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* IN THE HIGH COURT OF DELHI AT NEW DELHI

+ ITA No. 650 of 2006

% *Reserved on : October 05, 2009*
Pronounced on : October 30, 2009

Commissioner of Income Tax, Delhi - XIII . . . Appellant

through : Ms. Suruchi Aggarwal with Mr. Anish Kumar, Advocates

VERSUS

M/s. Mereena Creations . . . Respondent

through : Mr. Pankaj Jain with Mr. R.K. Chauhan, Advocates

CORAM :-
THE HON'BLE MR. JUSTICE A.K. SIKRI
THE HON'BLE MR. JUSTICE SIDDHARTH MRIDUL

1. Whether Reporters of Local newspapers may be allowed to see the Judgment?
2. To be referred to the Reporter or not?
3. Whether the Judgment should be reported in the Digest?

A.K. SIKRI, J.

1. This appeal was admitted on the following substantial questions of law :-

> "1) Whether the ITAT was correct in law in deleting the addition of interest income from FDRs amounting to Rs.6,85,624/- under the head "Income from Other Sources" by treating it as business income?
>
> 2) Whether the ITAT was correct in law in allowing the deduction under Section 80HHC of the Income Tax Act, 1961 when there was no profit from export business?"

2. For answering the aforesaid questions, following facts need to be mentioned.

3. The respondent/assessee had filed income tax return for the assessment year 2001-02 declaring *'Nil'* income. Return was processed by issuing notice under Section 143(2) of the Income Tax Act, 1961 (hereinafter referred to as the 'Act'). The assessee is a 100% manufacturer/exporter of readymade garments. While framing the assessment, the Assessing Officer (AO) found that the assessee also had interest income on the fixed deposit receipts and the assessee had claimed deduction under Section 80HHC of the Act on this interest income as well treating the same as business income. He also found that the profit from business, after deducting 90% of duty drawbacks, were determined at negative figure. The AO worked out the deduction under Section 80HHC by adopting negative figure and computed the figure accordingly, thereby making a deduction of Rs.28,88,993/-. In doing so, the AO relied upon the judgment of the Supreme Court in the case of ***M/s. Tuticorin Alkali Chemicals & Fertilizers Ltd.*** v. ***Commissioner of Income Tax,*** 227 ITR 172 as well as orders of the Madras Bench of the Tribunal.

4. In appeal preferred by the assessee, the Commissioner of Income Tax (Appeal), vide orders dated 16.2.2004, enhanced the income of the assessee holding that the assessee was not entitled to any deduction under Section 80HHC as profits of the business were in the negative and, thus, dismissed the appeal of the assessee. In further appeal preferred by the assessee before the Income Tax Appellate Tribunal (for short, the 'Tribunal'), the assessee has triumphed as, vide

impugned orders dated 1.9.2005, the appeal of the assessee has been allowed and the additions made by the AO deleted.

In this backdrop, the aforesaid two questions have arisen relating to addition of interest income from FDRs and deduction under Section 80HHC.

5. **Re: Question No.1**

In the income tax return filed by the assessee, as a 100% manufacturer/exporter of readymade garments, the assessee had claimed deduction to the tune of Rs.1,22,02,454/- under Section 80HHC of the Act. The assessee had earned interest income of Rs.6,85,624/- from the FDRs and claimed the same as business income, thus, including it in the total income for the purpose of deduction under Section 80HHC of the Act. The AO, however, was of the opinion that the interest income from FDRs was income from other sources and, therefore, could not be included while computing the deduction under Section 80HHC. The case of the assessee was that interest was received on deposits kept as margin money or security for bank guarantee, etc. and, therefore, it is to be treated as business income. It was also pleaded that the assessee had paid bank interest of Rs.20,59,029/- during the year under consideration on export facility taken from the bank and an interest of Rs.6,85,624/- had been paid for securing limits on deposits tendered with the bank on such funds and, thus, the net amount of interest of Rs.13,70,405/- was to be allowed as business expenditure. He, thus, argued that the amount of interest which had been earned had a clear nexus with the

amount borrowed from the bank on which interest had been paid. The Tribunal has accepted this submission of the assessee holding that in these circumstances the interest received par-takes the character of the business receipts and it is only the net interest that would be considered for deduction under Section 80HHC of the Act. Therefore, it could not be treated as income from other sources.

