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Court : Income Tax Appellate Tribunal ITAT Mumbai

Decided On : May-29-2006

Judge : K Boliya, P M Devi

Appellant : Float Glass India Ltd.

Respondent : Joint Cit

Judgement :

1. This appeal has been filed by the assessee against the order dated 18-12-1998 of Commissioner (Appeals)-XLVII, Mumbai. The first ground of appeal pertains to confirmation by the learned Commissioner (Appeals) of the assessing officer's finding that expenditure of Rs. 6,28,588 cannot be added to the actual cost of the project for the purposes of allowing depreciation under Section 32 of the Income Tax Act.

2. The facts are that the assessee company, during the year, was in the process of setting up the project for manufacture of glass. The assessee company commenced trial production on 27-11-1994 and commercial production on 24-3-1995. The accounting year for the present assessment year ended on 31-3-1995. The assessee claimed before the assessing officer that all expenditures incurred by the assessee prior to commencement of business were for the purpose of bringing into existence the various assets and put them in working condition. It was claimed that all such expenses have to be capitalized and added to the cost of the assets for the purpose of allowing depreciation. The assessing officer accepted this claim in principle, but, held that the following expenses are not

related to bringing into existence the new assets: He, therefore, disallowed the claim to the extent of the above expenses totalling to Rs. 6,28,588. The learned Commissioner (Appeals) upheld the finding of the assessing officer for similar reasons.

3. The learned counsel appearing before us on behalf of the assessee company contended that all the expenses have a direct nexus with the setting up of the new project and the same have been incurred by the assessee only for the purpose of bringing into existence the assets, prior to commencement of the business. It is submitted that the project was being set up near Panvel and the employees associated with the construction of the project and various other technical personnel had to go to Panvel for supervising the setting up of the project. For this purpose, the guest-house was maintained and other expenses had to be incurred. The learned counsel relied on the Supreme Court decision in the case of *Challapari Sugars Ltd. v. CIT* and invited our attention to the ratio of this case, relevant part of which is reproduced below from the headnote Interest paid before the commencement of production on amounts borrowed by the assessee for the acquisition and installation of plant and machinery forms part of the 'actual cost' of the assets to the assessee within the meaning of the expression in Section 10(5) of the Indian Income Tax Act, 1922, and the assessee will be entitled to depreciation allowances and development rebate with reference to such interest also.

As the expression 'actual cost' has not been defined, it should be construed in the sense which no commercial man would misunderstand.

For this purpose, it would be necessary to ascertain the connotation of the expression in accordance with the normal rules of accountancy prevailing in commerce and industry. The accepted accountancy rule for determining cost of fixed assets is to include all expenditures necessary to bring such assets into existence and to put them in working condition. In case money is borrowed by a newly started company which is in the process of constructing and erecting its plant, the interest incurred before the commencement of production on such borrowed money can be capitalized and added to the cost of the fixed assets

created as a result of such expenditure.

The learned counsel emphasized that as held by the Supreme Court, the expression 'actual cost' has to be understood as per the established rules of accountancy. The learned counsel invited our attention to Accounting Standard 10. Para 9.3 of this accounting standard reads as under : Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.

The learned counsel argued that in the present case, the entire expenditure was incurred at the site and is entirely referable to the setting up of the project. It is contended that there is no basis for the assumption of the revenue authorities that these expenses have no relation with the setting up of the project.

4. The learned CIT-departmental Representative supported the orders of the revenue authorities and contended that the expenses are in the nature of personal expenses and cannot be said to have been incurred for setting up of the project. It is also submitted that entertainment expenses and guest-house expenses are otherwise not allowable under the Income Tax Act.

5. We have given a careful consideration to the rival submissions and have gone through the facts. Insofar as the expenditure on gifts is concerned, we are of the view that this expenditure cannot be said to have been incurred for bringing into existence any assets. However, with regard to entertainment expenses and guest-house expenses, apparently these expenses have been incurred during the course of setting up of the new project and these expenses have a direct nexus with setting up of the new project. By virtue of some other provisions of the Income Tax Act, certain expenses may be disallowable or partly disallowable, but, for the purpose of determining the 'actual cost' of the assets under Section 43(I) of the Income Tax Act, the entire expenditure which is incurred for the purpose of bringing into existence the relevant assets and putting such assets into working

condition, has to be capitalized and added to the cost of the project.

The learned counsel for the assessee has also invited our attention to (1983) 140 ITR (St.) 1, relevant part of which is reproduced below : 17-11-1982 : Their Lordships Fazal Ali and Vohra, JJ dismissed a Special Leave Petition by the department against an order of the Bombay High court dated 12-2-1978 in ITA No. 189 of 1978 refusing to direct the Tribunal to refer the question whether, where the assessee agreed to pay, in addition to the price, a sum imposed as penalty by the customs authorities on the importer for failure to have the item covered by import licence, the assessee was entitled to include this amount of penalty in the actual cost of the machinery for the purposes of allowing depreciation and development rebate. From the above, it may be seen that the Bombay High Court, in the above case, upheld the finding of the Tribunal that even penalty levied by the customs authorities has to be added to the actual cost of machinery for the purpose of allowing depreciation and development rebate. In the case of Challapalli Sugars Ltd. (supra), the Supreme Court held that the expression 'actual cost' should be construed in the sense which no commercial man would misunderstand. All expenses necessary to bring the assets into existence and to put them in working condition have to be added to 'actual cost'. We, therefore, direct the assessing officer to allow capitalization of entertainment expenses of Rs. 5,09,734 and guest-house expenses of Rs. 15,439.

