IN THE HIGH COURT OF DELHI AT NEW DELHI

% Judgment delivered on: 26.04.2016

+ **ITA 264/2002**

M/S CONTINENTAL CARRIERS ..... Appellant

Through: Mr Piyush Kaushik, Advocate.

versus

COMMISSIONER OF INCOME TAX,
NEW DELHI ..... Respondent

Through: Mr Dileep Shivpuri, Senior Standing Counsel with Mr Sanjay Kumar, Junior Standing Counsel.

AND

+ **ITA 415/2004**

M/S CONTINENTAL CARRIERS ..... Appellant

Through: Mr Piyush Kaushik, Advocate.

versus

COMMISSIONER OF INCOME TAX,
NEW DELHI ..... Respondent

Through: Mr Dileep Shivpuri, Senior Standing Counsel with Mr Sanjay Kumar, Junior Standing Counsel.

CORAM:
JUSTICE S.MURALIDHAR
JUSTICE VIBHU BAKHRU

JUDGMENT

VIBHU BAKHRU, J

1. The present appeals have been preferred by M/s Continental Carriers (hereafter 'the Assessee') under Section 260A of the Income Tax Act, 1961 (hereafter 'the Act') impugning orders dated 24th April, 2002 and 10th February, 2004 passed by the Income Tax Appellate Tribunal (hereafter 'ITAT') in ITA Nos. 5890/Del/1996 and 4169/Del/2000 respectively. Whereas ITA No. 5890/Del/1996 was preferred by the Assessee against an order dated 23rd September, 1996 passed by the Commissioner of Income Tax Act (Appeals) [hereafter 'CIT(A)'] for Assessment Year (AY) 1993-94, ITA 4169/Del/2000 was filed by the Revenue against an order dated 31st July, 2000 passed by CIT(A) for AY 1997-98.

2. The controversy involved in both the appeals relates to the method of computing the income received or brought into India in convertible foreign exchange for the purposes of deduction under Section 80-O of the Act.

3. The Assessee is a partnership firm and involved in the business of clearing and forwarding of goods for import and export, in India. It is asserted that in 1988, the Assessee commenced a new business activity which resulted in Assessee earning income by way of commission from certain foreign enterprises. It is not disputed that the commission earned

from foreign enterprises was brought into India in convertible foreign exchange and was eligible for deduction under Section 80-O of the Act.

4. During the Previous Years relevant to AYs 1993-94 and 1997-98, the Assessee earned Rs.1,56,10,111/- and Rs.4,19,66,477/- as commission in foreign currency respectively. The Assessee filed its return of income for AY 1993-94 on 28th October, 1993, *inter alia,* claiming a deduction of Rs.78,05,005/-, being 50% of the gross commission from foreign enterprises, under Section 80-O of the Act. The return filed by the Assessee was picked up for scrutiny. During the assessment proceedings, the Assessee claimed that it was entitled to deduction of 50% of the gross commission from foreign enterprises under Section 80-O of the Act. However, without prejudice to the said contention, the Assessee also computed its net income from foreign enterprises at Rs.1,30,12,924/- and claimed 50% of the said income - that is, Rs.65,06,462 - as an allowable deduction under Section 80-O of the Act. The question whether the Assessee is entitled to deduction under Section 80-O on the gross foreign income or the net foreign income is no longer in dispute and it is common ground that the Assessee would be entitled to 50% of the eligible net income earned in convertible foreign

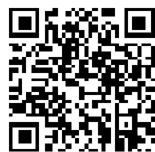
exchange (hereafter referred to as 'the Foreign Income') as a deduction under Section 80-O of the Act.

5. The Assessee computed the Foreign Income at Rs.1,30,12,924/- in the following manner: the Assessee first computed the average profit margin on its domestic receipts for the AYs 1978-79 to 1987-88 - a period of 10 years during which the Assessee did not have any commission from foreign enterprise - at 11.5%. Accordingly, the Assessee computed the net profits attributable to domestic receipts at Rs.26,92,496/- (being 11.5% of Rs.2,34,13,012/-). The Assessee then deducted the net profits from domestic receipts from the consolidated net profit of Rs. 1,57,05,421/- as per its Profit and Loss Account to compute its Foreign Income as Rs. 1,30,12,925/-.

