

*** THE HONOURABLE SRI JUSTICE L. NARASIMHA REDDY**

and

*** THE HON'BLE SRI JUSTICE CHALLA KODANDA RAM**

+ I.T.T.A.No.95 of 2004

% 11.12.2014

The Elegant Chemicals Enterprises Private Limited,
Hyderabad.

.... Appellant

Vs.

\$ The Assistant Commissioner of Income Tax,
Circle – 1 (3),
Hyderabad.

.... Respondent

! Counsel for the Appellant: SRI S. RAVI

Counsel for Respondent: Ms. KIRANMAYEE

<Gist :

>Head Note:

? Cases referred:

1. [2007] 291 ITR 500 (SC)
2. [1987] 168 ITR 164
3. [1959] 35 ITR 148

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JUDGMENT: *(per the Hon'ble Sri Justice L.Narasimha Reddy)*

An important question, which of course, was dealt with by the Courts on earlier occasions, arises for consideration in this appeal.

The appellant is a manufacturer of pharmaceutical formulations and most of its business is to undertake custom manufacturing of the products, as regards which, orders are placed by the reputed companies. One of its main customers is M/s.Procter & Gamble (I) Limited (for short 'M/s. P&G'). In the ordinary course of business, the appellant has been receiving orders of manufacture of 'Vicks 500'. M/s. P&G intended to get manufactured a different version of that product, namely, 'Vicks 1000', to be supplied to the Latin American Countries. That, however, needed installation of new machinery. It entered into contract with the appellant in this regard. It has undertaken to meet the expenditure for installation of the new machinery and to place orders for ensuring viable production thereon.

In accordance with the contract entered into by it, with M/s. P&G, the appellant acquired the machinery for manufacture of new product, and the test run was also conducted. At that stage, M/s. P&G expressed its inability to continue with the contract and resiled from it. The appellant submitted a claim for Rs.1,08,94,000/- as compensation for unilateral termination of the contract. After negotiation, M/s.P&G paid a sum of Rs.87,33,056/- towards sterilization of assets of the company and Rs.21,60,944/- towards reimbursement of interest and other revenue expenditure.

The amounts received by the appellant from M/s. P&G were reflected in the return submitted for the Assessment Year 1998-99. The amount was claimed as capital receipt. The Assessing Officer passed an order under Section 143(1) of the Income Tax Act, 1961 (for short 'the Act'), on 30.09.1999. However, on 12.02.2002, a fresh order under Section 143(3) of the Act was passed duly exercising power under Section 148 of the Act and the amount of Rs.87,33,056/- was treated as revenue receipt. Aggrieved by that, the appellant preferred an appeal before the Commissioner of Income Tax (Appeals)-II, Hyderabad. The appeal was rejected on 26.12.2002. Thereupon the appellant filed I.T.A.No.294/Hyd/2003 before the Hyderabad Bench 'B' of the Income Tax Appellate Tribunal (for short 'the Tribunal'). The appeal was dismissed by the Tribunal through order dated 31.03.2004. Hence, this appeal, in which, the following four questions are raised:

1. Whether on the facts and circumstances of the case, the Income Tax Appellate Tribunal was correct in law in holding that the issue of notice under Section 148 of the Income Tax Act, 1961 for reopening the assessment already concluded under Section 143(1) of the Act pursuant to a return disclosing full and true particulars of income is permissible?
2. Whether on the facts and circumstances of the case the Tribunal was correct in law in distinguishing the decision of the Uttaranchal High Court in the case of CIT vs Sedco Forex International Drilling Company Limited (264 ITR 320) and in holding that the levy interest under Section 234B of the Act is permissible?
3. Whether on the facts and circumstances of the case Tribunal was correct in concluding that the compensation received by the Appellant from P&G for sterilization of the assets consequent upon the termination of the contract between the appellant and P&G was liable to be taxed as the revenue receipt, and the same was not in the nature of capital receipt?
4. Whether on the facts and circumstances of the case the Tribunal was correct in law in declining to consider alternative plea put forth before it for adjustment in the gross block, ignoring the fact that the methodology of computation of losses had a direct bearing and the

cost of assets procured by the appellant and therefore the compensation received was identifiable as being towards the capital assets?

Sri S. Ravi, learned Senior Counsel for the appellant submits that question No.1 deserves to be answered against the appellant in view of the judgment of the Supreme Court in ***Assistant Commissioner of Income Tax v. Rajesh Jhaveri Stock Brokers P. Ltd.***^[1] and did not press it. Similarly, he did not press question No.2.