6. Learned counsel for the Revenue submitted that this issue now stands covered in favour of the Revenue by the judgment of this Court in *Commissioner of Income Tax* v. ***Shri Ram Honda Power Equip,*** 289 ITR 475. Learned counsel for the assessee, on the other hand, argued that the case would be covered by the subsequent judgment of this Court in *Commissioner of Income Tax* v. ***Bharat Rasayan Ltd.,*** 172 Taxman 338.

7. We have considered the submissions of learned counsel for the parties.

8. We may point out at the outset that merely because the assessee is engaged in a business would not *ipso facto* mean that all incomes earned, irrespective of the source of income, would be business incomes. Scheme of the Act, in this behalf, is very clear. Section 14 of the Act provides distinct heads under which the income of an assessee can be classified. In respect of each income received by an assessee, the AO has to under which particular head it falls, having regard to the source of income from where it is derived. It is the manner in which the income is derived that is relevant and not

merely the fact that the person is engaged in a business or a profession.

9. In the present case, the interest income is derived from fixed deposit receipts. Therefore, the question which arises is as to whether it is to be treated as business income or *'income from other sources'*. As noted above, the assessee is having export business and is, thus, claiming benefit of Section 80HHC of the Act. The money kept in the fixed deposit might have been earned from the exports made by the assessee. However, whether interest earned on the surplus that the assessee kept in the form of FDR would also be treated as business income? This very question has been specifically answered in favour of the Revenue by this Court in ***Shri Ram Honda*** (supra).

10. In that case, after discussing various facets of Section 80HHC of the Act and various judgments, a Division Bench of this Court summarized its conclusions in the following manner :-

> "*Conclusions*
>
> To summarise our conclusions:
>
> (i) In computing what the profits derived from exports for the purposes of 80HHC(1) read with 80HHC(3) are, the nexus test has to be applied to exclude that which does not partake of profits that can be said to have been derived from the business of exports.
>
> (ii)In the specific context of Clause (baa) of the Explanationn to Section 80HHC, while determining the 'profits of the business', the AO has to undertake a two-step exercise in the following sequence. He has to first 'compute' the profits of the business under the head "profits and gains of business or profession." In other words, he will have to compute business profits, in terms of the Act, by applying the provisions of Sections 28 to 44 thereof.

(iii) In arriving at profits of the business by the above method, the AO will exclude all such incomes which partake the character of 'income from other sources' which in any event are treated under Sections 56 and 57 of the Act and are thereforee not to be reckoned for the purposes of Section 80HHC. The AO will apply the law as explained in the judgments of the Kerala High Court referred to above which have been affirmed by the Hon'ble Supreme Court.

(iv) Where surplus funds are parked with the bank and interest is earned thereon it can only be categorised as income from other sources. This Page 0528 receipt merits separate treatment under Section 56 of the Act which is outside the ring of profit and gains from business and profession. It goes entirely out of the reckoning for the purposes of Section 80HHC.

(v) Interest earned on fixed deposits for the purposes of availing credit facilities from the bank, does not have an immediate nexus with the export business and thereforee has to necessarily be treated as income from other sources and not business income.

(vi) Once business income has been determined by applying accounting standards as well as the provisions contained in the Act, the assessed would be permitted to, in terms of Section 37 of the Act, claim as deduction, expenditure laid out for the purposes of earning such business income.

(vii) In the second stage, the AO will deduct from the profits of the business computed under the head profits and gains of business or profession the following sums in order to arrive at the 'profits of the business' for the purposes of Section 80HHC(3):

(a) 90% of any sum referred to in Clauses (iiia), (iiib) and (iiic) of Section 28 i.e. export incentives;

(b) 90% of any receipts by way of brokerage, commission, interest, rent, charges or any other receipt of a similar nature included in such profits; and

(c) profits of any branch, office, warehouse or any other establishment of the assessed situate outside India

(viii) The word 'interest' in Clause (baa) of the Explanationn connotes 'net interest' and not 'gross interest'. thereforee, in deducting such interest, the AO will take into account the net interest i.e. gross interest as reduced by expenditure incurred for earning such interest. The decision of the Special Bench of the ITAT in Lalsons to this effect is affirmed. In holding as above, we differ from the judgments of the Punjab & Haryana High Court in Rani Paliwal and the Madras High Court in Chinnapandi and affirm the ruling of the Special Bench of the ITAT in Lalsons.

> (ix) Where, as a result of the computation of profits and gains of business and profession, the AO treats the interest receipt as business income, then deduction should be permissible, in terms of Explanationn (baa) of the net interest i.e. the gross interest less the expenditure incurred for the purposes of earning such interest. The nexus between obtaining the loan and paying interest thereon (laying out the expenditure by way of interest) for the purpose of earning the interest on the fixed deposit, to draw an analogy from Section 37, will require to be shown by the assessed for application of the netting principle."

