.e.*, deposited during the current financial year 2008-09, late deposit is immaterial if tax is deposited in the financial year in which tax is deducted)	2008-09
July 26, 2008	July 26, 2008	August 7, 2008	April 1, 2009 [*i.e.*, deposited in the next financial year after the due date given under section 200(1)]	2009-10
March 31, 2009	March 31, 2009	May 31, 2009	May 31, 2009 (deposited in the next financial year but before the due date)	2008-09
March 31, 2009	March 31, 2009	May 31, 2009	June 1, 2009 [deposited in the next financial year but after the due date given under section 200(1)]	2009-10
May 16, 2008	May 16, 2008	June 7, 2008	Not deposited	Not deductible
Dec., 1, 2008	Not deducted	-	Not deposited	Not deductible
June 10, 2008	June 10, 2008	July 7, 2008	July 20, 2010 [deposited in a subsequent financial year but after the due date given under section 200(1)]	2010-11

143.2 ***Compliance of TDS provisions in case of a resident [Sec. 40(a)(ia)]*** - With a view to augment compliance of TDS provisions, clause (*ia*) has been inserted in section 40(*a*).

143.2-1 *CONDITIONS* - Section 40(*a*)(*ia*) is applicable if the following conditions are satisfied—

1. It covers the following expenses—

	TDS provisions given in the following sections—
Interest	193 or 194A
Commission or brokerage	194H
Fees for technical services	194J
Fees for professional services	194J
Payment to contractors/sub-contractors	194C
Rent	194-I
Payment of "royalty" to a resident	194J

2. In the above cases recipient is resident in India.

143.2-2 *CONSEQUENCES IF THE ABOVE CONDITIONS ARE SATISFIED* - If the aforesaid conditions are satisfied, the expenditure is not deductible (with effect from the assessment year 2005-06) in the following cases—

Cases	*Expenditure given in column 1 of the above table - Is it deductible in the current previous year*	*Is such expenditure deductible in any subsequent previous year*
Case 1 - Tax is deductible but not deducted	No deduction in the current previous year	If tax is deducted in any subsequent year, the expenditure will be deducted in the year in which TDS will be deposited by the assessee with the Government.

Cases	*Expenditure given in column 1 of the above table - Is it deductible in the current previous year*	*Is such expenditure deductible in any subsequent previous year*
Case 2 - Tax is deductible (and is so deducted) during the last month (*i.e.*, in the month of March) of the previous year but it is not deposited on or before the due date of submission of return of income under section 139(1)	No deduction in the current previous year	If tax is deposited with the Government after the due date of submission of return of income, the expenditure will be deductible in that year in which tax will be deposited.
Case 3 - Tax is deductible (and is so deducted) during any month but other than the last month (*i.e.*, any time before March 1) of the previous year but it is not deposited on or before March 31 of the previous year	No deduction in the current previous year	If tax is deposited with the Government after the end of the current previous year, the expenditure will be deductible in that year in which tax is deposited.

Provisions illustrated - Consider the following cases—

1. X Ltd. pays a sum of Rs. 1 lakh as rent of office building during the previous year 2008-09. As the amount is not more than Rs. 1,20,000, tax is not deducted at source under section 194-I.

Since tax is not deductible, disallowance under section 40(*a*)(*ia*) is not applicable.

2. A consultancy fees of Rs. 40,000 is credited by Y Ltd. to the account of payee on January 1, 2008 without tax deduction at source under section 194J. It will not be allowed as deduction for the previous year 2007-08 by virtue of section 40(*a*)(*ia*).

Suppose, tax is deducted on December 1, 2009 and it is deposited on July 1, 2010, the consultancy fees of Rs. 40,000 will be allowed as deduction for the previous year 2010-11.

3. Interest of Rs. 80,000 on company deposit is paid by Z Ltd. on March 10, 2009. Tax is deducted on the same day. Tax is deposited with the Government through internet banking on August 10, 2009 (*i.e.*, before the due date of submission of return of income: September 30, 2009), it will be allowed as deduction for the previous year 2008-09.

Suppose, tax is deposited on October 10, 2009, then by virtue of section 40(*a*)(*ia*) it will be allowed as deduction for the previous year 2009-10 (and not for the year 2008-09).

4. A Ltd. pays Rs. 2,20,000 to a resident work contractor on October 30, 2008 after deduction of tax at source under section 194C. Disallowance under section 40(*a*)(*ia*) is not applicable if tax is deposited at any time on or before March 31, 2009.

If suppose tax is deposited on April 5, 2009, then by virtue of section 40(*a*)(*ia*) it will be allowed as deduction for the previous year 2009-10 (and not for the previous year 2008-09).

5. B Ltd. is a subsidiary of an overseas company. It maintains books of account on the basis of March-February year (accounting year starts on March 1 and ends on February 28/29 of the next calendar year, Income-tax Act does not require that books of account should be maintained on financial year basis). On February 28, 2009, it transfers a sum of Rs. 3 lakh as commission to the account of a broker in its books of account. Tax is deducted at source at the rate of 10.3 per cent under section 194H. Tax is deposited on April 20, 2009 [*i.e.*, within 2 months from the last date of the accounting year as permitted by section 200(1) read with rule 30(1)(*b*)(*i*)(1)].

By virtue of the provisions of section 40(*a*)(*ia*), Rs. 3 lakh will be allowed as deduction for the previous year 2009-10 (and not for the previous year 2008-09).

143.2-3 ***FREQUENTLY ASKED QUESTIONS*** - The following questions are frequently asked—

■ *Whether section 40(*a*)(*ia*) covers every TDS default* - Only defaults specified above are covered by section 40(*a*)(*ia*). For instance, section 40(*a*)(*ia*) is not applicable in respect of delay in filing of TDS return.

■ *Whether TDS defaults in respect of expenses claimed as deduction under other heads are covered* - The provisions of section 40(*a*)(*ia*) are applicable only in respect of expenses claimed as deduction under the head "Profits and gains of business or profession". Expenses claimed under any other head are not covered by section 40(*a*)(*ia*).

■ *Whether section 40(*a*)(*ia*) is applicable in respect of expenses actually "paid" without TDS* - Tax is deductible under sections 193, 194A, 194C, 194H, 194-I and 194J either at the time of payment or at the time of giving credit to the recipient. However, section 40(*a*)(*ia*) is applicable only in respect of TDS defaults if amount is payable. If amount is actually paid and tax is not deducted under the above sections, section 40(*a*)(*ia*) is not applicable. Section 40(*a*)(*ia*) has to be subjected to strict interpretation. Going by the rule of strict interpretation, the default with reference to actual "payment" of expenditure would not entail disallowance.

■ *Whether section 40(*a*)(*ia*) is applicable in respect of genuine and* bona fide *but erroneous belief that the deductor had no obligation for TDS* - Section 40(*a*)(*ia*) is applicable even in respect of *bona fide* mistakes committed by a deductor. The considerations are different for levy of penalty under section 271C and for disallowance under section 40(*a*)(*ia*). There is no specific provision under section 40(*a*)(*ia*) for not invoking this section where the deductor was prevented by a reasonable cause.

■ *Whether under section 40(*a*)(*ia*) entire amount is to be disallowed even in respect of short deduction* - There is no specific provision under section 40(*a*)(*ia*) to cover cases of short deduction. However, proportionate expenditure may be disallowed keeping in view the intention of Legislature.

143.3 ***Securities transaction tax [Sec. 40(a)(ib)]*** - The provisions are given below—

	*Disallowance of securities transaction tax under section 40(*a*)(*ib*)*	*Rebate under section 88E*
For the assessment years 2005-06 to 2008-09	Securities transaction tax is not deductible	Rebate under section 88E is available
From the assessment year 2009-10 onwards	Disallowance under section 40(*a*)(*ib*) has been omitted and securities transaction tax will be deductible as business expenditure under section 36(1)(*xv*)	No rebate

143.3A ***Fringe benefit tax [Sec. 40(a)(ic)]*** - Fringe benefit tax is not deductible.

143.4 ***Income-tax [Sec. 40(a)(ii)]*** - Any sum paid on account of any rates or tax levied on the profits or gains of any business or profession or assessed at a proportion of, or otherwise on the basis of, any such profits and gains, is not deductible.

Any sum paid outside India and eligible for relief of tax under section 90/90A/91 is not allowable. However, the taxpayers will continue to be eligible for tax credit in respect of income-tax paid in a foreign country in accordance with the provisions of section 90/90A/91.

One should keep in view the following points :

■ In Thailand business tax, is not on income. It is on turnover. Consequently, section 40(*a*)(*ii*) has no application to business tax paid by an assessee in Thailand—*CIT* v. *K.E.C. International Ltd.* [2002] 256 ITR 354 (Bom.).

■ Payment of income-tax, surcharge and education cess is not deductible as per section 40(*a*)(*ii*) and so interest under section 234A, 234B or 234C which has to be regarded as accretion to tax cannot also be allowed to be deducted—*see Assam Forest Products (P.) Ltd.* v. *CIT* [1989] 180 ITR 478 (Gauhati). Any penalty, fine under the Income-tax Act is not deductible.

■ Surtax paid is not allowable as deduction—*Smith Kline & French (India) Ltd.* v. *CIT* [1996] 219 ITR 581 (SC). Even dividend tax is not deductible.

■ Foreign income-tax cannot be allowed as deduction—*CIT* v. *Indian Overseas Bank Ltd.* [1963] 50 ITR 725 (Mad.).

■ Interest-tax paid or payable by a "credit institution" under the Interest-tax Act, 1974 is deductible.