As regards question Nos. 3 and 4, the learned Senior Counsel submits that the amount in question was not received by the appellant in the ordinary course of business and on the other hand, it was meant for installation of the machinery, which was specially got manufactured for production of a typical product, namely, 'Vicks 1000'. He contends that M/s. P&G itself recognized that the appellant is exposed to huge loss on account of the installation of machinery and thereafter keeping it idle, and accordingly, paid the compensation in the form of "sterilization of assets". He submits that the case is squarely covered by the judgment of this Court in ***Commissioner of Income Tax v. Barium Chemicals Ltd***^[2] and that the Assessing Officer, the Commissioner and the Tribunal were not justified in concluding that the amount received by the appellant towards "sterilization of assets" deserves to be treated as revenue receipt. Learned Senior Counsel further submits that if the concern of the Department is that the amount, which is received as compensation for the machinery, should not go untouched under the Act, in the event of it being treated as capital receipt, the same can be taken into account, in the context of determining the written down value of the assets.

Ms. Kiranmayee, learned counsel representing Sri J.V. Prasad, learned Standing Counsel for the respondent, on the other hand, submits that the order placed upon the appellant by M/s.P&G even for manufacture of 'Vicks 1000' was in the ordinary course of business;

and the mere fact that the appellant had to make special arrangement for it, does not make much difference. She submits that the amount paid by M/s. P&G albeit calling it as 'sterilization charges' is nothing but the compensation for business loss, and is revenue receipt, pure and simple. She placed reliance upon the judgment of the Supreme Court in ***Commissioner of Income Tax, Nagpur v. Rai Bahadur Jairam Valji and others***^[3].

In all fairness, the learned counsel for the appellant has given up question Nos.1 and 2. Question No.4 is nothing but a facet of question No.3 and it would arise only in the event of the answer to question No.3 being in favour of the appellant.

The distinction between the 'capital receipt' on the one hand, and the 'revenue receipt' on the other hand, is not that easy to maintain. Obviously because, the implication of the classification of the amounts received by the assessee into either of the categories would entail in serious consequences, acute attention is paid both by the assessee and the Assessing Officer higher the amount and greater the compensation.

This Court, in ***Commissioner of Income Tax v. Barium Chemicals Ltd*** (2nd supra), reviewed the law on the subject, by taking assistance of the judgments rendered by English and Indian Courts. Every aspect was meticulously analysed and ultimately, their Lordships summed up the matter as under:

"From the foregoing decisional law, it is reasonably clear that in order to decide whether or not a payment is a revenue receipt, its true nature and substance must be looked into. The form in which it is expressed is not decisive. How the assessee treated the payment is not conclusive of its nature. If the assessee himself has treated the payment in his account books as compensation or consideration received for loss of earnings or profits, it is a revenue receipt. If the payment is received in the ordinary course of the business of the assessee for loss of stock-in-trade, it is a revenue receipt. If, on the other hand, the payment received is towards compensation for extinction or sterilisation partly or fully of a

profit earning source (capital asset), such receipt not being in the ordinary course of the assessee's business, it must be construed as a capital receipt."

The following paragraph of the judgment of the Supreme Court in ***Godrej and Company v. CIT ((1959) 37 ITR 381 (SC))*** was taken note of.

"On an analysis of these cases which fall on two sides of the dividing line, a satisfactory measure of consistency in principle is disclosed. Where on a consideration of the circumstances, payment is made to compensate a person for cancellation of a contract which does not affect the trading structure of his business, nor deprive him of what in substance is his source of income, termination of the contract being a normal incident of the business, and such cancellation leaves him free to carry on his trade (freed from the contract terminated), the receipt is revenue: Where, by the cancellation of an agency, the trading structure of the assessee is impaired, or such cancellation results in loss of what may be regarded as the source of the assessee's income, the payment made to compensate for cancellation of the agency agreement is normally a capital receipt."

From the above, it becomes clear that broadly stated, the distinction between the capital receipt on the one hand and the revenue receipt on the other hand, would depend upon factors such as (1) whether the amount was received in the ordinary course of business or otherwise; and (2) whether it was paid as a measure of compensation or consideration for loss of earnings or profits or towards compensation or sterilization partly or fully for profit earning sources (capital asset). If it is former, it is the revenue receipt and if it is latter, it is capital receipt.

The expression "in the course of ordinary business" needs to be analysed carefully. Every activity undertaken by an assessee cannot be treated as part of its ordinary course of business. Sale of a manufactured product can certainly, be treated as an act in the ordinary course of business. However, the installation of machinery or carrying repairs therefor, does not fall into that category.

The facts in ***Barium Chemicals Ltd's case*** are similar to the case on hand. The assessee therein placed an order for installation of machinery on an English company and half way through, the contract was abandoned. The manufacturing capacity of the machinery so installed remained at 30% of the optimum. Realizing this and other factors, the agency, which undertook to install the machinery, paid compensation. The Revenue wanted to treat that amount as revenue receipt, whereas the assessee it can be treated, only as capital receipt. This Court upheld the contention of the assessee. The judgment has been holding the field for the past quarter of a century.