6. The ground No.2 pertains to confirmation by the learned Commissioner (Appeals) of an addition of Rs. 46,05,942 made by the assessing officer by treating the aforesaid receipts as revenue income and not allowing deduction of such income from the cost of the project. The facts are that the aforesaid receipts arose from sale of unusable materials, wooden drums, packing material, etc. The assessee claimed before the assessing officer that all such materials and equipments were acquired by the assessee in connection with the setting up of the new project and as and when such equipments become unusable, the same are sold away as scrap. The expenditure incurred on acquisition of such materials is added to the cost of the project prior to commencement of production and the receipts realized on sale of non-useful materials are deducted from the cost of the project. The assessing officer rejected the assessee's claim and held that the

receipt of Rs. 46,05,942 was chargeable to tax as revenue receipts as held by the Supreme Court in the case of Tuticorin Alkali Chemicals & Fertilizers Ltd. v. CIT . The learned Commissioner (Appeals) upheld the 7. The learned counsel appearing for the assessee submitted that the receipts have a direct nexus with the setting up of the project and therefore the same must be deducted from the cost of the project and cannot be independently brought to the charge of tax. He relied on the Supreme Court decision in the case of CIT v. Bokaro Steel Ltd. . The learned CIT-departmental Representative 8. We have considered the rival submissions vis-a-vis the facts of the case. Admittedly, the expenditure incurred on acquisition of the relevant equipments and materials is added to the cost of the project.

Thus, this expenditure goes to enhance the cost of the assets for the purposes of allowing depreciation. Once the equipment/material can no more be used, the same are sold and the assessee realizes income by such sales. In our view, once the cost of the equipment is added to the cost of the project, the sale proceeds realized from disposal of such material must be reduced from the cost of the project. The Supreme Court decision in the case of Bokaro Steel Ltd. (supra) supports this view. The relevant part of the ratio of this decision may be reproduced below from the headnote : Held, dismissing the appeal, that the first three heads of income were (i) the rent charged by the assessee to its contractors for housing workers and staff employed by the contractors for the construction work of the assessee including certain amenities granted to the staff by the assessee, (ii) hire charges for plant and machinery which were given to the contractors by the assessee for use in the construction work of the assessee, and (iii) interest from advances made to the contractors by the assessee for the purpose of facilitating the work of construction. The activities of the assessee in connection with all these three receipts were directly connected with or incidental to the work of construction of its plant undertaken by the assessee. The advances which the assessee made to the contractors to facilitate the construction activity of putting together a very large project was as much to ensure that the work of the contractors proceeded without any financial hitch as to help the contractors. The arrangements which were made between the assessee company and the contractors pertaining to these three receipts were arrangements which were

intrinsically connected with the construction of its steel plant.

The receipts had been adjusted against the charges payable to the contractors and had gone to reduce the cost of construction. They had, therefore, been rightly held as capital receipts and not income of the assessee from any independent source.

Considering the entire facts and legal position, we reverse the order of the learned Commissioner (Appeals) on this issue and direct the assessing officer to exclude the aforesaid sum from the total income of the assessee and reduce it from the cost of the project.

9. The ground No. 3 pertains to disallowance of depreciation of Rs. 18,98,300. The facts are that the assessing officer disallowed assessee's claim for depreciation to the extent of Rs. 18,98,300 solely on the ground that the aforesaid depreciation was disallowed while processing the return of income under Section 143(1)(a) of the Income Tax Act. Since no other reasons were mentioned by the assessing officer, when the matter came up before the learned Commissioner (Appeals), he called for remand report and the assessing officer submitted his remand report vide letter dated 9-12-1998. The assessing officer stated that the assets were put to use in the accounting year for a period of less than six months and therefore depreciation was allowable at 50 per cent of the normal rate. The assessing officer informed that in respect of plant and machinery, the assessee claimed depreciation correctly at 50 per cent of the prescribed rate. However, in respect of certain items like furniture, equipments and building, the assessee claimed full depreciation on the ground that even prior to commencement of business, these assets were used for the business purposes. The assessing officer stated in the remand report that the business was commenced in March, 1995, and therefore depreciation was allowable only at 50 per cent of the normal rate. The learned Commissioner (Appeals) agreed with the assessing officer's view. He has also observed that on the similar issue, the assessee's appeal against the adjustment made under Section 143(1)(a) was dismissed by the Commissioner (Appeals). The disallowance was, therefore, confirmed.