■ Where the assessee-company takes over a running business of the vendor-firm at a consideration (which has been ascertained by taking into account assets and liabilities including income-tax payable of the vendor firm), the income-tax liability of the vendor-firm paid by the assessee is not

deductible. This is because of the fact that when assets and liabilities are taken into account for ascertaining the purchase consideration, the liabilities in effect, reduce the purchase consideration. Therefore, income-tax liability of the vendor firm taken over and paid by the assessee-company is a capital expenditure and is not entitled to deduction—*Puspa Perfumery Products (P.) Ltd.* v. *CIT* [1992] 194 ITR 248 (Cal.), *Dashmesh Transport Co. (P.) Ltd.* v. *CIT* [1980] 125 ITR 681 (Punj. & Har.). The aforesaid rule is, however, not applicable if the expenditure is not a capital expenditure in the hands of the payer. For instance, tax is due by A to the Income-tax department. A contacts B (a money lender) to request him to discharge that liability to the department and executes a pronote in favour of B. If A is unable to honour the pronote and B writes off the debt, then in the hands of B, it is deductible. It is not a capital expenditure of B, nor is it hit by the provisions of section 40(*a*)(*ii*).

- Purchase cess/water cess do not come within this provision.

143.5 *Wealth-tax [Sec. 40(a)(iia)]* - Any sum paid on account of wealth-tax under the Wealth-tax Act, 1957, or any tax of a similar nature chargeable under any law in force in any foreign country is not deductible.

The following points one should keep in view :

- "Any tax chargeable with reference to the value of any particular asset of the business or profession" is not subject to disallowance [*Explanation* to section 40(*a*)(*iia*)]. The words "any particular asset" in the aforesaid *Explanation* cannot be read as the aggregate of the assets defined as "net wealth" in section 2(*m*) of the Wealth-tax Act—*T.S. Krishna* v. *CIT* [1973] 87 ITR 429 (SC).
- The tax paid by tea companies on their tea gardens under the UP Large Land-holding Tax Act, 1957, is not a wealth-tax or any other tax referred to in section 40(*a*)(*iia*)—*Dehradun Tea Co. Ltd.* v. *CIT* [1973] 88 ITR 197 (SC).
- Municipal property taxes chargeable under the local tax laws of Japan are not "any tax of similar character chargeable under any law in force in any country outside India" within the meaning of section 40(*a*)(*iia*) and, therefore, such taxes are deductible—*Mitsui Steamship Co. Ltd.* v. *CIT/Kawasaki Kisen Kaisha Ltd.* v. *CIT* [1975] 99 ITR 7 (SC).

143.6 *Salary payable outside India without tax deduction [Sec. 40(a)(iii)]* - Section 40(*a*)(*iii*) is applicable if the following conditions are satisfied—

Condition one	The payment is chargeable under the head "Salaries" in the hands of the recipient.
Condition two	It is payable— *a.* outside India (to any person resident or non-resident); or *b.* in India to a non-resident.
Condition three	Tax has not been paid to the Government nor deducted at source under the Income-tax Act.

If the aforesaid conditions are satisfied, then the payment is not allowed as deduction.

Provisions illustrated - The following illustration is given in respect of salary payable for the previous year 2008-09 by a company to (a) any person outside India or (b) a non-resident in India —

Amount Rs.	Date on which tax is supposed to be deducted (i.e., the date of salary payment)	Actual date of tax deduction	When tax should be deposited under section 200(1)	Actual date of tax deposit	Previous year in which salary payment is deductible
40,000	July 31, 2008	July 31, 2008	August 7, 2008	November 10, 2008	2008-09
90,000	March 31, 2009	March 31, 2009	April 7, 2009	April 7, 2009	2008-09
1,60,000	March 31, 2009	March 31, 2009	April 7, 2009	April 12, 2009	2008-09
70,000	March 31, 2009	Not deducted	April 7, 2009	April 12, 2009	2008-09
75,000	March 31, 2009	March 31, 2009	April 7, 2009	Not deposited	2008-09
95,000	March 31, 2009	Not deducted	April 7, 2009	Not deposited	Not deductible

If salary payable outside India is exempt under section 10 in the hands of the recipient, the aforesaid disallowance is not applicable—*Oceanic Contractors Inc.* v. *ITO* [1990] 33 ITD 213 (Bom.).

143.7 ***Provident fund payment without tax deduction at source [Sec. 40(a)(iv)]*** - Any payment to a provident fund or other fund established for the benefit of employees of the assessee is not deductible if the assessee has not made effective arrangements to secure that tax shall be deducted at source from any payments made from the fund which are chargeable to tax under the head "Salaries".

Where in the case of a provident fund established by a company, by creating a trust, the management of the company had drawn the attention of the secretary of the trust to the requirements of the Income-tax Act, for deduction of tax at source and the secretary had confirmed that the requirements would be complied with, it was *held* that this constituted effective arrangement contemplated in section 40(*a*)(*iv*)—*CIT* v. *Delhi Cloth & General Mills Co. Ltd.* [1981] 127 ITR 11 (Delhi).

143.8 ***Tax on perquisite paid by the employer [Sec. 40(a)(v)]*** - The provisions of section 40(*a*)(*v*) are given below—

1. The employer provides non-monetary perquisites to employees.

2. Tax on non-monetary perquisites is paid by the employer.

3. The tax so paid by the employer is not taxable in the hands of employees by virtue of section 10(*10CC*).

4. While calculating income of the employer, the tax paid by the employer on non-monetary perquisites is not deductible under section 40(*a*)(*v*).

Provisions illustrated - During the previous year 2008-09, A Ltd. pays Rs. 40,000 per month as salary to X (28 years) and provides a rent-free unfurnished house (lease rent being Rs. 10,000 per month). The tax on perquisite is paid by A Ltd. as follows—

	Rs.
Salary	4,80,000
Value of perquisite (15 per cent of salary)	72,000
Gross salary	5,52,000
Less: Deductions	—
Net income	5,52,000
Tax on net income (including EC and SHEC)	72,720
Average rate of tax (Rs. 72,720/Rs. 5,52,000 × 100): 13.17%	
Tax on perquisite (13.17% of Rs. 72,000)	9,485

Total expenditure incurred by A Ltd. in respect of employee X is as follows—

	Rs.
Salary to X	4,80,000
Rent-free house to X (Rs. 10,000 × 12)	1,20,000
Tax on perquisite borne by A Ltd.	9,485
Total	6,09,485

While calculating business income of A Ltd., Rs. 9,485 is not deductible by virtue of section 40(*a*)(*v*) [amount deductible being Rs. 4,80,000 + Rs. 1,20,000]. In the hands of X, Rs. 9,485 is not chargeable to tax. The same rule is applicable if tax on perquisite paid by A Ltd. is lower than Rs. 9,485. If, however, tax paid by A Ltd. is more than Rs. 9,485 then the "excess" amount is deductible in the hands of A Ltd. and the same is chargeable to tax in the hands of X [see also problem 63-P6].

Amount not deductible in the case of partnership firm [Sec. 40(*b*)]

144. *See* paras 317 and 318.

Amounts not deductible in the case of an association of persons and body of individuals [Sec. 40(*ba*)]

145. *See* paras 323.1 and 323.2 for detailed discussion.

Amount not deductible under section 40(c)/(d)

146. The disallowance under section 40(*c*)/(*d*) is not applicable from the assessment year 1989-90.

Payments to relative [Sec. 40A(2)]

147. Any expenditure, by way of payment to the persons mentioned in para 147.3, is liable to be disallowed in computing business profits to the extent such expenditure is considered to be excessive or unreasonable having regard to the fair market value of goods or services or facilities, etc.

Before, understanding the implication of section 40A(2), it is imperative to understand the meaning of terms "relative" and "persons having substantial interest".

147.1 ***Who is relative [Sec. 2(41)]*** - The term "relative", in relation to an individual, means the husband, wife, brother or sister or any lineal ascendant or descendant of that individual [sec. 2(*41*)].

147.2 ***"Substantial interest" - Meaning of*** - A person is deemed to have substantial interest in the business or profession if such person is the beneficial owner of at least 20 per cent of equity capital (in the case of a company), or if such person is entitled to 20 per cent profits of a concern (in any other case), at any time during the previous year.

147.3 ***Payment to persons covered by section 40A(2)*** - If a payment has been made or is to be made by a taxpayer in respect of an expenditure to a person mentioned in column (*2*) of the table given below, section 40A(2) is applicable. Consequently the excess portion shall be disallowed to the extent such expenditure is considered excessive or unreasonable having regard to the fair market value of goods, services, facilities, etc. In other words, if the following conditions are satisfied, then to the extent the payment is excessive, it will be disallowed —

a. expenditure is incurred for goods, services or facilities ;

b. for the above, payment is made to a person mentioned in column *2* of the table *infra*; and

c. it is considered as excessive or unreasonable having regard to the following —

i. fair market value of the commodity or service or facility; or

ii. legitimate business needs of the business of the assessee; or

iii. benefit derived by or accruing to assessees as a result of the expenditure.

Who has incurred the expenditure (i.e. the taxpayer)	*To whom the payment is made*	*Example* [illegible]
1. An individual	To a relative	X purchases goods from his brother.
2. A company	To a director of the company or any relative of the director	A, B and C are three directors of X Ltd. X Ltd. employs Mrs. A or Mrs. B is paid by X Ltd. for her tax advise.
3. A firm	To a partner of the firm or a relative of the partners	A and B are two partners of AB and Co., a firm. The firm purchases raw material from the sister of B.
4. An association of persons	To a member of the association or a relative of the member	XY, an association of persons, has X and Y as its two members. The association purchases goods manufactured by the son of X.