Conclusion Nos. (iv) and (v), reproduced above, make it clear that the Court was of the view that where surplus funds are parked with the bank and interest is earned thereon, it can only be categorized as *'income from other sources'*. Thus, it goes out of reckoning for the purpose of Section 80HHC.

11. The submission of learned counsel for the assessee, however, was that in the present case the assessee had taken loans from the bank on which the interest was paid and as a security for those loans, FDRs in question were kept with the bank and, therefore, the assessee was entitled to the netting of interest for the interest income and expenses thereto. This is also categorically answered in ***Shri Ram Honda*** (supra). The Court was of the opinion that even in a case where the exporter is required to mandatorily keep monies in fixed deposit, in order to avail credit facility for the export business, and interest earned on fixed deposits for the purpose of availing of credit facilities from the bank, it was held that the interest income has to be treated as *'income from other sources'* and not business income as it does not have an immediate nexus with the export business.

12. We would like to mention the distinction between the income *'derived from'*, the expression used in Section 80HHC, from the term *'attributable to'*, as explained by the Supreme Court in the case of ***Cambay Electrical Supply Industrial Co. Ltd.*** v. ***CIT,*** 113 ITR 84, followed again in ***Ashok Leyland Ltd.*** v. ***CIT***, 224 ITR 122. The words *'derived from'* had to be given restricted meaning and income could be said to be *derived from* an activity only if the said activity was the immediate minimum and effective sources of the income. Profits and gains are well understood to mean only the business income and not any other income. So long as the assessee has no business of lending money and the interest is not earned from the export business, it cannot be business income but income under other sources. (See – ***Tuticorin Alkali Chemicals & Fertilizers*** (supra)).

13. In a recent judgment given in the case of ***Commissioner of Income Tax – XIII*** v. ***M/s. S.B. Jain Publishers Overseas,*** (ITA No. 642/2006 decided on 21.8.2009), the assessee had received interest income of Rs.3,50,000/- from M/s. CBS Publishers, to whom it had made certain advance. This advance was given against the supply of books. Said M/s. CBS Publishers delayed the supply and for the period the publishers kept the advance, they paid interest to the assessee. Since the advance was given for the business purpose, it was held that interest earned thereupon would inextricably treated as business income and not income from other sources. However, on the basis of Section 80HHC, it was held that even in that situation, the entre interest received was to be dealt with in accordance with

the provisions of Section 80HHC read with explanation (baa) of the Act and, thus, the assessee was not entitled for netting of interest income.

This discussion leads us to answer the question, as formulated, in favour of the Revenue and against the assessee.

14. <u>Re: Question No.2</u>

Insofar as the second question is concerned, both the parties are relying upon the judgment of the Supreme Court in ***IPCA Laboratory Ltd.*** v. ***Deputy Commissioner of Income Tax,*** 266 ITR 521. It is the interpretation to the said judgment on which there is a dispute. Learned counsel for the Revenue submitted that in case there are no profits from the export business, deduction under Section 80HHC of the Act cannot be allowed. Learned counsel for the assessee, on the other hand, argued that a clear finding of fact is recorded that the assessee is a 100% manufacturer and exporter and, therefore, eligible for deduction under Section 80HHC of the Act. In these circumstances, his submission was that if there was a loss in one activity and profit in the other, then the loss cannot be ignored and the assessee would be entitled to benefit of provision of Section 80HHC by netting the result of the two activities. He submitted that the Tribunal on more than one occasion had construed the judgment of the Supreme Court in ***IPCA Laboratory*** (supra) in the aforesaid manner, which is accepted by the Tribunal in the impugned judgment in the following words :-

> "8. In the case of CIT Vs. M/s. Paramount Products (P) Ltd. in ITA No. 3273/Del/2001 dated 13.1.2005 the Bench of the

Delhi Tribunal, after considering the decision of the Apex Court in the case of IPCA Laboratory reported in 256 ITR 521, in para 7 and 8 of the order held as under :-

