Bombay High Court Commissioner Of Income-Tax vs Bangalore Clothing Co. on 15 January, 2003 Equivalent citations: (2003) 180 CTR Bom 127, 2003 260 ITR 371 Bom, 2003 (3) MhLj 764 Author: S Kapadia Bench: S Kapadia, J Devadhar JUDGMENT S.H. Kapadia, J. 1. This appeal is filed by the Department under Section 260A of the Income-tax Act, 1961, raising the following question of law in respect of the assessment year 1992-93. 2. Before formulating the question, the facts may be seen. Facts ; 3. The assessee filed its return of income on January 29, 1993, declaring total income of Rs. 3,32,297 after claiming deduction under Section 80HHC of Rs. 13,38,789. The Assessing Officer completed the assessment under Section 143(3) on February 14, 1994, on the total income of Rs. 3,32,300 after allowing deduction under Sections 80HHC and 80-I. 4. This assessment order of the Assessing Officer, dated February 14, 1994, was revised by the Commissioner under Section 263 of the Act. The order of the Commissioner is dated October 31, 1996. By the said order, the Commissioner of Income-tax directed the Assessing Officer to reconsider the claims made by the assessee under Sections 80HHC and 80-I. In this case, we are concerned with computation of deduction under Section 80HHC 5. Thereafter, the Assessing Officer passed the fresh order of assessment under Section 143(3) read with Section 263 of the Act. This was on March 30, 1998. By the said order, the Assessing Officer disallowed the claim of deduction under Section 80HHC on the ground that the receipt of charges for job work done by the assessee in India amounting to Rs. 66,35,083 was not a part of the total turnover. In this connection, the Assessing Officer relied upon Explanation (baa) to Section 80HHC. In short, it was held by the Assessing Officer that such charges did not form part of the total turnover. Being aggrieved, the assessee carried the matter in appeal to the Commissioner of Income-tax (Appeals) who took the view that the assessee was entitled for deduction as the assessee was processing the goods on job work basis which was part of business activity of the assessee. In the circumstances, the turnover from job work activity was included in the total turnover of the assessee. The appellate authority further took the view that the Assessing Officer had erred in reducing 90 per cent. of the job work turnover from the business profits calculated for the purposes of Section 80HHC. He accordingly directed the Assessing Officer not to reduce 90 per cent. of job work turnover from business profits. In short, the appellate authority reduced the total turnover and increased the business profits. Being aggrieved, the assessee filed an appeal to the Tribunal against the order of the Commissioner of Income-tax under Section 263 of the Act vide Appeal No. 2278 of 1996 whereas, the Department filed its Appeal No. 5091 against the order of the first appellate authority. Both the appeals are disposed of by the impugned order passed by the Tribunal. By the impugned order, it was held by the Tribunal that job work charges received by the assessee were not in the nature of brokerage, commission, rent or interest and, therefore, 90 per cent. of such charges ought not to have been excluded from the business profits. That, Explanation (baa) did not apply to such charges. Accordingly, the Tribunal cancelled the order under Section 263 and restored the assessment order dated February 14, 1994. Consequently, the Department's appeal was dismissed as infructuous. Being aggrieved

by this order passed by the Tribunal, the Department has come in appeal. 6. On the facts enumerated above the following question of law is framed by the court under Section 260A of the Income-tax Act : "Whether labour charges (job work receipts) received by the assessee stood excluded from the expression 'profits of business' under Explanation (baa) to Section 80HHC and whether the Tribunal was right in holding that 90 per cent. of the labour charges ought not to have been excluded from such business profits while computing deduction under Section 80HHC?" Arguments: 7. Mr. R.V. Desai, learned senior counsel appearing on behalf of the Department, contended that in view of the express provision under Explanation (baa) to Section 80HHC, the Tribunal had erred in including labour charges in the business profits and excluding such charges from the total turnover. He contended that Section 80HHC talks of deduction in respect of profits retained for export business. He contended that rent, brokerage, commission, interest and labour charges have no nexus with the export activity. That, such items do not earn foreign exchange for the country and, therefore, by way of Explanation (baa) inserted with effect from April 1, 1992, the Legislature has clarified that such items of income cannot form part of the business profits. He relied upon the judgment of this court in the case of CIT v. S. G. Jhaveri Consultancy Ltd, [2000] 245 ITR 854 in support of his contention. He contended that by including such charges in the business profits, a distorted figure of export profits is arrived at by the assessee. He submits that the issue is no more res Integra in view of the above judgment. He contended that, in this case, when the Tribunal decided the matter, the above judgment of the High Court was not available. However, since then, the law is settled in numerous judgments of this court including the above judgment in the case of S.G. Jhaveri Consultancy Ltd, [2000] 245 ITR 854 (Bom). He, therefore, submitted that the appeal needs to be allowed. 