Receipts with no nexus to exports have to be excluded for s. 80HHC deduction

CIT vs. Dresser Rand India (Bombay High Court)

Explanation (baa) to s. 80HHC defines the term "profits of the business" to mean business profits as reduced by 90% of.. "receipts by way of brokerage, commission, interest, rent, charges or any other receipt of a similar nature". The Tribunal took the view, on the basis of **Bangalore Clothing** 260 ITR 371 (Bom) that receipts towards recovery of freight, insurance, packing receipts, sales tax set off/refund and service income were "**operational income**" and not liable to be excluded under Expl (baa) to s. 80HHC. On appeal by the Revenue, HELD reversing the Tribunal:

(i) The ratio of **Ravindranathan Nair** 295 ITR 228 (SC) is that Explanation (baa) to s. 80HHC required **receipts constituting independent income having no nexus with exports to be reduced from business profits under clause (baa) so as to avoid distortion in the computation of export profits**;

(ii) In **Bangalore Clothing Co** 260 ITR 371 (Bom) it was held that If an item of income is closely linked with business operations and constitutes "operational income", it cannot be excluded under Explanation (baa) to s. 80HHC. **This proposition is inconsistent with the law in Ravindranathan Nair and is no longer good law**. The submission that **Bangalore Clothing** was impliedly approved in **Baby Marine Exports** 290 ITR 323 (SC) is **not acceptable** because that judgement turned on the fact that the export house premium was an integral part of the consideration for the sale realized by the assessee, a supporting manufacturer.

IN THE HIGH COURT OF JUDICATURE AT BOMBAY
O. O. C. J.
INCOME TAX APPEAL NO.2186 OF 2009
The Commissioner of Income Tax6
..Appellant.
Vs.
M/s. Dresser Rand India Pvt. Ltd. ..Respondent.

....

Mr. Suresh Kumar for the Appellant.
Mr. F. V. Irani with Mr. A.K. Jasani for the Respondent.

CORAM : DR. D.Y.CHANDRACHUD &
J.P. DEVADHAR, JJ.
8th April, 2010

ORAL JUDGMENT (PER DR.D.Y.CHANDRACHUD, J.):
1. Admit.

2. The Appeal arises out of an order of the Income Tax Appellate Tribunal dated 6th June, 2008 in relation to Assessment Year 2002-03. The question of law which has been formulated by the Revenue in this Appeal under Section 260A of the Income Tax Act, 1961 is as follows:

> "Whether on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that 90% of recovery of freight, insurance and packing receipts amounting to Rs.49,14,076/, sales tax set off/refund amounting to Rs.38,33,148/and service income of Rs. 2,89,17,545/are not to be excluded from profits of business within the meaning of clause (baa) of explanation to Section 80HHC of the Act for the purpose of computation
> of deduction u/s.80HHC of the Income Tax Act, 1961?"

3. The issue that has been the subject matter of submissions in this Appeal is whether 90% of the recovery of freight, insurance and packing receipts; sales tax set off/refund and service income are liable to be excluded from the profits of business in view of Explanation (baa) to Section 80HHC. Sub section (1) of Section 80HHC contemplates a deduction to an assessee being an Indian company or a person resident in India and engaged in the business of the export out of India of any goods or merchandise to which the Section applies. The deduction is to be allowed in computing the total income of the assessee to the extent of profits referred to in sub section (1B) derived by the assessee from the export of such goods or merchandise. Clause (a) of sub section (3) of Section 80HHC provides a formula for determining the profits derived from such export. Where the export out of India is of goods or merchandise manufactured or processed by the assessee, the profits derived from such export "shall be the amount which bears to the profits of the business", the same proportion as the export turnover in respect of such goods bears to the total turnover of the business carried on by the assessee. In other words, the proportion between the export turnover and the total turnover of the business is applied to the profits of the business, in order to determine the extent to which the profits are to be regarded as being derived from export. Explanation (baa) which was inserted by the Finance Act of 1991 defines the expression "profits of the business" as follows:

> "(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."

