

* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

+ **INCOME TAX APPEAL NO. 656/2011**

% **Reserved on: 20th January, 2012**
Date of Decision: 29th March, 2012

PINE PACKAGING PRIVATE LIMITED ...Appellant
Through Dr. Rakesh Gupta, Mr.
Ashwani Taneja & Ms. Rani Kiyala,
Advocates.

VERSUS

COMMISSIONER OF INCOME TAXRespondent
Through Mr. Anupam Tripathi, Sr.
Standing Counsel & Ms. Anusha
Singh, Advocate.

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE R.V. EASWAR

SANJIV KHANNA, J.:

Pine Packaging Private Limited has filed the present appeal impugning the order dated 14th January, 2011 passed by the Income Tax Appellate Tribunal (tribunal, for short) in ITA No. 4084/Del/2010. The appeal pertains to assessment year 2007-08. In the return of income, the assessee had shown turnover of Rs.9,81,75,513/- and net profit of Rs.86,95,402/-. After adjustment of brought forward unabsorbed depreciation of

Rs.45,24,020/-, the balance income was set off/reduced from the deduction claimed under Section 80 IC of the Income Tax Act, 1961 (Act, for short).

2. The dispute in the present appeal pertains to claim for deduction under Section 80 IC of the Act on Rs.1,05,09,877/- received as “standing charges” from Hindustan Lever Limited. The aforesaid amount was included by the assessee as a part of on the total receipts of Rs.9,81,75,513/- on which deduction under Section 80IC was permissible.

3. The Assessing Officer, CIT (Appeals) and the tribunal have concurrently held that standing charges do not qualify for deduction under Section 80 IC as the said payment was not income or profit/gain derived from manufacturing or production of articles and things but payment made on account of failure of Hindustan Lever Limited to place purchase orders for the minimum stipulated/agreed quantity. The standing charges, it has been held, therefore, constituted compensation for remaining idle or reimbursement of certain expenses for the said reason. It was not a part of the sale price.

4. The contention of the assessee is that the standing charges are nothing, but the sale consideration received from

Hindustan Lever Limited and therefore, are profits/income derived from manufacture or production of articles or things.

5. The core issue, which requires adjudication and decision is whether the standing charges payable to the assessee by Hindustan Lever Limited under the agreement dated 23rd June, 2004 qualify and can be treated as a sale consideration received for products manufactured/produced by the assessee and thus are eligible for deduction under Section 80 IC of the Act.

Accordingly, we frame the following substantial question of law:-

“Whether the standing charges payable under the agreement dated 23rd June, 2004 qualify and are eligible for deduction under Section 80 IC of the Income Tax Act, 1961?”

6. As we have with their consent heard the counsel for the parties, we proceed to decide the said question.

7. Section 80 IC of the Act reads as under:-

“80-IC. Special provisions in respect of certain undertakings or enterprises in certain special category States.—(1) Where the gross total income of an assessee includes any profits and gains derived by an undertaking or an enterprise from any business referred to in sub-section (2), there shall, in accordance with and subject to the provisions of this section, be allowed, in computing the total income of the assessee, a deduction from such profits and gains, as specified in sub-section (3).

(2) This section applies to any undertaking or enterprise,—

(a) which has begun or begins to manufacture or produce any article or thing, not being any article or thing specified in the Thirteenth Schedule, or which manufactures or produces any article or thing, not being any article or thing specified in the Thirteenth Schedule and undertakes substantial expansion during the period beginning—

(i) on the 23rd day of December, 2002 and ending before the 1st day of April, 2012, in any Export Processing Zone or Integrated Infrastructure Development Centre or Industrial Growth Centre or Industrial Estate or Industrial Park or Software Technology Park or Industrial Area or Theme Park, as notified by the Board in accordance with the scheme framed and notified by the Central Government in this regard, in the State of Sikkim ; or

(ii) on the 7th day of January, 2003 and ending before the 1st day of April, 2012, in any Export Processing Zone or Integrated Infrastructure Development Centre or Industrial Growth Centre or Industrial Estate or Industrial Park or Software Technology Park or Industrial Area or Theme Park, as notified by the Board in accordance with the scheme framed and notified by the Central Government in this regard, in the State of Himachal Pradesh or the State of Uttaranchal ; or