6. The AO rejected the Assessee's method of computing the Foreign Income for deduction under Section 80-O of the Act and determined the Foreign Income by applying the Assessee's profit margin on its consolidated income. In other words, the AO applied the ratio of assessed income to gross receipts on the commission received and computed the deduction under Section 80-O at Rs.32,57,779/- for AY 1993-94.

7. For the AY 1997-98, the Assessee filed its return claiming a deduction of a sum of Rs.2,00,98,400/- under Section 80-O of the Act. The Assessee had computed the aforesaid deduction by deducting 80% of the expenses relating to postage, telegram, telephone and fax etc. and 10% of the expenses relating to salaries from the gross commission received from foreign enterprises to compute its Foreign Income. 50% of the Foreign Income so computed was claimed as deduction under Section 80-O of the Act. The AO rejected the aforesaid computation and computed the deduction under Section 80-O by applying the same formula as adopted by the AO while computing the deduction under Section 80-O for AY 1993-94. Since the total receipts disclosed by the Assessee for AY 1997-98 was Rs. 7,19,42,363/-, out of which commission from foreign enterprises amounted to Rs.4,19,66,477/- and the total expenses were assessed at Rs. 3,16,25,140/-; the AO computed the deduction under Section 80-O of the Act as under:

He computed the expenses attributable to foreign income at Rs.1,84,48,041/- on a proportionate basis to the gross income of the Assessee [(Rs. 3,16,25,140 /7,19,42,363) x 4,19,66,477/-]. He then calculated the Foreign Income at Rs. 2,34,18,436/- by deducting the expenses attributable to receipts from foreign enterprises from those



receipts [4,19,66,477/- − 1,84,48,041/- = 2,34,18,436/-]. Accordingly, he computed the deduction under Section 80-O of the Act, being 50% of the Foreign Income, at 1,17,59,217/- [50% of 2,34,18,436/-]

8. The Assessee appealed against the respective assessment orders for AYs 1993-94 and 1997-98 before the CIT(A). By an order dated 23rd September, 1996, the CIT(A) rejected the Assessee's challenge to the quantum of deduction under Section 80-O of the Act as computed by the AO for AY 1993-94 and upheld the AO's conclusion that the average rate of net profit for a period of 10 years provided no basis for determining the Foreign Income. The CIT(A) concurred with the AO that since, the Assessee had not maintained separate books of accounts, the most scientific method for determining Foreign Income would be by allocating expenses between the domestic income and income from foreign enterprises on a proportionate basis.

9. However, for AY 1995-96, the CIT(A) accepted the methodology of computing Foreign Income as was canvassed by the Assessee, in the alternative, for AY 1993-94. The CIT(A) accepted that the average profit margin for income other than Foreign Income was 11.5% and, thus, average expenses for domestic business was 88.5% of the gross domestic income. On this basis, the domestic expenditure was calculated at

Rs.3,01,55,138/- [being 88.5% of 3,40,73,602/-]. The balance expenses being Rs.1,04,27,180/- (that is, after deducting Rs.3,01,55,138/- from the total expenses of Rs.4,05,82,318/-) were held to be attributable to earning commission from foreign enterprises in convertible foreign exchange. Accordingly, the Foreign Income for AY 1995-96 was computed at Rs. 1,61,50,615/- (that is, gross foreign commission of Rs.2,65,77,795/- less Rs.1,04,27,180/-). This method was also accepted by the CIT(A) for AY 1996-97.

10. The CIT(A), by an order dated 31st July, 2000 followed the earlier decisions for AYs 1995-96 and 1996-97 and, computed the deduction under Section 80-O of the Act at Rs.1,84,34,998/- for AY 1997-98.