4. Profits of the business, as explanation (baa) would postulate have to be first computed under the head "Profits and gains of business or profession" under the provisions of Section 28 to 44D of the Income Tax Act, 1961. They have to be reduced by (i) ninety

percent of the incentive income 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 (ii) The profits of any branch, office, warehouse or any other establishment of the assessee situate outside India.

5. The Tribunal in the present case noted that the Commissioner of Income Tax (Appeals) followed the decision of this Court in the case of **Commissioner of Income Tax v. Bangalore Clothing Co.1**. The Tribunal was of the view that the Commissioner was correct in the view which was taken and accordingly held that 90% of the receipts on account of the recovery of freight, insurance and packing charges; sales tax refund and service income were liable to be excluded under Explanation (baa) to Section 80HHC.

6. The submission which has been urged on behalf of the Revenue is that the issue in the Appeal is covered by the judgment of the Supreme Court in **Commissioner of Income Tax v. K. Ravindranathan Nair2**. The Revenue submits on the basis of the decision in **Ravindranathan Nair** that independent incomes which are unrelated to the export activity are liable to be excluded in the computation of business profits by virtue of Explanation (baa) to Section 80HHC. The contention of the Revenue is that processing charges were specifically dealt with by the Supreme Court in its judgment and that consequently the view of the Tribunal is ex facie erroneous. Learned counsel submitted that the other items which are referred to in the question formulated would also be governed by the same principle and being independent incomes, unrelated to exports these would be liable to exclusion in accordance with Explanation (baa) to Section 80HHC.

7. On behalf of the assessee the contention of the Revenue that the issue would be covered by the decision in **Ravindranathan Nair** is seriously contested. Learned counsel urged that (i) If an item of income is closely linked with business operations, that is to say, it constitutes operational income, then it cannot be excluded under Explanation (baa) to Section 80HHC; (ii) The aforesaid proposition is directly supported by a decision of a Division Bench of this Court in **Bangalore Clothing** (supra) which must be treated as having been impliedly approved by the Supreme Court in **Commissioner of Income Tax v. Baby Marine Exports3**; (iii) The reliance placed by the Revenue on the decision in **Ravindranathan Nair**'s case on this issue is misplaced because the issue which arises in this Appeal was not in issue before the Supreme Court; (iv) If the contention of the department is accepted, that would render the formula prescribed by Section 80HHC (3) mathematically absurd.

8. The rival submissions would require the Court to determine in the first instance whether as contended by the Revenue the issue in appeal would be governed by the decision in **Ravindranathan Nair** or whether as urged on behalf of the assessee, the Supreme Court had no occasion to deal with the issue on the questions which arose in that case. In **Ravindranathan Nair**, the facts were that the assessee carried out processing of cashew nuts at its factory which were then exported. The assessee also processed cashew nuts for exports on a job work basis which were returned after processing. The assessee earned processing charges. Consequently, the assessee was both a job worker and an exporter. The assessee made a claim for export incentives under

Section 80HHC(3) for Assessment Year 199394 but did not include the receipts on account of processing charges in his total turnover. The business proceeds of Rs.1.94 Crores included receipts towards processing charges of Rs.1.54 Crores. These receipts for processing charges were not included by the assessee in the total turnover. The issue which arose before the Supreme Court was whether the Revenue was correct in including the processing charges amounting to Rs.1.54 Crores in the total turnover while arriving at export profits under Section 80HHC(3) as it stood at the material time. The Supreme Court held that the expression "derived from" in sub section (1) of Section 80HHC is narrowed than the words 'attributable to' and consequently it is only profits derived from exports which become the basis for working out the formula provided in sub section (3). The Supreme Court held that if the processing charges were a part of the gross total income, being profits from business, then they had to be included in the total turnover in the formula provided by sub section (3). The expression "included in such profits" indicated that the processing charges formed a part of the gross total income, being business profits. The contention of the assessee that the processing charges were liable to be excluded from the total turnover was rejected by the Supreme Court. The question as to whether the processing charges (i) constitute independent income like rent, commission and brokerage; and (ii) were liable to be excluded to the extent of 90% from the gross total income while arriving at business profits was dealt with in the following observations :

> "In our view, for the above reasons, the said processing charges, which was part of gross total income, was an independent income like rent, commission, brokerage etc., and, therefore, 90 per cent of the said sum had to be reduced from the gross total income to arrive at the business profits and since the said processing charge was an important component of business profits, it also had to be included in the total turnover in the said formula to arrive at the business profits in terms of clause (baa) to the said Explanation."