Who has incurred the expenditure (i.e., the taxpayer)	*To whom the payment is made*	*Example*
5. A Hindu undivided family	To a member of the family or relative of such person	X is the karta of X (HUF), with other members being Y, Z and A. The family appoints Mrs. A as selling agent.
6. Any taxpayer	To an individual who has a substantial interest in the business of the taxpayer or a relative of such individual	X holds 20 per cent equity share capital in X Ltd. X Ltd. hires trucks owned by the brother of X and pays rent.
7. Any taxpayer	To a company who has a substantial interest in the business of the taxpayer, any director of such company or a relative of such director	Y Ltd. holds 20 per cent equity shares in X Ltd. A and B are directors of Y Ltd. X Ltd. pays salary to Mrs. B.
8. Any taxpayer	To a firm/association of persons/ Hindu undivided family who has a substantial interest in the business of the taxpayer or partner/ member of such person or a relative of partner/member	A and B are two partners of AB and Co., a partnership firm, AB and Co. holds 20 per cent equity share capital in X Ltd. X Ltd. appoints Mrs. B as a software consultant.
9. Any taxpayer	To a company, one of whose directors has a substantial interest in the business of the taxpayer or payment is made to any director of such company or any relative of such director	A and B are directors of Y Ltd. A holds 20 per cent equity share capital in X Ltd. X Ltd. purchases material for packaging from Mrs. B.
10. Any taxpayer	To a firm/association of persons/HUF, one of whose partners/members has a substantial interest in the business of the taxpayer or payment is made to any other partner/ member of such firm/ association/HUF or any relative of such person	A and B are two partners of Y and Co., a firm. B is 20 per cent partner in X and Co., another firm. X and Co. appoints Mrs. A as its legal adviser and pays fees.
11. An individual	To a person in whose business the taxpayer or any of his relative has a substantial interest	Mrs. X holds 20 per cent equity share capital in Y Ltd. X purchases goods from Y Ltd.
12. A company	To a person in whose business the taxpayer/any director of taxpayer/any relative of such director has a substantial interest	Mrs. A owns 20 per cent equity share capital in Y Ltd. A is a director in X Ltd. X Ltd. purchases raw material from Y Ltd.
13. A firm/association of persons/HUF	To a person in whose business the taxpayer/any partner/member of the taxpayer or any relative of such partner/member has a substantial interest	A's brother B is a 30 per cent partner in Y Co., a firm. A is a partner in X Co., another firm. X Co. purchases goods from Y Co.

Note - In the examples mentioned in column *3*, if the payment is excessive or unreasonable, then the Assessing Officer may disallow the excess payment. For instance, in example 1, X purchases goods (1000 kg.) from his brother at the rate of Rs. 100 per kg., whereas the market rate is Rs. 90 per kg., then the Assessing Officer shall disallow Rs. 10,000 (*i.e.*, Rs. 10 × 1000). Similarly, in example 2, X Ltd. employs Mrs. A on salary of Rs. 15,000 per month, whereas Mrs. A will not get more than Rs. 6,000 per month from any other employer, then Rs. 9,000 per month shall be disallowed in the hands of X Ltd.

147.4 ***Other points*** -The following points require special attention —

- *All categories of expenses* - Disallowance covers all categories of expenses including expenditure on purchase of raw material, stores, or goods, salaries to employees and other expenditure by way

of bonus, commission, etc. For instance, interest paid to son/wife of partner at 24 per cent is hit by section 40A(2), where interest paid in other cases is only 12 or 15 per cent—*Anandji Shah* v. *CIT* [1990] 181 ITR 171 (Ker.).

■ *Reasonableness* - Where payment for any expenditure is made to a relative or an associate falling within the aforesaid categories, the Assessing Officer should determine the reasonableness of the expenditure with reference to the fair market value of goods, services or facilities for which payment is made. The Assessing Officer should also examine the legitimate needs of the business or profession and the benefits derived by or accruing to the assessee from such expenditure. As the provision is meant to encounter evasion of tax through excessive or unreasonable payments to relatives or associate concerns, the Assessing Officer should exercise his judgment in a reasonable and fair manner.

The Karnataka High Court in ***Recon Machine Tools (P.) Ltd.*** v. ***CIT*** [2006] 155 Taxman 252 held that there cannot be any yardstick in the matter of professional or technical services. The Court held that 5 per cent royalty charged in consideration of providing technical know-how and consultancy is reasonable.

■ *Getting lesser payment from relatives* - Section 40A(2) applies only when the assessee has incurred expenses while making payments to persons covered by the said section. It is not applicable in case of charging of lesser price from a sister concern for sale of the assessee's products— *Varinder Agro Chemicals Ltd.* v. *CIT* [2002] 120 Taxman 150 (Chd.) (Mag.).

■ *Co-operative society* - A co-operative society is outside the purview of section 40A(2)—*Shivamrut Dudh Utpadak Sah. Sangh Maryadit* v. *CIT* [1999] 71 ITD 157 (Pune), ***CIT*** v. ***Manjara Shetkari Sahakari Sakhar Karkhana Ltd.*** [2008] 166 Taxman 287 (Bom.).

■ *Section 40A(2)* v. *Section 40(b)* - Section 40A(2) would not apply to a case covered by section 40(*b*)—*Chhajed Steel Corporation* v. *CIT* [2001] 116 Taxman 37 (Mag.)/77 ITD 419 (Ahd.).

■ *Section 40A* v. *Chapter X* - The provisions of section 40A(2) cannot override the provisions contained in Chapter X (*i.e.*, transfer pricing). Even otherwise, if there are different provisions over the same subject, then, in law, the specific provisions would prevail. So, even assuming that provisions of section 40A are attracted, these are the general provisions applicable to all transactions while the provisions of Chapter X are specific provisions relating to international transactions only. Therefore, the provisions of Chapter X which are more specific would apply—***Aztec Software & Technology Services Ltd.*** v. ***CIT*** [2007] 162 Taxman 121 (Bangalore).

Payments exceeding Rs. 20,000 paid otherwise than by account payee cheques or bank drafts [Sec. 40A(3)]*

148. The provisions of section 40A(3) are given below—

148.1 ***The rule*** - The following conditions should be satisfied—

Condition one	The assessee incurs any expenditure which is otherwise deductible under the other provisions of the Act for computing business/profession income (*e.g.*, expenditure for purchase of raw material, trading goods, expenditure on salary, etc.). The amount of expenditure exceeds Rs. 20,000.
Condition two	A payment (or aggregate of payments made to a person in a day) in respect of the above expenditure exceeds Rs. 20,000.
Condition three	The payment mentioned in *Condition two* is made otherwise than by an account payee cheque or an account payee demand draft (it is made in cash or by a bearer cheque or by a crossed cheque or by a crossed demand draft).

*Section 40A(3) cannot be said to be invalid on the ground that it places a restriction on right to carry on business and is arbitrary—*Attar Singh Gurmukh Singh* v. *ITO* [1991] 59 Taxman 11 (SC).

If the above conditions are satisfied, then—

a. from the assessment year 2008-09, 100 per cent of such payment will be disallowed; and

b. up to the assessment year 2007-08, 20 per cent of such payment is not allowed as deduction

▪ Even payment made for purchase of goods falls within the expression "expenditure" occurring in this section.

▪ From the assessment year 2009-10, if the aggregate payment (otherwise than by an account payee cheque/draft) to the same person during a day exceeds Rs. 20,000, the provisions of section 40A(3) will apply and the entire amount of such payment will be disallowed.

148.2 ***Exceptions*** - Rule 6DD prescribes the following circumstances under which no disallowance will be made of the expenditure even if the payment exceeding Rs. 20,000 is made otherwise than by an account payee cheque or demand draft :

▪ Payment made to banking and other credit institutions*, such as the Reserve Bank of India, commercial banks in the public and private sectors, co-operative banks or land mortgage banks, primary credit/agricultural credit societies, Life Insurance Corporation of India, [rule 6DD(*a*)].

▪ Payment made to Government (both Central and State Governments), if under the rules framed by it, such payment is required to be made in legal tender, such as a payment of direct taxes, customs duty, excise, railway freight, sales tax, etc. [rule 6DD(*b*)].

▪ Payment through the banking system, *e.g.*, letters of credit, mail or telegraphic transfer, book adjustment in the same bank or between one bank and another and bills of exchange payable to a bank, use of electronic clearing system through a bank account, credit card and debit card [Rule 6DD(*c*)].

▪ Payment made by book adjustment by an assessee in the account of the payee against money due to the assessee for any goods supplied or services rendered by him to the payee [rule 6DD(*d*)].

▪ Payment to a cultivator, grower or producer in respect of the purchase of agricultural or forest produce or product of animal husbandry (including live stock, meat, hides and skins) or dairy or poultry farming or fish or fish products or products of horticulture or apiculture (even if these products have been subjected to some processing provided the processing has been done by the cultivator, grower or the producer of the product) [rule 6DD(*e*)].

Product of animal husbandry - The expression 'the produce of animal husbandry' in the above para would include 'livestock and meat'. If payment exceeding Rs. 20,000 is made to a producer of the products of animal husbandry (including livestock, meat, hides and skins) otherwise than by an account payee cheque or draft for the purchase of such produce, no disallowance should be attracted under section 40A(3). This exception is, however, not be available on the payment for the purchase of livestock, meat, hides and skins from a person who is not proved to be the producer of these goods and is only a trader, broker or any other middleman by whatever name called—**Circular No. 4/2006**, dated March 29, 2006.