(iii) on the 24th day of December, 1997 and ending before the 1st day of April, 2007, in any Export Processing Zone or Integrated Infrastructure Development Centre or Industrial Growth Centre or Industrial Estate

or Industrial Park or Software Technology Park or Industrial Area or Theme Park, as notified by the Board in accordance with the scheme framed and notified by the Central Government in this regard, in any of the North-Eastern States ;

(b) which has begun or begins to manufacture or produce any article or thing, specified in the Fourteenth Schedule or commences any operation specified in that Schedule, or which manufactures or produces any article or thing, specified in the Fourteenth Schedule or commences any operation specified in that Schedule and undertakes substantial expansion during the period beginning—

(i) on the 23rd day of December, 2002 and ending before the 1st day of April, 2012, in the State of Sikkim ; or

(ii) on the 7th day of January, 2003 and ending before the 1st day of April, 2012, in the State of Himachal Pradesh or the State of Uttaranchal ; or

(iii) on the 24th day of December, 1997 and ending before the 1st day of April, 2007, in any of the North-Eastern States.

(3) The deduction referred to in sub-section (1) shall be—

(i) in the case of any undertaking or enterprise referred to in sub-clauses (i) and (iii) of clause (a) or sub-clauses (i) and (iii) of clause (b), of sub-section (2), one hundred per cent. of such profits and gains for ten assessment years commencing with the initial assessment year ;

(ii) in the case of any undertaking or enterprise referred to in sub-clause (ii) of clause (a) or sub-clause (ii) of clause (b), of sub-section (2), one hundred per cent. of such profits and gains for five assessment years commencing with the initial assessment year and thereafter, twenty-five per cent. (or thirty per cent. where the assessee is a company) of the profits and gains.

(4) This section applies to any undertaking or enterprise which fulfils all the following conditions, namely :—

(i) it is not formed by splitting up, or the reconstruction, of a business already in existence :

Provided that this condition shall not apply in respect of an undertaking which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such undertaking as is referred to in section 33B, in the circumstances and within the period specified in that section ;

(ii) it is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

Explanation.—The provisions of Explanations 1 and 2 to sub-section (3) of section 80-IA shall apply for the purposes of clause (ii) of this sub-section as they apply for the purposes of clause (ii) of that sub-section.

(5) Notwithstanding anything contained in any other provision of this Act, in computing the total income of the assessee, no deduction shall be allowed under any other

section contained in Chapter VIA or in section 10A or section 10B, in relation to the profits and gains of the undertaking or enterprise.

(6) Notwithstanding anything contained in this Act, no deduction shall be allowed to any undertaking or enterprise under this section, where the total period of deduction inclusive of the period of deduction under this section, or under the second proviso to sub-section (4) of section 80-IB or under section 10C, as the case may be, exceeds ten assessment years.

(7) The provisions contained in sub-section (5) and sub-sections (7) to (12) of section 80-IA shall, so far as may be, apply to the eligible undertaking or enterprise under this section.

(8) For the purposes of this section,—

(i) “Industrial Area” means such areas, which the Board, may, by notification in the Official Gazette, specify in accordance with the scheme framed and notified by the Central Government ;

(ii) “Industrial Estate” means such estates, which the Board, may, by notification in the Official Gazette, specify in accordance with the scheme framed and notified by the Central Government ;

(iii) “Industrial Growth Centre” means such centres, which the Board, may, by notification in the Official Gazette, specify in accordance with the scheme framed and notified by the Central Government ;

(iv) “Industrial Park” means such parks, which the Board, may, by notification in the

Official Gazette, specify in accordance with the scheme framed and notified by the Central Government ;

(v) “Initial assessment year” means the assessment year relevant to the previous year in which the undertaking or the enterprise begins to manufacture or produce articles or things, or commences operation or completes substantial expansion ;

(vi) “Integrated Infrastructure Development Centre” means such centres, which the Board, may, by notification in the Official Gazette, specify in accordance with the scheme framed and notified by the Central Government ;

(vii) “North-Eastern States” means the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland and Tripura ;

(viii) “Software Technology Park” means any park set up in accordance with the Software Technology Park scheme notified by the Government of India in the Ministry of Commerce and Industry ;

(ix) “Substantial expansion” means increase in the investment in the plant and machinery by at least fifty per cent. of the book value of plant and machinery (before taking depreciation in any year), as on the first day of the previous year in which the substantial expansion is undertaken ;

(x) “Theme Park” means such parks, which the Board, may, by notification in the Official Gazette, specify in accordance with the scheme framed and notified by the Central Government.”