8. In reply, it has been urged by Mr. Inamdar, learned counsel appearing on behalf of the assessee, that the above judgment in the case of S. G. Jhaveri Consultancy Ltd. [2000] 245 ITR 854 (Bom) did not apply to the facts of the present case. He contended that, in this case, the assessee carried on composite business of manufacturing garments, of undertaking processing work on job work basis and the assessee also used to act as a seller of garments. He contended that all the three activities of manufacturer, processor and trader constituted one consolidated activity. He contended that the assessee had exported goods manufactured by it. That, the assessee was an exporter of manufactured goods and since the assessee carried on composite business, the assessee was required to compute profits under Section 28 of the Income-tax Act. He contended that under Section 28, business profits were required to be computed and from such business profits items like commission, rent, brokerage, interest and charges were required to be reduced. He contended that the word "charges" in Explanation (baa) will not apply to job work charges if such job work charges were received as a part of composite business. He contended that the words "labour charges" were a misnomer. He contended that he had no quarrel with the proposition of law laid down by the Division Bench of the Bombay High Court in the case of S. G. Jhaveri Consultancy Ltd. [2000] 245 ITR 854. He however, pointed out that the judgment of the Bombay High

Court in S. G. Jhaveri Consultancy Ltd. [2000] 245 ITR 854 was a sequel to the judgment of the Bombay High Court in the case of CIT v. K. K. Doshi and Co. [2000] 245 ITR 849. Mr. Inamdar, learned counsel for the assessee, therefore, invited our attention to the facts of the case in K. K. Doshi and Co. [2000] 245 ITR 849 (Bom). He pointed out that in the case of K.K. Doshi and Co. [2000] 245 ITR 849 (Bom), job work was undertaken by the assessee not as a part of main business but it was undertaken on seasonal basis. He contended that if job work is taken on seasonal basis then such activity has no nexus with earning of export profits and, therefore, the court, in that matter, was right in excluding job work charges from business profits. However, it was argued that in the present case, the facts are entirely different because, in this case, the assessee was a manufacturer, trader and processor. That, the job work was a part of composite business activity. In the circumstances, he submitted that the judgments of this court in K. K. Doshi and Co.'s case [2000] 245 ITR 849 and S.G. Jhaveri Consultancy Ltd. [2000] 245 ITR 854 did not apply. Mr. Inam-dar contended that the assessee partly sold the manufactured garments and partly exported the same. He contended that job work was a part of composite activity undertaken by the assessee. He, therefore, contended that job work charges received by the assessee cannot be excluded from business profits. On the facts, he submitted that the total turnover of the assessee during the assessment year in question from the composite activity was Rs. 1,62,46,524 out of which the turnover attributable to job work was Rs. 66,35,083. He contended that the Department erred in excluding the said amount of Rs. 66,35,083 from the total turnover. He contended that under Section 80HHC(3), as it stood at the relevant time, the total turnover included price of the goods sold domestically. He contended that the Department erred in arriving at the business profit of Rs. 19,45,738 by excluding 90 per cent. of Rs. 66,35,083 vide Explanation (baa) and consequently the business profits stood reduced to (-) Rs. 49,70,051. He contended that consequently the assessee has lost the total deduction because the resultant business profit stood reduced to a negative figure indicating minus profit/loss. He contended that there is no dispute in this case of the assessee having made exports. He contended that the assessee has earned export profits. However, on account of error in the computation of business profits, the assessee has become disentitled to deduction under Section 80HHC. He, therefore, contended, on the facts, that labour charges which form part of the composite business of the assessee should be included and not excluded from business profits. He submitted that, in this case, we are concerned with the assessment year 1992-93. He contended that the law stood amended on and from April 1, 1992. That, after April 1, 1992, under the amended law, business profits were required to be computed under Section 28 from which the assessee was entitled to deduct rent, interest, commission. That, these items of income were required to be deducted as they have no nexus with earning of export profits. He contended that prior to April 1, 1992, Explanation (baa) did not exist and, consequently, the said items of income were not required to be excluded from business profits. He contended that after April 1, 1992, the Legislature has introduced a fiction under Section 80HHC(3). That, by that fiction in the cases