Coming to the facts of the present case, the appellant has been manufacturing the product as and when orders are placed in ordinary course of business. The one, as regards which the payment was made, is not as a contract or order of that nature. M/s. P&G wanted the appellant to produce a product as regards which it i.e., appellant does not have the arrangement or machinery. An equipment with altogether different specifications was to be acquired only, to meet the needs of M/s. P&G. Barring that, there was no other necessity for the appellant to install that machinery. Obviously for that reason, the agency agreed to provide funds for installation. The machinery was installed and hardly before the test run was completed, M/s.P&G resiled from the contract.

Realizing its obligations under the law, M/s. P&G paid the amounts as indicated in the preceding paragraphs. The basis for the respondent to treat the amount as revenue receipt is that

- a. The sample of the product, which was required to be manufactured through a machinery, was already produced.
- b. The machinery was being put to use, even after the cancellation of the contract.

As regards the former, it needs to be observed that the production of the item, was not on commercial scale but was only as a

sample. It is too well known, the sample can be manufactured with ordinary techniques and once it is approved, a specialized machinery is required to be installed, for commercial production. As regards the second, the observation of the Commissioner was that though for the manufacture of the same product, for which, the machinery was meant, it was being used to produce other drugs. When the entire machinery was installed in connection with a typical product to be produced on commercial lines, for the first time, the inference drawn by the authorities under the Act cannot be sustained in law.

Reliance is placed by the respondent upon the judgment of this Court in ***Commissioner of Income Tax, Nagpur v. Rai Bahadur Jairam Valji (3rd supra)***. That was a case, in which, the assessee was an ordinary supplier of limestone and dolomite and one of its customers, who placed orders for fairly long period, stopped the orders on the grounds of lack of economic feasibility. The amount was paid in the form of damages. It was not even alleged that any special machinery was erected or installed for execution of the order placed by the purchasers. Even while rejecting the contention of the assessee that the amount deserves to be treated as capital receipt, their Lordships observed that in case it is established that any item or machinery was installed or was brought into existence, to honour the order of the customer, the amount paid as compensation for stoppage of the work, deserves to be treated as capital receipt. Their Lordships observed as under:

“Dr. Radha Binode Pal, who appeared for him, argued that for the purpose of carrying out the agreement dated January 5, 1935, the respondent had executed works of a capital nature such as construction of quarters, tenements and the like, and had incurred expenses exceeding Rs.4 lakhs on that account, that all this had to be thrown away when the quarry at Paraghat had to be abandoned, and the sum of Rs.2,50,000/- was really a reimbursement of the amount spent by him as above and was therefore a capital receipt. If the facts were as stated by the respondent, the position in law would no doubt be as contended for by him. But have those facts been established ? In his statement

before the Income-tax Officer, the respondent merely stated that the amount in question was paid as consideration for the termination of the contract of 1934 and not of 1940, and it is pointed out by the Tribunal that the respondent did not substantiate even this assertion.”

The contention, and the answer, contained in the paragraph, are illustrative of the principle. It is a different matter that, it was not accepted, on facts.

In the instant case, there is no dispute that the new machinery installed by the appellant was exclusively for the purpose of manufacturing a specialized product and the contract in that behalf was terminated even before the production has commenced.

The aforesaid discussion results the third question being answered in the affirmative. However, that is not the end of the matter.

The amount received by the appellant from M/s. P&G being Rs.87,33,056/- certainly deserves to be treated as capital receipt. However, the said amount cannot be kept outside the purview of the taxation. The machinery installed for manufacturing the new product has already become part of assets. Under the Act, the written down value of the assets has been fixed. Once the appellant has the advantage of receiving a sum towards installation of machinery alone, the same deserves to be deducted from the WDV, to the extent it has been added to the value of block assets. It would have its own impact upon the amount of depreciation to be allowed on the block assets. We, therefore, answer the fourth question to the extent indicated above.

In the result, the appeal is partly allowed, answering questions 1 and 2 against the appellant and answering questions 3 and 4 to the extent indicated above in favour of the respondent. There shall be no order as to costs.

The miscellaneous petitions filed in this appeal shall also stand disposed of.

L.NARASIMHA REDDY, J

CHALLA KODANDA RAM, J

Date: 11.12.2014

Note: L.R copy to be marked

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[\[1\]](#) [2007] 291 ITR 500 (SC)

[\[2\]](#) [1987] 168 ITR 164

[\[3\]](#) [1959] 35 ITR 148