8. It is not disputed that for income to qualify for deduction under the said Section, the profit/income earned should be derived from business of manufacture or production of article or thing, which is eligible for deduction.

9. The expression “derived from” in taxation laws means something which has direct or immediate nexus with the specified activity, which in the present case means manufacture or production of article or thing. Manufacture or production of article or thing should be the direct and proximate cause of the said receipt and not the indirect causation and reason for the said income. Mere second/third connection is not sufficient; the manufacture/production should be the *causa causaus*. The expression “derived from” is a narrower expression than the words “attributable to” which includes direct as well as indirect receipts which may not have immediate or direct nexus with the specified activity. In the present case, in view of words “derived from”, we have to look at the immediate source which has generated or resulted in the said receipt/income. The immediate source will be the first degree source and not the second or the third degree source, which is a step removed from the specified activity (see ***Pandian Chemicals versus CIT***, (2003) 262 ITR

278 (SC) and *Liberty India versus CIT*, (2009) 317 ITR 218 (SC).

10. In view of the said legal position, we turn to and examine the terms and conditions of the agreement dated 23rd June, 2004 to decipher whether the standing charges payable under the said agreement had the first degree and direct nexus as receipts/income earned from manufacture or production of articles and things as specified. The relevant clauses of the agreement, relied before us, read as under:-

“5. PRICE

1. The Purchase Price of the Products manufactured and/or processed and packed and sold under the Contract shall be agreed upon from time to time on the basis of the costing terms specified in Annexure “3” to this Agreement.
2. The Company or its nominated appointees shall be allowed an interest free credit period of 15 days from the date of its supply.
3. In the event that the Company or its nominated associates does not provide firm plans and/or the Purchase Order (s) for the Normative production possible as defined in Annexure “2”, the company shall pay to the Seller standing charges calculated, subject to some limits and covenants, as given in Annexure “3”. Once a quarter, both the parties shall agree on a cumulative basis (since the beginning of the year) the extent of shortfall in demand from the Seller or its nominated associates after netting off any

quantity that the Seller has not been able to supply.

4. In the event the actual production exceeds Normative Production possible as defined in Annexure “2”, conversion cost payable to the Seller shall stand reduced as enunciated in Annexure “3”.

11. Annexure 2 to the said agreement gives list of products along with the quantitative details and stipulates the minimum quantity, which should be purchased. It is stated that the products and their quantity can be changed, added or deleted later on depending upon the market situation. Annexure 2 then records the standard capacity of the specified machines installed by the assessee for the time being. Clause 3 of Annexure 2 computes and states the normative production possible, which is calculated on the basis of 22 hours and with reference to 315 days in a year. For the sake of completeness, clauses 2 to 4 of the Annexure 2 are reproduced below:-

“2) Standard Capacity of the Machine for the time being.

1 Blow Moulding Machine (Techne), 4 Blow Moulding Machine (KW) & 2 Injection Moulding Machines

3) Normative Production Possible:

Number of Hours = 22

Number of days = 315

Output from a machine based on cavitation & cycle time of mould assigned respectively to each machine.

Normative Production = (3600/Cycle Time)

*No of Cavities * No of Hours * No of days

4) For the above capacity of machines, the tentative project cost is about Rs.1050 million. The agreement is for 75 million pieces per annum. The nos. may change later on, with mutual consent, depending upon the actual no. of machines.

Note: Standard capacity and normative production possible would change for each type of machines.”

12. The relevant portion of Annexure 3 reads as under:-

“Estimation of Selling Price: The key features of the pricing of PRODUCT are enunciated as given below. For other elements of costing, the Company and the Seller shall refer to the Cost Model attached with this letter. Where the features are specifically elaborated below the basis shall be as per this.

1. Raw material prices of polymers of different grades will be taken as per the Price List prevailing on 7th of the previous month. In the event of any upward or downward revision in cost, price shall be adjusted appropriately, as per the Cost Model. The Company shall guide the Seller on the rates.
2. Wastage will be considered based on the specification of each product and on the configuration of the mould as well as further discussions between the parties. The losses include any recycling wastage of the plastic runner generated from each mould, which

would be specified in the specifications given by the Company.