10. The learned counsel appearing for the assessee forcefully argued before us that if the assets have been used for business purposes prior to commencement of the business, depreciation has to be allowed at the full rates. He invited our attention to the second proviso under Section 32, which reads as under Provided also that where an asset being commercial vehicle is acquired by the assessee on or after the 1-10-1998, but before the 1-4-1999, and is put to use before the 1-4-1999, for the purposes of business or profession, the deduction in respect of such asset shall be allowed on such percentage on the written down value thereof as may be prescribed.

The learned counsel contended that the relevant assets on which full depreciation has been claimed have been used for the purposes of assessee's business for a period of more than six months and therefore full depreciation is allowable.

11. The learned CIT Departmental Representative contended that admittedly the commercial production was started on 24-3-1995 and the trial production was started on 27-11-1994. Thus, during the year, the assessee carried on business activity for a period of less than six months. It is submitted that in these circumstances, it cannot be said that the assets were used for the entire year for the purposes of business of the assessee.

12. We have considered the rival submissions and have gone through the facts as also the legal position. Under Section 32, depreciation is allowable while computing the income under the head profits and gains of business or profession. Section 32 lays down that depreciation shall be allowable in respect of assets used for the purpose of the business or profession. In our view, if the business itself has not commenced, it cannot be said that any assets have been used for the purpose of business. The intention and the object of Section 32 is to allow deduction from the income earned by the assessee from the exercise of business or profession. It is true that in the present case, some of the assets might have been used by the assessee for the purpose of setting up of the new project. In our view, the user of the assets for business, for the purposes of Section 32, will start only after the business is commenced. The learned counsel for the assessee has relied on the Bombay High Court decision in the case of Bralco Metal Industries

(P) Ltd. v. CIT , for the proposition that the expression 'for the purposes of the business' is wider in scope than the expression 'for the purpose of earning profits'. It is submitted that even before the assessee started earning profit, the assets can be used for business purposes. In our view, the Bombay High Court decision cannot be applied to the facts of the assessee's case.

There is no dispute that the commercial production was commenced in the month of March, 1995. Therefore, the assessee has carried on business for a period of less than six months and it cannot be said that the assets were used for business purposes for the whole year. We, therefore, confirm the order of the learned Commissioner (Appeals) on this issue.

13. The ground No. 4 pertains to disallowance of depreciation of Rs. 6,45,90,327 made by the assessing officer and confirmed by the learned Commissioner (Appeals). The assessing officer made the aforesaid disallowance with the following discussion at para 13 of his order : As per the chart of depreciation filed with the return, it is seen that the assessee has claimed depreciation for the full period amounting to Rs. 12,91,80,655. The excess depreciation claimed by the assessee as per the prescribed rules has already been disallowed. Considering that the production has commenced in the later half of the year that too is in the month of March, therefore, as per proviso to Section 32(I), the entitlement of the assessee is only to the extent of 50 per cent of the amount i.e. Rs. 6,45,90,327 only.

The learned Commissioner (Appeals) confirmed the assessing officer's finding.

14. The learned counsel appearing for the assessee submitted before us that the disallowance has been made on incorrect assumption. It is submitted that the assessee itself claimed depreciation at only 50 per cent of the normal rate and therefore there is no basis for the disallowance. It is argued that complete details were filed before the assessing officer as also before the learned Commissioner (Appeals), but these relevant details have been completely ignored. The learned counsel invited our attention to the details, which are compiled in the paper book at pp. 33 to 41. As per these details, it appears that the assessee claimed depreciation on plant and machinery @ 12.5 per cent as against the admissible

rate of 25 per cent. This shows that the assessee has claimed depreciation at 50 per cent of the normal rate, because plant and machinery was used for business purposes for a period of less than six months. We feel -that this issue has not been properly examined by the assessing officer with regard to the correct factual position. Therefore, this issue is restored back to the assessing officer for fresh consideration and is directed to allow adequate opportunity to the assessee to establish the correctness of the claim for depreciation. The issue shall be redecided accordingly.

15. The last ground of appeal pertains to rejection by the revenue authorities of the assessee's claim for capitalization of the sum of Rs. 97,39,722 being depreciation for the period prior to commencement of business. The assessee claimed that various assets were being used during the course of setting up of the project and such assets depreciated on account of such use. The assessee, therefore, suffered loss on account of diminution of the value of such assets and such loss has to be capitalized and added to the cost of the project. The revenue authorities rejected this claim on the ground that such notional loss cannot be added to the cost of the project for the purposes of allowing depreciation.

16. We have heard both the sides on this issue and have gone through the facts. In our view, the claim made by the assessee company is not acceptable. The assessee acquired assets during the setting up of the project and such assets might have been used by the assessee for the purposes of setting up of the project. Once the business commences and such assets continue to be used for business purposes, the assessee will be entitled to depreciation on the actual cost of the assets. Such actual cost of the assets cannot be increased by adding thereto any notional depreciation. It may be mentioned that if any asset depreciates in value on account of its use and if such asset is sold by the assessee before commencement of the business, the loss arising to the assessee shall be added to the cost of the project. Therefore, the assessee will not suffer on account of such depreciation invalid of the asset. In our view, no such notional depreciation can be added to the actual cost of the assets. Therefore, we confirm the order of the learned Commissioner (Appeals) on this issue.