Purchase of animals - Any person, by whatever name called, who buys animals from the farmers, slaughters them and then sells the raw meat carcasses to the meat processing factories or to the traders/retail outlets would be considered as producer of livestock and meat. The exemption is subject to the following conditions—

1. A declaration from the person receiving the payment that he is a producer of meat;

2. A confirmation that the payment, otherwise than by an account payee cheque or account payee bank draft, was made on his insistence; and

3. A further confirmation from a veterinary doctor certifying that the person specified in the certificate is a producer of meat and that slaughtering was done under his supervision—**Circular No. 8/2006**, dated October 6, 2006.

▪ Payment made to a producer in respect of purchase of products manufactured or processed without the aid of power in a cottage industry [rule 6DD(*f*)].

*This exception applies only to payments to RBI, commercial banks in public/private sector, co-operative banks, LIC, etc. and not to payments made in any party's account maintained by these institutions.

■ Payment made to a person who ordinarily resides or carries on business in a village not served by any bank [rule 6DD(*g*)] [if, however, the payment is made in a town having banking facilities to a villager whose village has no bank, the exemption from the operation of section 40A(3) will not be available - Press Note dated May 8, 1969].

■ Payment of terminal benefits, such as gratuity, retrenchment compensation, etc., of payable to an employee or his legal heirs and if such sum does not exceed Rs. 50,000 in aggregate [rule 6DD(*h*)].

■ Payment made by an assessee by way of salary to his employee after deducting tax from salary in accordance with the provisions of section 192 and when such employee—

a. is temporarily posted for a continuous period of 15 days or more in a place other than his normal place of duty or on a ship ; and

b. does not maintain any account in any bank at such place or ship [rule 6DD(*i*)].

■ Payment required to be made on a day on which the banks were closed either on account of holiday or strike [rule 6DD(*j*)].

■ Payment made by any person to his agent who is required to make payment in cash for goods or services on behalf of such person [rule 6DD(*k*)]. An employee cannot be considered as an agent for this purpose—***CIT*** v. ***Vijaykumar Rameshchand & Co.*** [2007] 108 ITD 626 (Pune).

■ Payment made by an authorised dealer or a money changer against purchase of foreign currency or travellers cheques in the normal course of his business [rule 6DD(*l*)].

148.3 *Scope of section 40A(3)* -The following points should be considered to understand the scope of section 40A(3) —

1. If aggregate payment in a day (otherwise than by an account payee cheque/draft) to the same person in respect of an expenditure, exceeds Rs. 20,000, it will be disallowed under section 40A(3), even if none of each payments in the day exceeds Rs. 20,000.

2. If an assessee makes payment of two different bills (none of them exceeds Rs. 20,000) at the same time in cash or by bearer or crossed cheque, section 40A(3) is not applicable even if the aggregate payment is more than Rs. 20,000. This is because of the fact that section 40A(3) is applicable only in respect of an "expenditure" which is in excess of Rs. 20,000. In other words, for applicability of section 40A(3) both the payment and amount of bill (or expenditure) should exceed Rs. 20,000.

3. Where the assessee makes payment over Rs. 20,000 at a time, partly by an account payee cheque and partly in cash or bearer cheque or crossed cheque to some parties but the payment in cash (or by bearer cheque or crossed cheque) alone at one time does not exceed Rs. 20,000, section 40A(3) is not attracted.

4. Provision of section 40A(3) does not apply in respect of an expenditure which is not to be claimed as deduction under sections 30 to 37. For instance, if an assessee gives donation in cash (eligible for deduction under section 80G), section 40A(3) is not applicable, since donation is not deductible under sections 30 to 37 but under section 80G. Conversely, if payment in excess of Rs. 20,000 is made (otherwise than by crossed cheque or draft), then deduction under sections 30 to 37 in respect of such payment is not available. For instance, if any assessee purchases a depreciable asset (say, a car) for Rs. 3 lakh by making payment in cash, depreciation (*i.e.*, 15 per cent of Rs. 3 lakh), which is otherwise deductible, will be disallowed under the provisions of section 40A(3).

5. Section 40A(3) is attracted to payments made for acquiring a stock-in-trade and other materials, purchase of goods or in respect of any expenditure which is deductible under sections 30 to 37—*Attar Singh Gurmukh Singh* v. *ITO* [1991] 59 Taxman 11 (SC), *Janta Metal Supply Co.* v. *CIT* [1991] 100 CTR (All.) 52.

6. Merely because a payment in excess of prescribed limit is made prior to delivery of goods, it cannot be said that it constitutes an advance and not expenditure for purposes of section 40A(3)—*Vijay Kumar Ajit Kumar* v. *CIT* [1991] 55 Taxman 388 (All.).

7. Payment of interest on loan is required to be made by account payee cheque/demand draft if it exceeds Rs. 20,000.

8. No addition under section 40A(3) can be made where income has been computed by applying net profit rate—***CIT*** v. ***Padam Chand Bhansali*** [2004] 85 TTJ (Jodh.) 215.

9. Where the assessee-rice mill purchases rice from a regional market yard and pays directly in the bank account of the concerned agent by depositing cash under a challan to ensure that the payee alone gets payment and origin and conclusion of transaction are traceable, section 40A(3) is not attracted to such payment—***Sri Renukeswara Rice Mills*** v. ***ITO*** [2005] 93 ITD 263 (Bang.).

148.4 *Where deduction has been claimed earlier on due basis and payment is made in the current year* - A special provision has been made in respect of those cases where deduction was claimed earlier on due basis. This provision is enumerated by section 40A(3)(*b*) which is given below—

1. The taxpayer had claimed a deduction in respect of an expenditure in any of the earlier years.

2. The amount of deduction exceeds Rs. 20,000.

3. In previous year 2008-09 (or in any subsequent year), payment is made in respect of the aforesaid liability.

4. The payment exceeds Rs. 20,000.

5. The payment is made otherwise than by an account payee cheque or draft.

If the above conditions are satisfied, the payment so made shall be deemed to be the business income of the taxpayer of the previous year in which the payment is made. No specific provision has been made that the payment so made shall be taxable as business income even if the business has been discontinued.

Provisions illustrated - Consider the following cases—

1. X Ltd. is a manufacturing company. On March 31, 1998, the company makes a provision for an outstanding bill of Rs. 80,000 for purchase of raw material. This provision appears on the liability side of the balance sheet as well as on the debit side of profit and loss account. It is allowed as deduction for computing the income of the company for the assessment year 1998-99. On April 4, 2006, out of Rs. 80,000, Rs. 27,000 is paid in cash. In this case, 20 per cent of Rs. 27,000 will be disallowed under section 40A(3). This disallowance will be applicable while computing income for the assessment year 1998-99. The Assessing Officer, in this case, can recompute the tax liability of the company for the assessment year 1998-99 by disallowing Rs. 5,400. This recomputation can be done under section 154 by the Assessing Officer at any time up to March 31, 2012.

2. Suppose in the above case, out of the outstanding balance, Rs. 30,000 is paid (otherwise than by account payee cheque or draft) on September 1, 2009, Rs. 30,000 will be taken as business income of the company for the assessment year 2010-11 by virtue of section 40A(3)(b) and it will be taxable.

148-P1 *Determine the amount of disallowance in the cases given below —*

1. Generally X pays salary to his employees by crossed cheques. Salary of December 2008 is, however, paid to three employees A, B and C by bearer cheque (payment being Rs. 6,000, Rs. 20,000 and Rs. 20,500, respectively).

2. X Ltd. purchases goods on credit from Y Ltd. on May 6, 2008 for Rs. 86,000 which is paid as follows —

a. Rs. 15,000 in cash on May 11, 2008 ;

b. Rs. 30,000 by a bearer cheque on May 31, 2008 ; and

c. Rs. 41,000 by an account payee cheque.

3. Z Ltd. purchases goods on credit from A Ltd. on May 10, 2007 for Rs. 16,000 and on May 30, 2008 for Rs. 15,000. The total payment of Rs. 31,000 is made by a crossed cheque on June 1, 2008.

4. A Ltd. purchases goods on credit from a relative of a director on June 20, 2008 for Rs. 50,000 (market value : Rs. 42,000). The amount is paid by a crossed cheque on June 25, 2008.

5. B Ltd. purchases raw material on credit from A who holds 20 per cent equity share capital in B Ltd. (the amount of bill being Rs. 36,000, market price being Rs. 19,000). It is paid in cash on July 26, 2008.

SOLUTION :

1. Rs. 20,500, being 100% of salary paid in cash to C will be disallowed.

2. Nothing will be disallowed out of the payment of Rs. 15,000 in cash on May 11, 2008, as the payment does not exceed Rs. 20,000. 100% of Rs. 30,000 will be disallowed. Nothing will be disallowed out of Rs. 41,000.

3. Though the amount of payment exceeds Rs. 20,000, nothing shall be disallowed. To attract disallowance, the amount of bill as well as the amount of payment should be more than Rs. 20,000.

4. Out of the payment of Rs. 50,000, Rs. 8,000 (being the excess payment to a relative) shall be disallowed under section 40A(2). As the payment is made by a crossed cheque and the remaining amount exceeds Rs. 20,000, 100% of the balance (*i.e.*, Rs. 42,000) shall be disallowed under section 40A(3).