9. The Supreme Court emphasized that Explanation (baa) requires that "receipts constituting independent income having no nexus with exports were required to be reduced from business profits under clause (baa)". Consequently, receipts by way of brokerage, commission, interest, rent, charges etc., though they formed part of the gross total income, had to be excluded in order to avoid distortion in the computation of export profits. Explanation (baa) postulates that though incentive profits and "independent incomes" constituted part of the gross total income, they have to be excluded from the gross total income "because such receipts had no nexus with the export turnover"4. The following observations of the Supreme Court place the matter beyond doubt:

> "Therefore, in terms of clause (baa), 90 per cent. of the "independent income" had to be deducted from gross total income to arrive at the business profits to which the fraction
> had to be applied. Since, the processing charges constituted independent income similar to rent, commission, etc., which formed part of the gross total income, the same had to be reduced by 90 per cent. as contemplated

in clause (baa) to arrive at business profits. Therefore, the said processing charges were includible in the total turnover in the formula under section 80HHC(3) of the Income Tax Act."

10. These observations of the Supreme Court explain the ambit of the expression "any other receipt of a similar nature included in such profits" under clause (1) of Explanation (baa). The Supreme Court has held that "independent incomes" which do not bear any nexus with export are liable to be excluded to the extent of 90% as stipulated in the explanation. This is in order to avoid the distortion in the application of the formula.

11. Counsel appearing on behalf of the assessee urged that the question as to whether processing charges formed part of the business profits and if so, if 90% of such receipts are liable to be excluded under Explanation (baa) did not fall for determination before the Supreme Court. Learned counsel submitted that in that case the assessee had urged that the formula in Section 80HHC(3) should be read to exclude processing charges from the total turnover even though they constitute part of the business profits. On behalf of the Revenue it was urged that though the processing charges were includible in business profits, they were simultaneously includible in the total turnover. Hence, it was submitted that the question as to whether processing charges, formed part of the business profits and if so, whether they would be susceptible to a reduction of 90% did not fall for determination of the Supreme Court. We are unable to accept the submission. The question which was formulated in the appeal before the Supreme Court was whether the department was right in including the processing charges of Rs.1.54 Crores in the total turnover while arriving at export profits under Section 80HHC(3). As the Supreme Court noted, in construing the provisions of Section 80HHC, there are four variables which are required to be considered viz. business profits, export turnover, total turnover and 90% of the sums referred to in Explanation (baa)5. Consequently, the ambit of the controversy which was raised before the Supreme Court did as a matter of fact require a determination of the nature of the receipts of a similar nature which are liable to be excluded under Explanation (baa) though they constitute a part of the profits of business. The Supreme Court has in several observations more particularly those in paragraphs 20 and 23 which have been extracted earlier clearly held that processing charges which formed part of the gross total income constitute independent income like rent, commission and brokerage and that therefore 90% of the sum had to be reduced from the gross total income to arrive at business profits. Having said this, the Supreme Court held that processing charges were includible in the total turnover as well in the formula prescribed by sub section (3). Consequently, the principles laid down by the Supreme Court in **Ravindranathan Nair**'s case constitute the ratio of the judgment which would bind this Court.
5 paragraph 22 page 241.

12. On behalf of the assessee reliance was sought to be placed on a judgment of a Division Bench of this Court in **Bangalore Clothing** (supra). In that case, the assessee claimed a deduction under Section 80HHC. The Assessing Officer disallowed the claim