3. Conversion cost includes depreciation, interest on term loans, profits, power cost, labour cost & overheads etc. and is agreed mutually between the Company & the Seller as conversion cost per day for each Machine.
4. Debt to Equity Ratio is taken at 67:33. On debt, actual rate of interest rate will be given and on equity, 18% Return on Equity will be given.
5. Plant and Machinery- Basis of working out Net Book Value
6. Power Norms for each machine will be specified after detailed study.
7. Labour cost is Rs.2964/- per machine per day. This has been estimated and will be firmed in the first 6 months when all the required machines are installed in the first phase.
8. Overheads will be as follows:

Repairs & Maintenance	2% of GBV
General Overheads	2% of GBV
Insurance	1% of GBV
9. Working Capital Charge will be @ 12% for 60 days (30 days on account of RM, 15 days on account of PG & 15 days on account of Debtors) and will be reviewed from time to time based on current market rates. Where by changing the Bankers it is possible to bring down this interest rate and the Seller is unwilling to do so, the Product pricing will be based on such different interest rate even though the Seller is unwilling to change the Bankers.

10. The final conversion charge shall be re-determined based on discussions related to financing cost of equipment, power costs, actual capital cost based on speed of the machine, import duties, etc. It will be done as soon as the installation of the machine is complete. Conversion cost shall be based on actual interest rate and will reduce each year since the Principal amount of loan should be repaid using the depreciation amounts in part (If the Seller does not pay back for any reason, the Principal amount shall be assumed to have been repaid). Conversion cost also includes Power cost, which will be firmed up in the first 6 months when all the required machines are installed in the first phase. Equity shall be re-determined every year based on Net Book Value minus Outstanding Loan (or Normative Outstanding Loan based on 5 years repayment basis for the loans). However, the Equity shall be at the minimum equal to initial Equity brought in by the Seller and shall remain at that level so long as the Asset continues in service either within 0 years or after that and where only a part of the asset is in service, a proportionate amount out of initial Equity to the extent of asset in service alone shall be considered. The IOE will be calculated based on average of opening Equity and Closing Equity.
11. Conversion and cost shall undergo change based on need subject to the mutual satisfaction of both the parties.

12. Standing Charges:

Standing Charges shall be equal to Salaries and Wages, Depreciation, Interest on Term Loans, 50% of Return, on Equity, Fixed

Portions of Repairs and Maintenance, Insurance, Rent if any.

- 13.** Where the Actual Production exceeds Normative Production, the conversion cost shall be rewarded as if on the excess production only 40% of Fixed Charges shall be considered. The fixed charges are the same as defined in Standing Charges in Clause 12 above. The Fixed Charges are the same as defined in Standing Charges in Clause 12 above but the Return of Equity will be considered as 100% instead of 50%. For example: (The numbers presented below are only an example to demonstrate the principle)

Machine Cost per day	Rs.100
Equity	Rs.40
Standing Charges	Rs.25
Charges	Rs.35

Idle Time, total standing charges of RS.45 (50% of ROE+100% of Other charges) will be paid.

But if the production exceeds Normative for that excess production, total charges will be 40% of Rs.65 (100% of ROE & Other Standing Charges)+Variable Charges. So the total charges for that extra production will be @ 61 per day.”

13. Annexure 3 prescribes the costing schedule and estimates the selling price, with reference to raw material, wastage, conversion cost, debt to equity ratio, plant and machinery, power norms, labour cost, over heads etc. It is on the basis of these clauses 1 to 11 that the assessee receives payment/cost on the supply/sale of products. There is no dispute that the price of the

products supplied was calculated on the basis of clauses 1 to 11.

14. Clause 12 onwards of Annexure 3 to the agreement deal with the standing charges. Standing Charges are payable where the Hindustan Lever Limited does not place orders for the minimum quantity as stipulated, i.e., the normative production possible. Standing charges are also payable where actual production exceeds the normative production possible and in such an event the standing charges are payable as enunciated in clause 13 of the Annexure 3 to the agreement, but this did not happen in the present case.

15. In the present case, the standing charges were payable because Hindustan Lever Limited did not place purchase orders for the normative production possible. In other words, the assessee was not given purchase orders equal to the normative production possible. The assessee, therefore, did not produce or manufacture the products because of lack of orders or failure of Hindustan Lever Limited to place purchase orders for the possible normative production. Payment has been made for non-production and not because of unsold production, and therefore the failure to buy. In these circumstances, it is not possible to accept the contention of the assessee that the

standing charges have been paid are towards the cost price of the products purchased by Hindustan Lever Limited from the assessee. It is not a part of the purchase/sale price. The standing charges, which have been paid are not towards the sale price but on account of the fact that Hindustan Lever Limited did not place the prescribed or the stipulated purchase orders for supply of products/articles. This had resulted in non-production and the charges which have been paid were to compensate the assessee for failure to produce and then market its products. This becomes clear when we examine Annexure 3 to the agreement.