11. Aggrieved by the order dated 23rd September, 1996 passed by the CIT(A) for AY 1993-94, the Assessee preferred an appeal before the ITAT. The Revenue, on the other hand, appealed against the CIT(A)'s order dated 31st July, 2000 for AY 1997-98. By an order dated 24th April, 2002, the ITAT rejected the Assessee's plea that only 11.5% of domestic receipts could be considered as expenditure allocable to foreign commission receipts as being not acceptable. The ITAT further held that the formula adopted by the AO in estimating the Foreign Income was *reasonable* and *scientific* and concurred with the AO's estimation of

Foreign Income for the purposes of deduction under Section 80-O of the Act. Following the aforesaid decision for AY 1993-94, the ITAT allowed the Revenue's appeal for AY 1997-98 by an order dated 10th February, 2004.

12. Aggrieved by the decision of the ITAT, the Assessee has filed the present appeals. These appeals, ITA 264/2002 and ITA 415/2004, were admitted on 7th October, 2002 and 6th August, 2004 respectively and the following questions of law - which is common to both appeals - was framed:

> "Whether on the facts and in the circumstances of the case the conclusion recorded by the Tribunal on the apportionment of the net income eligible for deduction under Section 80-O of the Income-tax Act, 1961, is bad in law, being wholly inconsistent with the evidence on record?"

13. We are informed that the Revenue also filed appeals before the ITAT for AY 1995-96 and 1996-97 which have since been disposed of by the ITAT by directing the deduction under section 80-O of the Act be computed in accordance with the decision of this court in the present appeals.

Submissions

14. Mr Piyush Kaushik, learned counsel appearing for the Assessee contended that the AO and the ITAT had grossly erred in not considering the submissions made by the Assessee and its computation of Foreign Income had been rejected without assigning any reasons. He further submitted that the AO had been inconsistent in the methodology adopted for computing the deduction under Section 80-O of the Act and the same was not considered by the ITAT. Mr Kaushik then referred to the decision of this Court in ***CIT v. EHPT India P. Ltd.***: **(2013) 350 ITR 41 (Del)** and on the strength of that decision contended that in cases where there is no statutory or fixed formula for allocation of expenditure between exempt and non-exempt income, the method of allocation of expenditure should be one which is consistently accepted by both the parties - the assessees and the Revenue - in the past; the method should be reasonable; and one which does not distort profits.

15. Next, he referred to the written submissions filed before the ITAT and contended that if the method adopted by the AO for computation of Foreign Income is accepted, it would imply that Assessee's domestic business had a profit margin of 41.73% in AY 1993-94 and 56.32% in AY 1997-98. This, according to him, established that the method of allocation of expenditure adopted by the AO indicated distorted profits

from domestic business and, therefore, could not be accepted. Mr Kaushik then referred to the decision of the Supreme Court in ***CIT v. Bilahari Investment P. Ltd.***:**(2008) 299 ITR 1 SC** in support of his contention that the AO could not reject the method adopted by the Assessee unless he recorded a finding that the same has resulted in distortion of profits. He submitted that since no such findings had been recorded, the ITAT's decision was erroneous. Mr Kaushik also relied upon the decision of the Supreme Court in ***CIT v. Realest Builders & Services Ltd.***: **(2008) 307 ITR 202 SC** and contended that it was incumbent upon the AO to give facts and figures to demonstrate that the method of accounting followed by the Assessee had resulted in under-estimation of profits. He also referred to the decision of the Supreme Court in ***CIT v. McMillan & Co.***: **33 ITR 182 SC** to contend that the method of accounting adopted by the Assessee must be scrutinised carefully and such power should be exercised reasonably and judicially.

16. Next, Mr Kaushik referred to the decision of the Supreme Court in ***CIT v. Woodward Governor India P. Ltd.***: **312 ITR 254 SC** and the decision of this Court in ***CIT v. Jagatjit Industries Ltd.***: **339 ITR 382 SC** in support of his contention that the method of accounting adopted by the

Assessee could not be changed unless the AO finds the same to distort profits.

17. Lastly, Mr Kaushik referred to the decision of the Supreme Court in ***Lalchand Bhagat Ambica Ram v. CIT*****: 37 ITR 288 (SC)** and of the Madras High Court in ***CIT, Chennai v. M/s Matrix Intel Pvt. Ltd. Chennai***: **2006-TIOL-389-HC-MAD-IT** and contended that it was incumbent upon the ITAT to consider all the facts, both for and against the Assessee, before rejecting the contentions or material submitted by the Assessee. He also relied on the decision of this Court in ***CIT v. Satish Kumar Chandna*****: 311 ITR 276 (Del)** in support of the aforesaid contention.