> "7. Insofar as the question of netting of the result of two activities is concerned, the Apex Court in the case of IPCA Laboratories Ltd. 266 KITR 52(SC) has already laid a dictum that if there is a loss in one activity and profit in the other then the loss cannot be ignored and the assessee will be entitled to the benefit of Section 80HHC only on then profit of the other activity, which is left after the set off of loss from the first activity. The B Bench of the Delhi Tribunal in the case of M/s. Jindal Exports Ltd. v. ITO where one of us the Ld Accountant Member was a party to the judgment after analyzing the ratio of the principle laid down by the Apex Court in IPCA Laboratories case has held that while computing profit not only the results of two activities is to be netted but the same are to be further netted by the export incentives. Otherwise full meaning cannot be given to the Apex Court judgment. The parties to the present appeal were confronted with the said decision of the Tribunal and have clearly conceded that the issue in their case is squarely covered by the decision of the Tribunal. The decision taken by the Tribunal vide paras 6 & 7 are reproduced as under :-
>
> > "6. We have given our thoughtful consideration to the pleas raised with reference to record before us. At the time when Special Bench of the Tribunal rendered its decision on 25.2.2004, the Apex Court decision in IPCA Laboratory had not been pronounced. The Supreme Court rendered the said decision on 11.3.2004. In the said decision Apex Court has decided that being incentive provision such provision needs to be liberally interpreted but liberal interpretation has to be as per the working of the section 80 HHC of the Act. As per the wordings of the section the benefit is not available then no benefit can be conferred by ignoring or misinterpreting the words contained in the section."

On the same page 529 in para H, the court has further held as under :-

> "It would not be denied that the word "profit" in section 80HHC(1) and Section 80HHC(3)(a) and 3(b) means a positive profit. In other words, if there is a loss then no deduction would be available under section 80 HHC or 3(a) or 3(b). In arriving at the figure of positive profit, if the net figure is a positive profit then the assessee will be entitled to a deduction. If the net figure is a loss that the assessee will not be entitled to a deduction."

15. After reading the judgment of the Supreme Court in *IPCA Laboratory* (supra), it clearly emerges: no doubt, unless there is a positive *'profit'*, the benefit of Section 80HHC would not be given. The Court interpreted it to mean that if there is a loss then no deduction would be available. However, how the test for determining the figure of positive profit is applied is stated as follows :-

> "In arriving at the figure of positive profit, both the profits and the losses will have to be considered. If the net figure is a positive profit then the assessee will be entitled to a deduction. If the net figure is a loss then the assessee will not be entitled to a deduction."

It is clear from the above that while computing export profit the result of two activities is to be netted. While doing so, export incentives are also to be taken into consideration.

16. We are, therefore, of the opinion that the Tribunal rightly construed the judgment and decided the case. Contention of the Revenue was negatived by giving the following example :-

> "If for sub-section(3) as ld counsel is suggesting that profit should be bifurcated between two spacie (sic) i.e. one from activity of export, be it of manufactured goods or of a trading goods and the other of export incentives, then in all cases the export incentives essentially have to be a positive figure irrespective of the fact whether there is a loss in export of manufacturing goods or from export of trading goods or from both. If this position is accepted then the loss in all situation has to be ignored and deduction on export incentives which will always be a positive figure shall have to be allowed. Viewed with the angle in IPCA case also, the assessee should have entitled to deduction u/s 80HHC on export incentives even if export profits after netting the results of the two activities are in negative. However, the Hon'ble Court has held that the assessee would not be allowed any deduction since its net result is a loss. At page 530 in para 11 the court has also held that provisions of section 80AB are applicable to section 80HHC. The Court further held :

"Section 80 AB makes it clear that the computation of income has to be in accordance with the provisions of the Act. If the income has to be computed in accordance with the provisions of the Act, then not only profits but also a loses have to be taken into consideration."

Reading the above makes it clear that losses cannot be ignored. The Hon'ble Court has reiterated these views at page 531.

"If after such adjustments there is a profit the assessee would be entitled to deduction under 80 HHC (1) if there is loss he will not be entitled to any deduction."

Following respectfully the views expressed and law laid down by apex court the conclusion would be that if there is a loss in main section then no deduction would be available to the assessee and the question of applicability of proviso would not come into play in such cases.

7. We are again fortified in our views by reading form middle of paragraph F to G at page 531 where the Hon'ble Court has held as under:-

"For purposes of such computation both profits and losses have to be taken into account. Thus the word profit in section 80 HHC (3) will mean profits after taking into account losses if any. More importantly in our view the term profit in section 80 HHC both in sub section (1) and in sub section (3), means a positive profit worked out after taking into consideration loses if any. Thus the word "profit" has the same meaning in section 80 HHC sub section (1) and (3)".

17. We, thus, answer this question in favour of the assessee and against the Revenue. The appeal is partly allowed in the aforesaid terms.

No costs.

(A.K. SIKRI)
JUDGE

(SIDDHARTH MRIDUL)
JUDGE

October 30, 2009
nsk