of exports of manufactured goods, profits derived from such exports (export profits) became deductible from the gross total income. That, in this case, the gross total income was the same as business income. That, prior to April 1, 1992, nothing was deductible from business profits because it took into account real profits whereas, after April 1, 1992, the Legislature has created a fiction in earmarking certain items as profit which were not profit in the real sense. He contended that items of income like rent, interest, commission did constitute real profit. These items were not excluded prior to April 1, 1992, from business profits. However, after April 1, 1992, they are excluded by virtue of Explanation (baa) and, therefore, after April 1, 1992, deduction is calculated on items which are not real profits. He submitted on the facts that for the assessment year in question, the business income computed under Section 28 was Rs. 18,55,545. He submitted that the only point which arises for determination in this appeal is the quantum of amount which needs to be deducted from Rs. 18,55,545. He contended that since job work charges received by the asses-see form part of the composite business and since they were a part of total turnover, no amount on that account was deductible from Rs. 18,55,545 whereas, according to the Department, an amount of Rs. 66,35,803 was deductible. He submitted that in the case of CIT v. Kantilal Chhotalal [2000] 246 ITR 439, this court has held that total turnover cannot include reassort-ment charges, labour charges, commission, interest, rent or receipts of similar nature. He contended that he has no dispute with that proposition provided the labour charges received by the assessee had no linkage with the export activity. He submitted, however, that all these judgments proceed on the basis that the receipts had no nexus with the export activity. He contended that reassortment charges were different from job work charges received by the assessee. He contended that reassortment charges had no connection with export activity and, therefore, the court was right in excluding such charges from the business profits. However, reassortment charges were quite different and distinct from job work charges received by the assessee and, therefore, such job work charges ought not to be excluded from the business profits. He contended that the assessee received job work charges as a part of manufacturing activity. That, the gross receipt of job work charges accrued to the assessee on account of manufacturing activity undertaken by the assessee. He, therefore, contended that the judgment of the Division Bench of this court in Kantilal Chhotalal [2000] 246 ITR 439 had no application to the facts of this case. He submitted that in all the above judgments accrual of receipt had no nexus with the manufacturing activity and, therefore, the receipts were rightly excluded from the business profits. He contended that after April 1, 1992, the law is amended. That, under the amended law, the assessee is called upon to compute business profits under Section 28 which was not the case prior to the amendment. He submitted that prior to this amendment, business profits were calculated without any deduction but after the amendment the Legislature has laid down that business profits shall be calculated in accordance with Section 28. He contended that, in the present case, business profits have been calculated under Section 28. He contended that since labour charges accrued to the assessee as a part of its manufacturing activity, such receipts had to be taken

into account while computing business profits under Section 28. He contended that before April 1, 1992, profits were not defined but after the amendment, profits from business and deduction therefrom have been defined by virtue of the fiction created in sections 80HHC(1) and 80HHC(3). Therefore, he contended that one has to go by a strict interpretation of sections 80HHC(1) and 80HHC(3). He, therefore, urged that labour charges received by the assessee which form part of its manufacturing activity cannot be reduced from business profits. Findings : 9. The narrow question, which arises for determination in this case is : whether the Department was right in reducing 90 per cent. of the job work turnover (labour charges) from the business profits calculated for the purposes of Section 80HHC? This matter needs to be decided in the light of the facts of this case. 10. In this case, we are concerned with exports of goods manufactured by the assessee. The assessee manufactures and processes goods and sells the same domestically and by way of exports. Under Section 80HHC, exporters are allowed, in the computation of their total income, a deduction of the entire profits derived from exports. The export profit is computed on the basis of the ratio of export turnover to total turnover. In effect the formula reads as under: 80HHC concession = Export turnover Export profit = Bussiness profits X ———————— Total turnover 11. In this case we are concerned with Sections 80HHC(1) and 80HHC(3) as it stood at the relevant time. In this case we are concerned with the assessment year 1992-93. For the purposes of deciding this matter, we may quote the Explanation (baa) to Section 80HHC. "(baa) 'profits of the