Sec. 41(1) couldn't be invoked in respect of conversion of advance received from parent co. into capital

Summary – The High Court of Madras in a recent case of Transworld Garnet India (P.) Ltd., (the Assessee) held that where foreign parent company advanced funds to be adjusted against future sales as assessee was incurring losses and on conversion of advances so received into capital, credited same to reserves, section 41(1) would not be attracted since parent company had not written it off

Facts

- The assessee had been set up completely with investment from the parent-company *i.e.,* WGI. Advances had also been received from WGI towards business needs and the said advances were to be adjusted against future sales of assessee to WGI.
- Accordingly, WGI had instructed the assessee to covert the advances made by them to capital and credit the same to reserves. The assessee thus, claimed that the amount was a capital receipt and, therefore, not liable to tax.
- The Assessing Officer held that the provisions of section 41(1) relating to cessation of liability were attracted and that the amount was liable to be brought to tax as income of the assessee.
- On appeal, the Commissioner (Appeals) held that the conversion of the advances did result in the wiping out of the losses incurred, paving the way for the entry of the Indian participant. He noted that there was no nexus between the allowance/reduction in the previous years and the amount in question to invoke the provisions of section 41(1). He, thus, concurred with the submission of the assessee that the amount of Rs. 10.77 crores constituted a capital receipt.
- On appeal, the Tribunal dismissed the appeal relying upon the judgment of the Supreme Court in the case of *CIT* v. *T.V. Sundaram Iyengar & Sons Ltd.* [1996] 222 ITR 344/88 Taxman 429. The Tribunal found that the amount was originally received as an advance against supply/export of garnet. Subsequently, the claim over the amount was waived and in such circumstances the Tribunal was of the view that the amount partook the character of a revenue receipt. Thus, according to the Tribunal, the subsequent transfer of the amount to general reserve would constitute only an application that would not change the nature of the taxability of the amount at a stage anterior thereto.
- On appeal to the High Court:

Held

- The findings of the Commissioner (Appeals) are based upon the financials as well as all relevant documents. The circumstances in which the infusion of capital was made and the findings relating thereto are also undisputed. Importantly, the Commissioner (Appeals) finds that there was nothing on record to lead to the conclusion that the advances from parent company, *i.e.,* WGI had been claimed as an allowance or reduction in any previous year. This finding of fact has not been disturbed by the Tribunal in any way.

- The provisions of section 41(1) to stand attracted, the benefit obtained by the assessee in the relevant year should have a direct nexus with an allowance or deduction for any previous year as a claim of loss, expenditure, or trading liability which has not been established in the present case. Since the Tribunal nonetheless decides the issue against the assessee relying on the judgment of the Supreme Court in the case of *T.V. Sundaram Iyengar & Sons Ltd.* (*supra*), the same is to be adverted to straightaway.
- In *T.V. Sundaram Iyengar & Sons Ltd.* (*supra*), the bench notes as a fact, that the amounts received had depleted by adjustments made by the assessee from time to time and the resultant balance had been transferred by the assessee to the profit and loss account. This is not the case in the present matter. The amounts in this case, though no doubt received as advances for supply of garnet, had remained static without depletion of any sort and more importantly, not been claimed in the previous years. This pre-condition to the application of section 41(1) has not been satisfied in the instant case. The case of *T.V. Sundaram Iyengar & Sons Ltd.* (*supra*) turned on two facts distinguishable from the present case - that the deposits received from the customers had remained unclaimed and become barred by limitation and that TVS itself, treated the money as its own, crediting it to the profit and loss account. No reference is made to section 41(1) or the compliance of the condition thereunder.
- In the present case, the entire amount of 10.77 crores has been converted to shareholding, and consequently, benefit could be said to have accrued to the assessee only in the capital field.
- The Supreme Court in a later decision, in the case of *Chief CIT* v. *Kesaria Tea Co. Ltd.* [2002] 254 ITR 434/122 Taxman 91, decided a matter relating to the write back by an assessee in its accounts, of a provision made for the earlier years towards purchase tax liability. The bench, after considering the circumstances contemplated by section 41(1) concluded that the following points are critical in the event the provisions of section 41(1) are to apply. In order to apply section 41(1) in the context of the facts obtaining in the present case, the following points are to be kept in view: (1) In the course of assessment for an earlier year, allowance or deduction has been made in respect of trading liability incurred by the assessee; (2) Subsequently, a benefit is obtained in respect of such trading liability by way of remission or cessation thereof during the year in which such event occurred; (3) in that situation the value of benefit accruing to the assessee is deemed to be the profit and gains of business which otherwise would not be his income; and (4) such value of benefit is made chargeable to Income-tax.
- In *Polyflex (India) (P.) Ltd.* v. *CIT* [2002] 257 ITR 343/124 Taxman 373, the Supreme Court considered the application of section 41(1) to excise duty refunded to the assessee. The bench stated that section 41(1) applies if the following conditions and circumstances are satisfied. In the assessment for the relevant year an allowance or deduction has been made of any loss, expenditure or trading liability incurred by the assessee. This is the first step. Coming to the next step the assessee must have subsequently (i) obtained any amount in respect of such loss or expenditure or (ii) obtained any benefit in respect of such trading liability by way of remission or cessation thereof. In case either

of these events happen, the deeming provision enacted in the closing part of sub-section (1) comes into play. Accordingly, the amount obtained by the assessee or the value of benefit accruing to him is deemed to be profits and gains of business or professionals and it becomes chargeable to income-tax as the income of that previous year.

- It is found that the judgments of the Supreme Court in the case of *Kesaria Tea Co. Ltd.* (*supra*) and *Polyflex (India) (P.) Ltd.* (*supra*) would be more relevant to the facts and circumstances of this case.
- The substantial questions of law are answered in favour of the assessee and the appeal is to be allowed.