5. Out of the payment of Rs. 36,000, Rs. 17,000 (being the excess payment to a person holding a substantial interest) shall be disallowed under section 40A(2). The remaining amount (*i.e.*, Rs. 19,000) does not exceed Rs. 20,000. Nothing shall be disallowed under section 40A(3) even if the payment is made in cash.

Expenditure on payment of salary or perquisite to employees [Sec. 40A(5)]

149. Provisions of section 40A(5) are not applicable from the assessment year 1989-90 onwards.

Fees for services payable to a former employee [Sec. 40A(6)]

150. The disallowance under section 40A(6) is not applicable from the assessment year 1989-90 onwards.

Provision for payment of gratuity [Sec. 40A(7)]

151. Apart from the provisions of section 43B [*see* para 155] and section 40(*a*)(*iv*) [*see* para 143.7], the effect of section 40A(7) is that gratuity is deductible only in the following cases —

1. Where gratuity is paid during the previous year or where gratuity has become payable during the previous year (if no deduction was claimed on the basis of provision earlier).

2. Where any provision for gratuity (to meet liability of gratuity in future) is made by way of any contribution towards an approved gratuity fund.

■ *Provisions in brief* - Provision for gratuity fund (for meeting future liability) is deductible only if such gratuity fund is an approved gratuity fund. In other words, any provision for unapproved gratuity fund (for meeting future liability) is not deductible. The following points should be noted—

1. An employee retires during the current year. Gratuity is paid to him during the current year. It is deductible during the current year if no deduction was claimed earlier.

2. An employee retires during the current year. Gratuity is payable to him. A part of the amount is paid during the current year and the balance will be paid in the next year. A provision is made towards gratuity in the books of account of the current year for making payment in the next year. The entire amount is deductible during the current year if no deduction was claimed earlier. In this case, deduction is available during the current year even if provision is made for gratuity fund, which is unapproved.

3. A company has 50 employees. To meet future liability to pay them gratuity at the time of retirement, a gratuity fund is created and the employer makes contribution every year. Employers' contribution to this fund is deductible only if the gratuity fund is an approved gratuity fund.

■ *Other points* - One should also keep in view the following —

1. Even if provision is not made for gratuity liability in the books of account maintained by the assessee, the amount of actuarial valuation of such liability cannot be claimed on the ground that section 40A(7) is not attracted as no "provision" is made in the books of account—*Shree Sajjan Mills Ltd.* v. *CIT* [1985] 156 ITR 585 (SC).

2. Where on termination of services of the employee, the assessee-company transferred gratuity amount due to the employee to the new company under which he continued his employment, in these circumstances gratuity amount payable to the employee should be taken to have been 'paid' within meaning of section 43(2), and therefore, the assessee would be entitled to claim deduction of the said amount under section 40A(7)—*J.R. Diamonds Ltd.* v. *CIT* [1999] 70 ITD 42 (SMC) (Mum.).

Interest on public deposit [Sec. 40A(8)]

152. No disallowance under this section is applicable from the assessment year 1986-87 (*vide* the Finance Act, 1985).

Restriction on contributions by employers to non-statutory funds [Sec. 40A(9)]

153. Provisions of section 40A(9) are given below —

■ *What is deductible* - Any sum paid by the assessee as an employer by way of contribution towards recognised provident fund, or approved superannuation fund or an approved gratuity fund is deductible to the extent if is required by any law.

■ *What is not deductible* - If the following conditions are satisfied, then such payment (except as stated above) is not deductible by section 40A(9) —

1. The contribution/payment is made by an assessee as an employer. It may be noted that if the expenditure incurred by the assessee is not in capacity of an employer, provisions of section 40A(9) are inapplicable.

2. It is paid towards setting up (or formation of) any trust, company, association of persons, body of individuals, society or it is paid by way of contribution to any fund (not being recognised provident fund, approved superannuation fund/gratuity fund).

3. Such contribution or payment is not required by any law.

■ *Other points* - The following points should be noted -

1. Contribution by an assessee (not being in capacity of an "employer") cannot be disallowed under section 40A(9).

2. All expenses incurred for the benefit of employees by an employer cannot be treated as contribution by the employer towards the various funds enumerated in section 40A(9). The expression used in section 40A(9) is not 'the expenses incurred by the employer for welfare activities of its employees in any form' but is confined to the amount paid for setting up or formation, or as contribution to any fund, trust, company, AOP, BOI, for any purpose. What is, therefore, disallowed under section 40A(9) is employer's contribution/payment towards a fund (for the benefit of employees) which is otherwise not required by any law (which is paid or contributed by an employer under contractual obligation or otherwise but not under a legal requirement).

Provisions illustrated - To clarify the above provisions, one may examine the following illustrations -

1. X Ltd. incurs an expenditure of Rs. 30,000 for maintenance of street lights in workers' colony. The expenditure is incurred without any legal or contractual requirement. In this case, nothing will be disallowed under section 40A(9), as it is not towards setting up or formation of, or as contribution to, any fund, society, etc.

2. Y Ltd. has a tea club in its office. Tea club provides tea, coffee, snacks, soft drinks to the employees during tea breaks. The club has been set up by employees (and or by Y Ltd.) for the benefit of employees without any legal requirement. Y Ltd. contributes Rs. 50,000 annually towards tea club. It will be disallowed under section 40A(9) in the hands of Y Ltd. The position will remain the same even if tea club was set up by the employer under the terms of employment but without any legal obligation.

3. Z Ltd. provides free tea, coffee, snacks, soft drinks to the employees during tea breaks. The actual expenditure for providing this facility is Rs. 56,950 during the previous year 2008-09. Nothing will be disallowed under section 40A(9), as it is not towards setting up or formation of, or as contribution to, any fund, society, etc.

4. Employer's contribution towards unrecognized provident fund or any other staff welfare fund (without any statutory requirement) will be disallowed under section 40A(9).

5. Contribution to a school which is situated in the colony of the assessee's employees and debited under head 'Staff welfare expenses', cannot be disallowed under section 40A(9)—***CIT*** v. ***Gujarat Guardian Ltd.*** [2006] 152 Taxman 37 (Delhi)(Mag.).

Disallowance of expenditure incurred in connection with income-tax proceedings [Sec. 40A(12)]

154. Section 40A(12) is not applicable from the assessment year 1993-94.

Disallowance of unpaid liability [Sec. 43B]†

155. Section 43B is applicable only if the taxpayer maintains books of account on the basis of mercantile system of accounting. The provisions of section 43B are given below -

155.1 ***General rule - Certain expenses are deductible on payment basis*** - The following expenses (which are otherwise deductible under the other provisions of the Income-tax Act) are deductible on payment basis—

a. any sum payable by way of tax, duty, cess or fee (by whatever name called under any law for the time being in force);

b. any sum payable by an employer by way of contribution to provident fund or superannuation fund or any other fund for the welfare of employees;

c. any sum payable as bonus or commission to employees for service rendered;

d. any sum payable as interest on any loan or borrowing from a public financial institution (*i.e.,* ICICI, IFCI, IDBI, LIC and UTI) or a State financial corporation or a State industrial investment corporation;

e. interest* on any loan or advance taken from a scheduled bank including a co-operative bank; and

f. any sum payable by an employer in lieu of leave** at the credit of his employee.

The above expenses are deductible in the year in which payment* is actually made. There is, however, one exception which is given in para 155.2 below.

155.2 ***Exception - When deductible on accrual basis*** - The exception is applicable if the following two conditions are satisfied—

Condition one	Payment in respect of the aforesaid expenses is actually made on or before the due date of submission of return of income#.
Condition two	The evidence of such payment is submitted along with the return of income.‡

If the above two conditions are satisfied and if the assessee maintains books of account on mercantile basis, then the expenditure is deductible on "accrual" basis in the year in which the liability is incurred.

155.3 ***Provisions illustrated*** - X Ltd. maintains books of account on mercantile basis. For the previous year 2008-09 (*i.e.,* the assessment year 2009-10), interest on term loan taken from Punjab National Bank (or any other sum given in para 155.1) is Rs. 1,95,000. The amount is paid as follows—

Date of payment	*Amount Rs.*
May 2, 2008	25,000
November 20, 2008	20,000

†Section 43B is constitutionally valid—*Srikakollu Subba Rao & Co.* v. *Union of India* [1988] 173 ITR 708 (AP) and not arbitrary and impossible of compliance—*Sanghi Motors* v. *Union of India* [1991] 59 Taxman 163 (Delhi). *Explanation 2* to section 43B is not *ultra vires*—*Escorts Ltd.* v. *Union of India* [1991] 59 Taxman 160 (Delhi).

*Conversion of unpaid sales tax into loan by a State Government is treated as payment of sales tax in the year of conversion [*see* para 155.5-1]. However, conversion of unpaid interest on loan into a fresh loan is not taken as actual payment [*see* para 155.5-7]

The Calcutta High Court has struck down this provision being arbitrary, unconscionable and *de hors* Apex Court decision in case of *Bharat Earth Movers* v. *CIT* [2000] 245 ITR 428/112 Taxman 61—*Exide Industries Ltd.*** v. ***Union of India*** [2007] 164 Taxman 9 (Cal.).

In the case of (*a*) company, (*b*) a person whose books of account are required to be audited under any law, and (*c*) a person who is a working partner in a firm whose books of account are required to be audited under any law, the due date of submission of return of income is September 30 of the assessment year (up to the assessment year 2007-08, it was October 31). In any other case, the due date of submission of return of income July 31 of the assessment year.

‡However, no annexure is possible with the new Income-tax Return Forms, *i.e.,* ITR-1 to ITR-8; such evidence should be kept by the taxpayer himself and it can be produced before the Assessing Officer whenever he is required to produce it.