business' means the profits of the business as computed under the head 'Profits and gains of business or profession' as reduced by- (1) ninety per cent. of any sum referred to in Clauses (iiia), (iiib) and (iiic) of Section 28 or of any receipts by way of brokerage, commission, interest, rent, charges or any other receipt of a similar nature included in such profits ; and (2) the profits of any branch, office, warehouse or any other establishment of the assessee situate outside India;" 12. The above Clause (baa) was introduced by an amendment to Section 80HHC for and from the assessment year 1992-93. It defines the expression "profits of the business", for the purposes of Section 80HHC, to mean profits of the business as computed under Section 28 of the Act as reduced by 90 per cent. of any sum referred to in Clauses (iiia), (iiib) and (iiic) of Section 28 or receipts by way of brokerage, commission, interest, rent charges or any other receipt of a similar nature included in such profits. We are not concerned with the remaining requisite of that Explanation. The narrow point which arises for determination in this case is : whether job work turnover/receipts came within the word "charges" under the above Explanation. According to the Department, the assessee has termed job work receipts as labour charges. Therefore, these charges did not form part of the business profits. According to the Department, job work receipt was similar to brokerage, commission, interest, rent, labour charges because they did not possess element of turnover. Therefore, job work receipts/labour charges were required to be reduced from the business profits as contemplated by the above Explanation. In this connection, the Department placed heavy reliance on the following judgments of the Bombay High Court to which one of us (Kapadia ].) was a party. They relied upon the judgments

in the case of CIT v. S.G. Jhaveri Consultancy ltd. [2000] 245 ITR 854 ; CIT v. K.K. Doshi and Co. [2000] 245 ITR 849 ; CIT v. Ravi Ratna Exports (P.) Ltd. [2000] 246 ITR 443 and CIT v. Kantilal Chhotatal [2000] 246 ITR 439. 13. The above judgments mainly deal with the interpretation of Section 80HHC(1) and (3). By those judgments, this court has laid down the mode of calculation of export profits/80HHC concession. In the present case, we are concerned, however, with application of those judgments to the facts of this case. Mr. R.V. Desai, learned senior counsel for the Department, argued before us that, in this case, the receipt was by way of labour charges and, therefore, such charges stood excluded from the business profits contemplated in the above formula. He contended that labour charges were similar to rent, commission, interest, mentioned in Clause (baa). He, therefore, contended that such charges did not come within the ambit of business profits in the above formula. He contended that for the purposes of calculating deduction under Section 80HHC, only those items of income are to be taken into account as business profits which items have relation to the export activity. He contended that, in the present case, receipt of labour charges had no nexus with the export activity. He, therefore, contended that labour charges stood excluded from the business profits in the above formula in view of Explanation (baa) to Section 80HHC and consequently the Assessing Officer had erred in his order dated February 14, 1994, in treating labour charges as part of business profits. 14. We do not find any merit in the argument advanced on behalf of the Department. In this case, we are concerned with profits from the business of exports of goods manufactured by the assessee. Therefore, the export profits were required to be computed in the ratio of export turnover to total turnover as contemplated by the above formula. Explanation (baa) was introduced into the Act by the Finance (No. 2) Act, 1991, with effect from April 1, 1992. Under the Circular of the Central Board of Direct Taxes bearing No. 621, dated December 19, 1991 (see [1992] 195 ITR (St.) 154), it has been stated that the above formula gave a distorted figure of export profits when receipts like interest, commission, etc., which do not have an element of turnover are included by the assessee in the profit and loss account. Therefore, Explanation (baa) came to be introduced. Under that Explanation profits of the business, for the purposes of Section 80HHC, does not include receipts which do not have an element of turnover like rent, commission, interest, etc. However, as some expenditure might be incurred in earning such incomes an ad hoc 10 per cent. deduction from such incomes is provided to account for those expenses. However, learned counsel for the Department cannot invoke Explanation (ban) in every matter involving receipts by way of brokerage, commission, interest, rent, labour charges, etc. These items of income have got to be seen in the context of the business activity of the assessee. To give an example, in the case of a manufacturing company which undertakes exports, receipt of interest or commission may not be operational income because they do not have the element of turnover and consequently Explanation (baa) will apply. However, that will not be the case if the assessee is carrying on the business of financing because in the case of financing, the interest income which accrues to the assessee will have the element of turnover and in such a case,