Reasoning and Conclusion

18. The question of law before us is a limited one and, that is, whether the conclusion of the ITAT with regard to the apportionment of expenses to determine the Foreign Income for the purposes of deduction under Section 80-O of the Act, is inconsistent with the evidence on record. The evidence in question, which is relied upon by the Assessee is the average profit margin of 11.5% from Assessee's domestic business determined by

averaging the profit margins for a period of 10 years prior to commencement of the new line of business. It was urged that on the aforesaid basis, the expenditure on domestic business could be reasonably estimated at 88.5% of domestic receipts. And, if the expenditure so estimated was reduced from the total expenditure incurred by the Assessee during the relevant previous years, the resultant figure would be the expenditure that could be attributed to Foreign Income.

19. A close examination of the aforesaid formula as canvassed on behalf of the Assessee clearly indicates that the same results in all fixed expenditure being allocated to domestic businesses and only the increased marginal expenditure is allocated towards computing the Foreign Income. The average profit margin of 11.5% attributable to domestic business has been calculated by averaging the profit margin for AYs 1978-79 to 1987-88, that is, during the period when the Assessee did not carry out the business resulting in Foreign Income. Plainly, the computation of this profit margin of 11.5% takes into account all costs - including fixed costs and variable costs - which constitute 88.5% of the gross domestic receipts. Now, if the method as canvassed by the Assessee is accepted, it would mean that all fixed costs would be allocated to the domestic

business and no part of it would be allocated towards earning Foreign Income.

20. In Cost Accountancy terms, all costs incurred by the Assessee for carrying on its business can be classified into Fixed Costs, Semi-variable Costs and Variable Costs. Fixed Costs are such costs which have to be incurred by the Assessee irrespective of whether the Assessee earns any income or not. Typically, such costs include costs for basic infrastructure, office space, etc. and such costs do not vary with the volume of business carried on by the Assessee. Variable costs are typically costs that vary in direct proportion to the volume of business carried out by the Assessee. These costs typically include costs such as costs for direct raw material that is incorporated in or consumed to produce the final product. Semi-variable costs are such costs which have elements of both fixed costs and variable costs. Such costs would vary with the volume of business but not in direct proportion. Typically, such costs may be costs such as electricity charges which have a fixed component of line charges and variable per unit cost for electricity consumed. In the method as adopted by the Assessee, no part of the fixed cost is allocated to foreign business and at best, only the marginal variable costs are sought to be attributed to earning Foreign Income. This, in our view, would plainly result in a

distorted apportionment of net profits of the Assessee between domestic income and foreign income.

21. To illustrate the above point, let us consider a hypothetical case of an assessee who's revenue receipts from business (Existing Business) in a particular year is Rs.1,00,000/-. He incurs office rentals and establishment costs of Rs. 60,000/-and other variable expenses of Rs. 20,000/-; thus declaring a profit of 20,000/- (translating to a net profit margin of 20%). In the next year, he expands his business by commencing a new activity ('New Business') from the same establishment which results in additional revenues of Rs. 50,000/- for which he incurs incremental variable cost of Rs. 10,000/-. Assuming that the revenues from existing business remain static and there are inflationary pressures on costs; the assessee would earn a profit of Rs. 60,000/- and his overall net profit margin would increase to 40% (i.e 60,000/150,000). If the method as canvassed by the Assessee is accepted, and the costs are allocated to the Existing Business based on the profit margin prior to commencement of New Business, the entire office rentals and establishment costs of Rs. 60,000/- would be allocated to the Existing Business even though the same establishment was used for carrying on the New Business. The result would be that while the profit margin of the

Existing Business would continue to be assumed at 20% and the profit margin of the New Business would be reflected at 80%.