Date of payment	*Amount Rs.*
August 16, 2009	25,000
December 5, 2009	30,000
June 12, 2010	35,000
November 2, 2010	40,000
Not paid so far	20,000

As the expenditure is covered by section 43B, it is deductible on payment basis in the year in which the payment is made. However, if the payment is made on or before the due date of submission of return of income for the assessment year 2009-10 (*i.e.*, on or before September 30, 2009), then such payment is deductible on accrual basis for the previous year 2008-09. Consequently, these payments are deductible as follows:

Date of payment	*Amount Rs.*	*Previous year in which deductible*	*Reasons*
May 2, 2008	25,000	2008-09	Payment made during the relevant year is deductible in that year
November 20, 2008	20,000	2008-09	Payment made during the relevant year is deductible in that year
August 16, 2009	25,000	2008-09	Payment made after the end of the relevant year but on or before the due date of submission of return of income (*i.e.*, September 30, 2009) is deductible in the year in which the liability is incurred
December 5, 2009	30,000	2009-10	Payment made after the due date of submission of return of income (*i.e.*, made after September 30, 2009) is deductible in the year in which the payment is made
June 12, 2010	35,000	2010-11	Payment made after the due date of submission of return of income (*i.e.*, made after September 30, 2009) is deductible in the year in which the payment is made
November 2, 2010	40,000	2010-11	Payment made after the due date of submission of return of income (*i.e.*, made after September 30, 2009) is deductible in the year in which the payment is made
Not paid	20,000	Not deductible	Not deductible as the payment is not made

155.4 ***Frequently asked questions*** - One should also keep in view the following points—

155.4-1 *SALES TAX DEFERRED SCHEME - DOES IT AMOUNT TO "PAYMENT" OF SALES TAX* - Several State Governments have introduced sales tax deferred schemes as a part of the incentives offered to entrepreneurs for setting up industries in backward areas. Under these schemes, eligible units are permitted to collect sales tax and retain such tax for a prescribed period. After this period, the sales tax is to be paid to the Government either in lump sum or in instalments.

In such a case a problem arises, whether sale tax is treated as "paid" for the purpose of section 43B. The following broad conclusions may be drawn on the basis of judicial rulings and Board's Circulars—

1. If under the sales tax legislation, sales tax so deferred is treated as actually paid then statutory liability shall be treated to have been discharged for the purpose of section 43B—Circular No. 496, dated September 25, 1987.

2. For this purpose, a State Government may amend its Sales Tax Act to provide that the sales tax (deferred under an incentive scheme framed by it) will be treated as actually paid so as to meet the requirements of section 43B—*CIT* v. *Gujarat Polycrete Pvt. Ltd.* [2000] 246 ITR 463 (SC).

3. Some State Governments, instead of amending the Sales Tax Act, have issued Government Orders notifying schemes under which sales tax is deemed to have been actually collected and disbursed as loans. The amount of sales tax liability converted into loans may be allowed as deduction in the assessment for the previous year in which such conversion has been permitted by or under Government Orders—Circular No. 674, dated December 29, 1993.

In other words, where sales tax due to the Government is converted as loan to be repaid by the assessee subsequently by instalments, it would amount to actual payment of sales-tax—*CIT* v. *Goodluck Silicate Industries (P.) Ltd.* [2002] 178 CTR (Guj.) 92.

155.4-2 *CONVERSION OF "OUTSTANDING INTEREST" INTO FRESH LOAN* - If any sum payable by an assessee as interest on any loan or borrowing or advance is converted by the bank or financial institution into a fresh loan or borrowing or advance, the interest so converted and not 'actually paid', shall not be deemed as 'actual payment' and not allowed as deduction in the computation of income under section 43B.

The converted interest, by whatever name called, in the wake of its conversion into a loan or borrowing or advance, will be eligible for deduction in the computation of income of the previous year in which the converted interest is 'actually paid'. In other words, nomenclature of the sum of converted interest will make no difference as the sum of converted interest whenever is actually paid will not represent repayment of the principal—**Circular No. 7/2006**, dated July 17, 2006.

Provisions illustrated - The following illustrations are given to have better understanding—

1. Loan taken from bank on March 31, 2005 is Rs. 20,00,000. Interest unpaid up to March 31, 2008 is Rs. 2,00,000. In the restructuring arrangement entered into in this case, the unpaid interest has been converted into a Funded Interest Term Loan (FITL) which has been shown separately from the original loan and no interest is chargeable on FITL. This converted interest (*i.e.*, FITL) is to be paid in 4 annual instalments from April 1, 2012 (each instalment being Rs. 50,000). In this case, deduction to the extent of the amount actually paid against the payment of instalment of FITL of Rs. 2,00,000 under section 43B shall be allowed in the relevant assessment year when it is actually paid. Interest on the original principal of Rs. 20,00,000, if any, actually paid will be independently allowable under section 43B.

2. Suppose in the above case, interest is payable on FITL. In such a situation the following shall be deductible on actual payment basis according to the provisions of section 43B—

a. interest on original loan of Rs. 20,00,000;

b. re-payment of FITL; and

c. interest on FITL

3. Loan taken by the assessee from a Term lending Institution in May, 2006 is Rs. 14 crore. Interest not paid up to April 1, 2008 is Rs. 2 crore. In a restructuring arrangement unpaid interest of Rs. 2 crore is merged with the principal amount of Rs. 14 crore. After merger the amount of loan becomes Rs. 16 crore which is payable by the taxpayer in 5 equal annual instalments from April 1, 2008. In the previous year 2008-09, the first instalment of Rs. 3.2 crore is paid by the taxpayer. The amount of deduction in the computation of income on account of actual payment of interest will be worked out in the following manner :

Rs. 3.2 crore × Rs. 2 crore ÷ Rs. 16 crore = Rs. 40 lakh.

Out of the repayment of Rs. 3.2 crore in the first year, deduction of Rs. 40 lakh will be admissible in terms of the provisions of section 43B as deduction, as Rs. 40 lakh out of Rs. 3.2 crore actually paid represents interest component. Balance Rs. 2.8 crore representing repayment of the principal shall not be admissible as deduction in the computation of income.

155.4-3 *"TAX", "DUTY", "CESS", "BANK INTEREST"- WHAT IS INCLUDED/NOT INCLUDED* - The following court rulings give some idea about the meaning of these terms—

1. Royalty payable to the Government in respect of mineral rights is a 'tax' within meaning of section 43B—*Grasim Industries Ltd.* v. *CIT* [1999] 64 TTJ (Mum.) 357, *CIT* v. *Popular Minerals* [2002] 258 ITR 593 (Raj.). Royalty is a tax for all purposes, including section 43B—*Gorelal Dubey* v. *CIT* [2001] 248 ITR 3 (SC).

2. Interest payable on arrears of purchase tax is not 'tax' within the meaning of section 43B—*CIT* v. *Padmavati Raje Cotton Mills Ltd.* [1999] 239 ITR 355 (Cal.). However, Rajasthan High Court held that interest accrued on delayed payment of sales tax under the Rajasthan Sales-tax Act, 1954 is part of tax within meaning of section 43B—***Shree Pipes*** v. ***CIT*** [2007] 162 Taxman 442 (Raj.).

3. It has been held in various judgments that the rent/kist is neither tax nor duty nor fee. Similarly, it cannot be called as 'cess'—*CIT* v. *Sri Balaji & Co.* [2001] 114 Taxman 682 (Kar.).

4. Interest on unpaid municipal tax is not covered by section 43B—*CIT* v. *Orient Beverages Ltd.* [2001] 117 Taxman 106 (Cal.). However, interest payable to sales tax determined, is tax—***Mewar Motors*** v. ***CIT*** [2004] 135 Taxman 155 (Raj.).

5. Audit fee payable to the Government, by a co-operative society, is not a tax or fee—*CIT* v. *Warma Sahakari Sakhar Karkhana* [2001] 119 Taxman 422 (Bom.).

6. Mandi tax is not a tax as it is paid by a trader who enjoys the facility of mandi because some services are provided by the mandi and, therefore, that cannot be taken as tax as the same is collected for the services rendered—*CIT* v. *Mohansingh & Sons* [1995] 216 ITR 432 (MP), *CIT* v. *Mohanlal Mishrilal & Sons* [1996] 87 Taxman 194 (MP).

7. Bottling fee and electricity charges are neither tax, nor duty, nor cess and, hence, they cannot be tagged in the provisions of section 43B— *Wolkem (P.) Ltd.* v. *CIT* [1995] 18 Tax World 239 (Jpr.-Trib.).

8. Where the assessee as a tea broker is neither purchaser nor seller of tea, the sale proceeds of tea are not the assessee's trading receipts and the sales tax collected by the assessee as a tea broker is not its income, the amount of sales tax collected and remaining unpaid at the end of the year cannot be disallowed under section 43B—*A. W. Figgis & Co. Ltd.* v. *CIT* [2002] 256 ITR 268 (Cal.).

9. X Ltd. purchases machinery from A Ltd. and draws promissory notes in favour of A Ltd. duly accepted by its bankers. A Ltd. discounts the promissory notes from Punjab National Bank and Punjab National Bank rediscounts the promissory notes from IDBI. X Ltd. is required to make payment to IDBI with interest. Interest payable to IDBI is not covered by section 43B, as there is no direct financial arrangement with IDBI.