16. The aforesaid formula for computation of sale price stipulates that the cost or the selling price was computed under clauses 1 to 11. However, as Hindustan Lever Limited was unable to place purchase orders in respect of the normative fixed stipulated number, they were liable to pay and have paid the standing charges. These are not charges payable for the supplies made or towards price of the products sold but for non/under utilization or idle plant/machinery etc. due to lack of orders. The payment was for non-production/ manufacture.

17. The products or the articles supplied are goods. Excise duty, if not exempt, is payable in many cases on ad valorem basis. Similarly, sales tax, if not exempt, is also payable. The

standing charges obviously do not form part of the supply made and are not treated as sale consideration or the price of the goods on which excise duty or the sales tax etc. would be or is payable. Keeping in view the nature and character of the standing charges, evidence and finding regarding nature and character of the manufacturing activity undertaken, it cannot be said that the said charges were paid for or towards sale consideration of the goods supplied. This is not a case where goods were produced but not purchased or supplied etc. The factual matrix as found does not support the claim of the appellant under Section 80IC of the Act. We add by way of caveat that in a given case, and depending upon the factual matrix/ evidence, charges similar to standing charges may represent cost/sale price or price for failure to purchase produced/ manufactured goods.

18. Learned counsel for the petitioner had submitted that this Court in ***CIT versus Sportking India Limited***, (2010) 324 ITR 283 (Del.) has held that payments received from insurance company was compensation for the goods destroyed by fire and therefore, is income derived from an industrial undertaking. The facts and ratio is different as the goods were manufactured and later on were destroyed in fire. The insurance company had

made payment for the goods produced. Similarly, in ***CIT versus Dharam Pal Prem Chand Ltd.***, (2009) 317 ITR 353 (Del.) it has been held that keeping in view the factual matrix, refund of excise duty paid was income derived from by an industrial undertaking. The factual matrix and the nature and character of payment, i.e., refund of excise duty in the said case was different. Excise duty may be a part of sale price or the sale consideration received, especially when the tax burden is not passed on and payment is made out of the sale proceeds. In the present case, on interpretation of the agreement, it is clear that the standing charges were paid to the assessee were not towards the cost price or the sale price of the products. Standing charges were payments made for non-utilization of the machinery etc., which remained idle and was not operated upto the normative production levels as stipulated in the agreement. Similar decision of the Guwahati High Court in ***Commissioner of Income Tax versus Meghalya Steels Ltd.*** in ITA No. 6/2010 dated 19.09.2010 relates to refund of excise duty, which was required to be first paid and then refunded. The assessee claimed refund on completion of formalities because the exemption notification had stipulated that the excise duty should be first paid by the manufacturer and then the refund could be

claimed. In ***Commissioner of Income Tax versus Arvind Construction Co. Ltd.*** [2009] 317 ITR 276 (Del), the assessee had carried out construction work as a sub-contractor in Iraq. Consequent upon an agreement between the Governments of India and Iraq after the outbreak of war, bonds were issued as consideration for the construction work. Principal amount/interest income of the bonds were treated as income derived from business of an industrial undertaking under Section 80HHB of the Act. The said decision is based on peculiar facts and is hardly relevant to the factual matrix in question. Income paid on late payment received from customers has been considered as profit and gains derived by an industrial development undertaking as it partakes and is sale consideration. In ***Commissioner of Income Tax versus Vidyut Corporation*** [2010] 324 ITR 221 (Bom.), the assessee had discounted the promissory note drawn by the purchaser with its bankers. The discount charges deducted by the banks were subsequently reimbursed to the assessee by the purchasers. Therefore, the reimbursed discounted charges, it was held, were a component of the sale price. It was nothing but interest paid towards delayed payment of the sale price of the goods. The bill discounting charges were, therefore, treated as an eligible

deduction under Section 80-IB of the Act as profits and gains derived from an industrial undertaking.

19. In view of the aforesaid discussion, the question of law accordingly has to be answered in affirmative, i.e., against the assessee and in favour of the Revenue. The appeal is accordingly dismissed. There will be no order as to costs.

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(SANJIV KHANNA)
JUDGE

-sd-
(R.V. EASWAR)
JUDGE

MARCH 29, 2012
VKR