receipts like interest, will not attract Explanation (baa). The point which we would like to make, therefore, is that in every matter the Assessing Officer will have to ascertain whether receipt of interest, commission, labour charges, etc., were a part of operational income. We cannot lay down any standard test for deciding what would constitute operational income. Broadly, the Department will have to consider the memorandum and articles of association of the company, the nature of the business, the nature of the activity and such other tests, The Department will also have to ascertain as to what is the dominant business of the company and whether receipts like interest, commission, etc., accrue as a part of the main business activity or whether they accrue out of incidental business. In the case of CIT v. K. K. Doshi and Co. [2000] 245 ITR 849 (Bom), the assessee had received Rs. 19.60 lakhs as service charges. It was held that the service charges of Rs. 19.60 lakhs did not have the element of turnover because the charges were received for a seasonal activity which was not an integral part of the manufacturing activity. Therefore, the test to be applied in all such matters is, whether interest, service charges, commission accrue out of the main business activity of the company and whether they were operational income. The case of K. K. Doshi and Co. [2000] 245 ITR 849 (Bom) shows, that service charges of Rs. 19.60 lakhs did not represent operational income and, therefore, came within Explanation (baa). However, we find that the Department just looks at the nomenclature of the receipt and if it finds that the nomenclature is rent, interest, commission then without any further inquiry into the nature of business, the Department invokes Explanation (baa) which is not the purpose and the object of that Explanation. In the present case, the receipt in question is labour charges. However, this nomenclature may not be accurate. In the present case, the assessee is a manufacturer and exporter of garments. In the present case, the Tribunal has recorded a finding of fact which is not challenged, namely, that there was no difference between the activities relating to export business carried on by the assessee and the processes carried on for manufacturing garments for others under job work contracts. The Tribunal has further found, on the facts, that the activity of labour job involved use of machinery, labour and material which were also forming part of the activity of manufacturing garments for its own sales. The Tribunal further found that there was no difference between manufacturing of garments for the assessee's own sales and manufacturing of garments for others on labour job basis. These are findings of fact. They have not been challenged in the memo of appeal. The memo of appeal proceeds only on the basis that because the receipt is by way of labour charges, Explanation (baa) stood attracted. As stated above, each case will have to be examined by the Assessing Officer. As stated above, in each case of receipt of labour charges, rent, interest commission, etc., the Assessing Officer will have to ascertain whether the element of turnover existed. In the present case, the Tribunal has found, on the facts, that there was an element of job work turnover and, therefore, the Tribunal concluded on the facts of this case that the receipt of labour charges was not in the nature of brokerage, commission, rent, interest or charges as mentioned in Explanation (baa) to Section 80HHC. Further, the assessee received Rs. 66,35,083 as processing charges. This can be

seen from the profit and loss account. The company is engaged in manufacture and sale of garments, both domestically and by way of exports. The processing charges earned was by using the entire undertaking of the company which also manufactured garments for domestic sales and export sales and which processing charges were earned by incurring expenditure for the factory like wages, electricity charges, etc., debited in the profit and loss account. That, the income of Rs. 66,35,083 was only an income from business and the expenditure for earning this income is included in several items of expenditure debited in the profit and loss account. In these circumstances, we do not wish to interfere with the finding of fact recorded by the Tribunal. As stated above, if the receipt of labour charges (job work charges), interest, commission, etc., accrues by way of operating income then it falls outside Explanation (baa). In the present case, the receipt accrued from manufacturing activity, The Tribunal has found that job processing activity was linked to the manufacturing activity of the assessee. In the circumstances, on the facts, the judgments cited by the Department do not apply to this case. Lastly, we may point out that, in this case, there is no challenge to the findings of facts recorded by the Tribunal in relation to the processing activity forming part of the manufacturing activity of the assessee. 15. In the circumstances, we answer the above question in the affirmative, i.e., in favour of the assessee and against the Department. 16. Accordingly, the appeal is dismissed with no order as to costs.