10. Government audit fees is not duty, cess or tax payable to the Government as understood under section 43B—*CIT* v. *Warma Sahakari Sakhar Karkhana Ltd.* [2001] 119 Taxman 422/[2002] 253 ITR 226 (Bom.).

11. Textile cess falls within ambit of section 43B—*Shri Rajasthan Syntex Ltd.* v. *Dy. CIT* [2002] 77 TTJ (Jodh.) 849.

12. The provisions of section 43B, were not applicable in regard to the expenditure by way of vend fee and additional vend fee payable by the assessee because vend fee is not in nature of tax, duty, cess or fee envisaged in section 43B(*a*)—*CIT* v. *Travancore Sugars & Chemicals Ltd.* [1999] 65 TTJ (Coch.) 598.

13. Premium collected by the assessee on sale of kerosene on behalf of the State Government cannot be treated as 'cess, fee, duty or tax, or 'any sum payable by the assessee by whatever name called' within meaning of section 43B—*Garo Devi* v. *ITO* [2001] 71 TTJ (Asr.) 880.

14. When a statutory liability has to be allowed as a deduction only on actual payment, the interest thereon for the delayed payment of the liability also will have to be allowed on actual payment only—*Grasim Industries Ltd.* v. *CIT* [1999] 64 TTJ (Mum.) 357.

15. Licence fee charged by a municipal corporation from the assessee for granting licence to the assessee to construct a hotel on a plot of land is of the nature of land revenue and as such it would be out of the purview of section 43B as it is clearly arising out of a contractual obligation and is not levied by any Act of Central or State legislature—*CIT* v. *C.J. International Hotels Ltd.* [2002] 75 TTJ (Delhi) 285.

16. The damage payable to local authority is not covered by section 43B—*K. Narendra* v. *CIT* [2002] 77 TTJ (Delhi) 76.

17. Cess levied under the West Bengal Rural Employment Production Act and the West Bengal Primary Education Act does not fall within the prohibitory items of deduction under section 40(*a*)(*ii*)—***Duncans Industries Ltd.*** v. ***CIT*** [2003] 87 ITD 457 (Kol.).

18. Interest on electricity duty being compensatory in nature, is allowable and cannot be disallowed under section 43B—***National Aluminium Co. Ltd.*** v. ***CIT*** [2006] 153 Taxman 18 (Mag.)/101 TTJ 948 (Ctk.).

19. SEBI turnover charges payable by member of stock exchange on basis of his turnover, are a cess or duty to be payable under law and, therefore, are covered under provisions of section 43B—***ITO*** v. ***Sureshchand Jain*** [2006] 100 ITD 435 (Mum.).

20. Interest on bottling fee paid by assessee-distillery under State Act is not to be disallowed under section 43B—***Udaipur Distillery Co. Ltd.*** v. ***CIT*** [2006] 100 ITD 422 (Jodh.).

155.4-4 *GIVING BANK GUARANTEE - DOES IT AMOUNT TO PAYMENT* - It is not taken as payment. This rule is applicable even if the Supreme Court has restrained the Excise Department from recovering disputed portion of excise duty from the assessee on the condition that the assessee should furnish a bank guarantee of equivalent amount to the Excise Department. Even in such a case, furnishing of bank guarantee cannot be treated as equal to actual payment of excise duty for the purpose of section 43B—*CIT* v. *Mugat Dyeing & Printing Mills* [2000] 75 ITD 387 (Ahd.), *CIT* v. *Rajasthan Patrika Ltd.* [2002] 125 Taxman 819 (Raj.), ***CIT*** v. ***Udaipur Distillery Co. Ltd.*** [2004] 134 Taxman 398 (Raj.).

155.4-5 *"PAYMENT" vis-a-vis "DUE"* - For claiming deduction under section 43B, in respect of payment of excise duty, etc., it is not necessary that liability to pay duty must be incurred first and only thereafter, payment of such duty is made. Therefore, deduction for tax, excise duty, etc., (which are otherwise deductible) is allowable under section 43B on payment basis even before incurring liability to pay such amount—***CIT*** v. ***Glaxo Smithkline Consumer Healthcare Ltd.*** [2007] 16 SOT 134 (Chd.)(SB), ***CIT*** v. ***C.L. Gupta & Sons*** [2003] 126 Taxman 500 (All.), ***Associated Pigments Ltd.*** v. ***CIT*** [1998] 234 ITR 589 (Cal.)†.

155.4-6 *PAYMENT OF EXCISE DUTY/CUSTOMS DUTY IN RESPECT OF GOODS FORMING PART OF CLOSING STOCK* - The entire amount of excise duty/customs duty paid by the assessee in a particular accounting year is an allowable deduction in respect of that year, irrespective of the amount of excise duty/customs duty which is included in valuation of the assessee's closing stock at end of accounting year—***Berger Paints India Ltd.*** v. ***CIT*** [2004] 135 Taxman 586 (SC).

155.4-7 *WHEN SALES TAX, ETC. NOT DEBITED TO P &L A/C BUT IN A SEPARATE ACCOUNT* - Where the assessee had credited sales tax collection and debited sales tax payment in a separate sales tax account, that would not render the provision of section 43B inapplicable—*CIT* v. *Associated Pigments Ltd.* [1973] 71 Taxman 244 (Cal.).

155.4-8 *PROVISION FOR APPROVED GRATUITY FUND* - Provision made for an approved gratuity fund is not covered by provisions of section 43B—***CIT*** v. ***Commonwealth Trust (I) Ltd.*** [2004] 269 ITR 290 (Ker.).

155-P1 *X Ltd. is a manufacturing company. The profit and loss account of X Ltd. for the year ending March 31, 2009 is given below—*

	Rs.		Rs.
Opening stock	17,000	Sales	52,55,000
Manufacturing expenses	32,56,500	Income-tax refund	2,000
Salary to employees	5,16,000	Excise duty refund (earlier allowed as deduction)	7,000
Employer's contribution to provident fund	30,000	Customs duty refund (not being allowed as deduction earlier)	8,000
Employer's contribution towards gratuity fund	10,000	Interest on income-tax refund, excise duty refund and customs duty refund	1,000
Taxes	1,50,000	Closing stock	33,000
Interest	2,12,000		
Audit fees to chartered accountant	20,000		
Licence fees to municipal authority	25,000		
Other expenses	86,000		
Net profit	9,83,500		
	53,06,000		53,06,000

†It is respectfully submitted that the ruling of the Kerala High Court in the case of ***CIT*** v. ***Kerala Solvent Extractions Ltd.*** [2008] 173 Taxman 155, requires reconsideration.

Notes :

1. Salary to employees is calculated as follows—

Different component	Amount Rs.	Payment made during 2008-09 Rs.	Paid from April 1, 2009 to September 30, 2009 Rs.
Basic salary, allowances and perquisites	*4,68,000*	*2,00,000*	*2,60,000*
Bonus	*10,000*	*1,000*	*8,500*
Commission on sales	*20,000*	*2,000*	*17,000*
Commission on purchases	*18,000*	*500*	*12,000*
Total	*5,16,000*		
Less:			
Employees' contribution towards provident fund	*28,000*	*28,000*	
Tax deducted at source	*2,000*	*1,900*	*100*
Balance	*4,86,000*		

Out of employees' contribution towards provident fund of Rs. 28,000, Rs. 25,000 is credited in the provident fund account of employees on or before the due date of making payment under the provident fund regulation.

2. Out of employer's contribution towards provident fund of Rs. 30,000, Rs. 26,000 is paid during the previous year 2008-09, Rs. 3,500 is paid on May 16, 2009 and Rs. 500 is paid on November 10, 2009. Provident fund is recognised provident fund.

3. Gratuity fund is approved gratuity fund and the amount is contributed during the relevant year.

4. Taxes and interest are calculated as follows -

Different component	Amount Rs.	Payment made during 2008-09 Rs.	Paid from April 1, 2009 to September 30, 2009 Rs.
Excise duty sales tax, custom duty and municipal tax	*1,10,000*	*62,500*	*32,000*
Income-tax	*40,000*	*2,000*	*38,000*
Interest from loan taken from a relative of director	*87,000*	*4,000*	*2,000*
Interest on term loan taken from State Bank of India	*1,25,000*	*15,000*	*98,000*

5. Licence fee to municipal authority and fees to chartered accountant are not paid till September 30, 2009.

Determine the amount of taxable income of X Ltd. for the assessment year 2009-10.

SOLUTION : In this case, bonus, commission on sales, commission on purchases, employer's contribution towards provident fund, employer's contribution towards gratuity fund, excise duty, sales tax, customs duty, municipal tax, interest on loan to State Bank of India and licence fee to municipal authority are covered by section 43B. If payment in respect of these expenses is made up to September 30, 2009 (*i.e.*, on or before the due date of submission of return of income), then such amount is deductible on "accrual" basis for the previous year 2008-09; otherwise such payment is deductible on payment basis in the year in which the payment is made.