of deduction on the ground that the receipt of charges for the job work done by the assessee in India was not a part of the total turnover. The Commissioner of Income Tax (Appeals) held that the job work constituted a part of the business activity of the assessee which would entitle the assessee to deduction under Section 80HHC and that the Assessing Officer had erred in reducing 90% of the job work turnover from the profits of business. The Tribunal held that job work charges were not in the nature of brokerage, commission, rent or interest and that Explanation (baa) did not apply to such charges. The issue before this Court was whether job work receipts stood excluded from the profits of business under Explanation (baa) to Section 80HHC and whether the Tribunal was right in holding that 90% thereof ought not to have been excluded from business profits. The contention of the Revenue was that for the purpose of calculating the deduction under Section 80HHC only those items of income are to be taken into account as business profits which have relation to export activity and the job work receipts had no nexus with export activity. The Division Bench held that there was no merit in the submission of the Revenue. The Division Bench held that in every case the Assessing Officer would have to determine as to whether a receipt of interest, commission, labour charges etc. constitutes a part of operational income. The Court noted that though the receipt in question was called a labour charge, this nomenclature may not be accurate as the assessee was a manufacturer and exporter of garments. The Court noted that there was a finding of fact recorded by the Tribunal that there was no difference between the activities relating to export business carried out by the assessee and the process carried out for manufacturing garments for others under job work contracts. There was a finding of fact in the order of the Tribunal that there was an element of job work turnover and that the receipt of labour charges was not in the nature of brokerage, commission, rent, interest or charges as mentioned in Explanation (baa). The processing charges earned were by using the entire undertaking of the company which was manufacturing garments for domestic sales and export sales and the processing charges were earned by incurring expenditure which was debited to the profit and loss account. In these peculiar facts the Division Bench held that it did not wish to interfere with the finding of fact that was recorded by the Tribunal.

13. We have dealt with the observations of the Division Bench in **Bangalore Clothing** in a considerable degree of detail because reading the judgment, it is evident that the Court considered that to be a case where a finding of fact which was arrived at by the Tribunal should not be disturbed. Be that as it may, the decision of the Division Bench to the extent to which it lays down a proposition of law inconsistent with the subsequent judgment of the Supreme Court in **Ravindranathan Nair**'s case cannot be regarded as laying down a binding position in law. In Bangalore Clothing, the specific contention of the Revenue was that only those items of income which have relation to export activity are liable to be taken into account while computing business profits under Section 80HHC. The Division Bench did not find any merit in the argument advanced on behalf of the Revenue. In this background we must reiterate that in **Ravindranathan Nair**'s case the Supreme Court has now categorically held that independent incomes like rent, commission, brokerage etc., though they formed a part of the gross total income have to be reduced by 90% as contemplated in Explanation (baa) in order to arrive at business

profits. The rationale for this which is indicated in the judgment of the Supreme Court is that profit incentives and items which constitute independent incomes have no element of export turnover and are consequently liable to be excluded to the extent that is stipulated in Explanation (baa). The decision in **Bangalore Clothing**, to the extent to which it lays down a principle of law at variance with the subsequent judgment of the Supreme Court in **Ravindranathan Nair**'s case would not therefore hold the field after the judgment of the Supreme Court.

14. However, it was sought to be urged that the decision in **Bangalore Clothing** was cited before the Supreme Court in its decision in **Baby Marine Exports** (supra). The submission of the assessee is that the judgment in **Bangalore Clothing** must be regarded as being impliedly approved by the Supreme Court in **Baby Marine Exports**. The issue before the Supreme Court in **Baby Marine Exports** was whether an export house premium received by the assessee is includible in the profits of the business of the assessee while computing the deduction under Section 80HHC. The assessee was engaged in the business of selling marine products both in the domestic and international markets in pursuance of a contract which it had entered into with export houses. The assessee received the entire FOB value of the exports together with a payment which was described as an export house premium of 2.25 % of the FOB value. The Tribunal in that case held that the export house premium received by the assessee was includible in the profits of the business under Section 80HHC. The contention of the Revenue before the Supreme Court was that as a supporting manufacturer, the assessee was entitled to a deduction only on the sale price of its goods and the premium received could not be held to be derived from the business of export. Before the Supreme Court reliance was placed by the assessee on the judgment of the Division Bench of this Court in **Bangalore Clothing** (supra) in support of the submission that if a particular receipt is in the nature of an operational income, it must be included in business profit. The Supreme Court held that the assessee being a supporting manufacturer under Section 80HHC (1A) it was entitled to a deduction of the profit derived from the sale of goods or merchandise to an export house for the purposes of export. The assessee, as consideration for the sale of the goods to an export house, received the entire FOB value of the goods and an export house premium of 2.25 %. The Supreme Court noted in its following observations that as a matter of fact the premium was a part of the sale price realized by the assessee:

> "The Appellate Tribunal has arrived at the definite conclusion that the Export House premium is nothing but an integral part of sale price realised by the assessee – a supporting manufacturer from the Export House. The Tribunal further held that the Export House premium cannot possibly be considered to be either commission or brokerage, as a person cannot earn commission or brokerage for himself."

15. The Supreme Court affirmed the finding of the Tribunal that the export house premium was an integral part of the sale price realized by the assessee from the export house. The submission of the Revenue that the premium was totally unrelated to export was held tobe lacking in merit. The Supreme Court held that the submission was

contrary to the specific terms of the agreement entered into by the assessee. The export house premium, as held by the Supreme Court, could be included in the business profit "because it is an integral part of business operation of the respondent which consists of sale of goods by the respondent to the export house". The decision of the Supreme Court in **Baby Marine Exports** therefore rests on two foundations. Firstly, the Supreme Court affirmed the finding of fact of the Tribunal that the export house premium was an integral part of the consideration for the sale realized by the assessee, which was a supporting manufacturer for an export house. Secondly, the premium, as a matter of fact, was related to the export activity since it formed an integral part of the business of the assessee which consisted of the sale of goods to an export house. The Supreme Court has, as a matter of fact, in the course of the discussion not affirmed the judgment of this Court in **Bangalore Clothing**. The decision undoubtedly was cited on behalf of the assessee but that in itself is not a ground for this Court to hold that it was impliedly approved.

There is nothing in the judgment of the Supreme Court to suggest that the judgment in **Bangalore Clothing** was either expressly or impliedly approved. The submission which has been urged on behalf of the assessee cannot therefore be accepted. The ambit of Explanation (baa) has been considered by the judgment of the Supreme Court in **Ravindranathan Nair**'s case. The legislative policy underlying the provision is that items which are unrelatable to the export activity must be excluded in the computation of business profits in order to prevent a distortion in the computation of the deduction under Section 80HHC. What provision should be made consistent with the legislative policy underlying Section 80HHC is evidently a matter for Parliament to determine. The duty of the Court is to interpret the language of the provision. In the present case the interpretation of the provision by the Supreme Court is binding and has to be followed.

16. We may note at this stage that counsel appearing on behalf of the assessee has relied upon the decisions of the Supreme Court in **Goodyear India Ltd. v. State of Haryana6, Commissioner of Income Tax v. Sun Engineering Works Pvt. Ltd.7, Jayantibhai Manubhai Patel v. Arun Subodhbhai Mehta8, Union of India v. Dhanwanti Devi9** and **Municipal Corporation of Delhi v. Gurnam Kaur10**, in order to urge that a precedent is followed for what is actually decides and that a decision on a question which has not been argued cannot be treated as a precedent. The submission which was urged was that the observations of the Supreme Court in **Ravindranathan Nair**'s case on the issue as to whether independent incomes are liable to be reduced to the extent of 90% in the computation of business profits was not an issue which arose before the Court and those observations would not constitute the ratio of the judgment. As we have already indicated, the issue which was dealt with by the Supreme Court squarely arose for the decision in the case and the interpretation which has been rendered on the ambit of the provisions of Section 80HHC, including of Explanation (baa) arose for the decision and constitutes the ratio of the judgment.

17. During the course of the submissions, it is conceded by counsel for the assessee that the discussion in respect of the issue of processing charges as an independent income unrelated to export, would similarly apply to the other issues raised in the question of law

framed by the Revenue viz. in regard to recovery of freight, insurance and packing receipts, sales tax refund and service income. In the circumstances, the question of law shall stand answered in favour of the Revenue and against the assessee.

The Appeal is accordingly allowed.

In the circumstances of the case, there shall be no order as to costs.

(Dr. D.Y.Chandrachud, J.)

(J.P. Devadhar, J.)