22. During the course of hearing, we had put the above fallacy in the method adopted by the Assessee to Mr Kaushik and had also adjourned the hearing to enable him to respond and advance contentions in support of the method adopted by the Assessee. However, Mr Kaushik did not advance any contention in support of the method as canvassed by the Assessee and limited his submissions to contend that the ITAT had not provided any such opportunity to the Assessee.

23. We may note that Mr Kaushik also did not dispute that the method as adopted by the AO - that is, to allocate expenses on proportionate basis - was in principle unfair or flawed. He merely contended that the same had resulted in the profit margins of the domestic business being computed at very high rates (41.73% for AY 1993-94 and 56.32% for AY 1997-98). This objection, in our view, is clearly without any merit as it fails to consider the result on the profit margin of foreign business. If the methodology as adopted by the Assessee is accepted, then the profit margin of the domestic business would remain 11.5% but that of foreign business would be 83.36% [(Rs.1,30,12,925/1,56,10,011)x100] for AY

1993-94 and 87.86% [(Rs.3,68,69978/4,17,66,477)x100] for AY 1997-98. It is the Assessee's case before the CIT(A) for AY 1995-96 that it did not incur any specific expenditure for earning the commission from foreign principals in respect of the said consolidation business. The Assessee also contended that *"Assessee has a running business establishment all over the country in regard to its original business i.e. clearing agency with branches in different parts of the country and the receipt of the commercial information regarding probable imports are merely incidental which are transmitted to foreign principals interested therein."*. Thus, *ceteris paribus,* the profit margins of the domestic business would clearly be expected to increase with the incremental revenue's being generated by way of commission from the existing fixed establishment.

24. It is also relevant to note that the average profit margin of 11.5% of domestic business, which is the bedrock of the Assessee's contention, has been calculated by averaging profit margins for AYs 1978-79 to 1987-88 which are several years prior to the AYs in question.

25. Turning to the decisions referred to by Mr Kaushik, it is clear that most of them are wholly inapplicable in the facts of the present case. In

EHPT India P. Ltd. *(supra),* this Court was concerned with apportionment of common expenses between income exempt under Section 10A of the Act and non-exempt income of the Assessee. In that case, the ITAT had upheld the allocation of common expenses on the basis of headcount of employees, which had been followed on a consistent basis. In that case, the Assessee had recorded common expenses separately for various costs centres and the same were apportioned in the ratio of head counts of the exempt and non-exempt units. This Court found that the method for apportioning common expenses between exempt and non-exempt units was not unreasonable and had been followed consistently by the Assessee in the past. However, in the present case, we are unable to accept that the method as canvassed by the Assessee is reasonable or results in a fair computation of domestic and Foreign Income. Further, the Assessee itself had not followed a consistent method for apportionment of expenses between domestic business and foreign business. Whilst for AY 1993-94, the Assessee had claimed deduction under Section 80-O of the Act on gross income, in AY 1997-98 the Assessee had deducted 80% of expenses relating to postage, telegram, telephone and fax etc. and 10% of the expenses relating to salaries from gross foreign commission to compute the Foreign Income.

26. Similarly, the decisions in the case of ***Bilahari Investment P. Ltd.*** (*supra*) and ***Realest Builders & Services Ltd.*** (*supra*) also do not support the Assessee in any manner. This is so because in the present case, it is apparent that the method of apportioning of expenses as canvassed by the Assessee does not lead to acceptable results.

27. Although, the ITAT ought to have discussed the method of apportionment as urged by the Assessee and articulated its reasons for rejecting the same, we are not inclined to remand the matter as the method of apportionment of expenses between domestic business and income from foreign commission is clearly unacceptable in the given facts of the case. Further, the ITAT has concurred with the view of the AO that the method provided by the Assessee was not acceptable as the expenses would vary from year to year. Finally, the ITAT had accepted the methodology adopted by the AO to compute Foreign Income to be reasonable and scientific and we find no infirmity with this view.

28. In view of the above, the question framed is answered in the negative, that is, in favour of the Revenue and against the Assessee.

29. The Appeals are, accordingly, dismissed. The parties are left to bear their own costs.

VIBHU BAKHRU, J

S.MURALIDHAR, J

APRIL 26, 2016
RK/pkv