	Rs.
Net profit as per profit and loss account	9,83,500
Adjustments under section 43B :	
Add: Bonus to employees	+ 10,000
Less: Bonus paid during 2008-09 (deductible on payment basis)	(-) 1,000
Less: Bonus paid during April 1, 2009 and September 30, 2009 (deductible on accrual basis)	(-) 8,500
Add: Commission on sales to employees	+ 20,000
Less: Commission on sales paid during 2008-09 (deductible on payment basis)	(-) 2,000
Less: Commission on sales paid during April 1, 2009 and September 30, 2009 (deductible on accrual basis)	(-) 17,000

	Rs.
Add: Commission on purchases to employees	+ 18,000
Less: Commission on purchases paid during 2008-09 (deductible on payment basis)	(-) 500
Less: Commission on purchases paid during April 1, 2009 and September 30, 2009 (deducted on accrual basis)	(-) 12,000
Add: Employer's contribution to recognised provident fund	+ 30,000
Less: Employer's contribution to recognised provident fund paid during 2008-09 (deductible on payment basis)	(-) 26,000
Less: Employer's contribution to recognised provident fund paid during April 1, 2009 and September 30, 2009 (deductible on accrual basis)	(-) 3,500
Add: Excise duty, sales tax, custom duty and municipal tax	+ 1,10,000
Less: Excise duty, sales tax, custom duty and municipal tax paid during 2008-09 (deductible on payment basis)	(-) 62,500
Less: Excise duty, sales tax, custom duty and municipal tax paid during April 1, 2009 and September 30, 2009 (deductible on accrual basis)	(-) 32,000
Add: Interest on SBI loan	+1,25,000
Less: Interest on SBI loan paid during 2008-09 (deductible on payment basis)	(-) 15,000
Less: Interest on SBI loan paid during April 1, 2009 and September 30, 2009 (deductible on accrual basis)	(-) 98,000
Add: Municipal licence fees	+ 25,000
Less: Municipal licence fees paid during 2008-09	*Nil*
Less: Municipal licence fees paid during April 1, 2009 and September 30, 2009	*Nil*
Adjustments under other sections :	
Add: Employees' contribution towards provident fund [the entire amount is part of income as per section 2(24)(x)]	+ 28,000
Less: Employees' contribution towards provident fund credited on or before the due date of making payment under the provident fund regulation [sec. 36(1)(va)]	(-) 25,000
Add: Income-tax (income-tax is not a deductible expenditure) [sec. 40(a)]	+ 40,000
Less: Income-tax refund (as income-tax is not deductible, income-tax refund is not chargeable to tax)	(-) 2,000
Less: Customs duty refund (as it was not allowed as deduction earlier, it is not chargeable to tax at the time of claiming refund)	(-) 8,000
Net income	10,76,500

Notes:

1. Excise duty refund is chargeable to tax as it was allowed as deduction earlier.
2. Interest on income-tax refund, etc., is chargeable to tax.
3. Employer's contribution towards provident fund paid on November 10, 2009 is deductible in the previous year 2009-10.

155-P2 *X Ltd. is a manufacturing company. The profit and loss account of X Ltd. for the year ending March 31, 2009 is given below -*

	Rs.		Rs.
Sales tax	*50,000*	*Sales*	*20,10,000*
Other expenses	*14,15,000*		
Net profit	*5,45,000*		
	20,10,000		*20,10,000*

Other information -

1. *Out of sales tax of Rs. 50,000, only Rs. 47,000 is paid. The payment is made as follows—*
a. *Rs. 40,000 on September 2, 2008;*
b. *Rs. 4,000 on September 12, 2009; and*
c. *Rs. 3,000 on November 1, 2009.*
2. *Return of income is submitted on November 10, 2009.*
3. *During the previous year 2008-09, the following payments are made in respect of expenses pertaining to earlier years—*
a. *bonus to employees pertaining to the previous year 2006-07 paid on April 30, 2008: Rs. 15,000;*
b. *customs duty pertaining to the previous year 2006-07 paid on December 1, 2008: Rs. 25,000;*
c. *electricity bill payable to BSES pertaining to previous year 2006-07 paid on May 3, 2008: Rs. 35,000;*
d. *excise duty pertaining to the previous year 2007-08 paid on May 20, 2008: Rs. 40,000; and*
e. *leave salary payable to employees pertaining to the previous year 2007-08 paid on December 2, 2008: Rs. 45,000.*

These payments do not pertain to the previous year 2008-09. Consequently, these are not recorded in the profit and loss account given above. Find out the net income of X Ltd. for the assessment year 2009-10.

SOLUTION :	*Rs.*
Net profit as per profit and loss account	5,45,000
Adjustments :	
Add: Sales tax	+ 50,000
Less: Sales tax paid during 2008-09 (deductible on payment basis)	(-) 40,000
Less: Sales tax paid during April 1, 2009 and September 30, 2009 [see Note 1]	(-) 4,000
Less: Bonus to employees [see Note 2]	(-) 15,000
Less: Customs duty [see Note 2]	(-) 25,000
Less: Leave salary [see Note 3]	(-) 45,000
Net income	4,66,000

Notes:

1. Sales tax debited to the profit and loss account given in the problem is covered by section 43B. The due date of submission of return of income is September 30, 2009. If the payment is made up to September 30, 2009, then it is deductible on accrual basis for the previous year 2008-09. The payment of sales tax of Rs. 4,000 on September 12, 2009 is, therefore, deductible on accrual basis. The payment made on November 1, 2009 is not deductible for the previous year 2008-09 even if return is submitted after the due date.

2. Bonus to employees pertaining to the previous year 2006-07 is paid on April 30, 2008. Similarly, customs duty pertaining to the previous year 2006-07 is paid on December 1, 2008. The due date of submission of return of income for the previous year 2006-07 (or the assessment year 2007-08) is October 31, 2007†. As these payments were not made up to October 31, 2007, these were not allowed as deduction for the previous year 2006-07. Payment made after this date is allowable as deduction on payment basis in the year in which the payments is made. Therefore, payment made on April 30, 2008 and December 1, 2008 are deductible for the previous year 2008-09.

3. For the previous year 2007-08 (*i.e.*, the assessment year 2008-09) the due date of submission of return of income is September 30, 2008†. Excise duty and leave salary are covered by section 43B. If payment in respect of these expenses are made up to September 30, 2008† then these payments are deductible on accrual basis for the previous year 2007-08. Excise duty is paid on May 20, 2008. It is deductible for the previous year 2007-08. However, leave salary is paid on December 2, 2008 (*i.e.*, September 2008 being the due date of submission of return of income). It is not deductible for the previous year 2007-08. It is deductible on payment basis for the previous year 2008-09.

†Up to the assessment year 2007-08, due date of submission of return of income, in the case of corporate-assessee, was October 31 of the assessment year.

4. Electricity bill payable to BSES is not covered by section 43B. Any expenditure, which is not covered by section 43B is deductible on accrual basis if the taxpayer maintains books of account on accrual basis. Consequently, it was deductible for the previous year 2006-07.

Deemed profit

156. The following receipts are chargeable to tax as business income :

156.1 ***Recovery against any deduction [Sec. 41(1)]*** - Section 41(1) is applicable if the following conditions are satisfied—

Condition one	In any of the earlier years a deduction was allowed to the taxpayer in respect of loss, expenditure (revenue or capital expenditure) or trading liability incurred by the assessee.
Condition two	During the current previous year, the taxpayer— *a.* has obtained a refund of such trading liability (it may be in cash or any other manner); or *b.* has obtained some benefit in respect of such trading liability by way of remission or cessation thereof ("remission or cessation" for this purpose includes unilateral act of the assessee by way of writing off of such liability in his books of account).

Note - All that condition one requires is that expenditure had been allowed as a deduction while making assessment for any earlier year. There is no further requirement that assessment must result in a positive income—***CIT*** v. ***Chaudhary Cotton Ginning and Pressing Factory*** [2004] 271 ITR 17 (Punj. & Har.).

156.1-1 *CONSEQUENCES WHEN THE ABOVE CONDITIONS ARE SATISFIED* - If the above two conditions are satisfied, 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 tax as the income of that previous year.

156.1-2 *GETTING REFUND WHEN THE CASE IS STILL PENDING* - For the purpose of *Condition two* (a) (*supra*), there may (or may not) be any remission or cessation of trading liability. Examine the case given below—

An assessee pays excise duty and claims the same as deduction in 2004-05. Later on in 2007-08, he gets a refund from the department by obtaining a favourable verdict from the High Court. The department files an appeal in the Supreme Court and the matter is still pending.

The amount refunded to the assessee is taxable in the previous year 2007-08. The amount of refund is taxable in the year in which the assessee gets the refund. In the case of refund there may (or may not) any remission or cessation.

Situation (a) - If the assessee (after claiming deduction in any of the earlier years) has obtained (may be in cash or any other manner) any amount in respect of such expenditure. In this situation there may (or may not be) any remission or cessation of trading liability.

Situation (b) - If the assessee (after claiming deduction in any of the earlier years) has obtained some benefit in respect of such trading liability by way of remission or cessation thereof.

If the court or the Tribunal upholds the levy at a later date, the assessee will not be without remedy to get back the relief (the amount so paid will be allowed as deduction under section 43B on "payment" basis)—*Polyfex India (P.) Ltd.* v. *CIT* [2002] 124 Taxman 373 (SC).

156.1-3 *RECOVERY BY SUCCESSOR IN BUSINESS* - Where the assessee to whom the trading liability may have been allowed is succeeded in his business either because of amalgamation or demerger of two companies or on account of the constitution of new firm or the business is continued by some other persons when the assessee ceases to carry on the business, then the person succeeding will be chargeable to tax on any amount received in relation to which deduction or allowance has been made.

156.1-4 *WHETHER UNILATERAL WRITING OFF OF TRADING LIABILITY IS COVERED BY SECTION 41(1)* - The expression "remission or cessation thereof", has been defined to include the remission or cessation of any liability by any unilateral act of the assessee by way of writing off such liability in his accounts. For instance, after claiming deduction in respect of a trading liability in 2003-04, the taxpayer writes off a sum of Rs. 15,000 by crediting the same in profit and loss account in the previous year