

Capital gains and other sources. The business income of the assessee is from his own business and his share income from M/s Meera Industries wherein he is a partner.

The assessee's own business is that of a developer of property into commercially viable structures.

The salient features of the business as a developer are as follows:

1. As a first step the assessee enters into an agreement with the owner of open land or land with old structures (hereafter referred to as owner).
2. Under the agreement the owner agrees to allow the assessee to develop his property and to construct on the said property buildings or structures which can be used for any purpose, planned/designed by the assessee.
3. It is a vital part and integral term and condition of the agreement that the construction should be carried out by the assessee himself at his own cost. But brick by brick, the construction so made would belong to the owner.
4. The assessee has to pay to the owner compensation during the period of agreement.
5. Property taxes etc. will be borne by the assessee.
6. The period of the agreement is generally long - more than 10 years, normally.
7. During the period of the agreement, the assessee is at liberty to give out the building or structures constructed on rent or otherwise to any body of his choice.
8. The assessee gets the right to receive such rent during the period of the agreement.
9. On expiry of the period of agreement, the owner is entitled to vacant possession of the property along with the buildings or structures put up by the assessee.

As mentioned in point No.8 above, it is the right of the assessee to receive rent from persons to whom the property constructed under the agreement with the owner is let out. It is these rental receipts that are offered to tax as business income after deducting the compensation paid to the owner, referred to as licence fees also, property tax etc. paid, financier's consideration which is interest on moneys borrowed from persons financing the construction.

For his previous year ending 1-11-1986 relevant for the Assessment Year 1987-88, the assessee's following agreements under the business described above come up for consideration.

- A. Agreement with Investa Chemicals.
- B Agreement with Seth Group.
- C. Agreement with Durgaprasad.
- D. Agreement with R.S. & Co.,
- E. Agreement with Purushottam.
- F. S.M.Modi Commercial Complex.

Apart from the income from the above agreements, share income from M/s Meera Industries, Capital gains and income from other sources are offered to tax for the Asst. Year 1987-88. In response to notices u/s 143(2) and 142(1) the assessee's authorised representative Sri Anil Kumar B. Vithlani, appeared from time to time and the case was discussed with him. The details called for have been filed and the income of the assessee is computed as under:

I. INCOME FROM BUSINESS:

- a) Share income from M/s Meera Industries (as per the firm's assessment order dated 19-2-1990) is : Rs.829043.
- b) As discussed earlier the assessee's own business comprises five different projects. The income derived from each of them is as under.
 - 1. Agreement with Investa Chemicals (accepted as returned) ... : (-) 39
 - 2. Agreement with Seth Group:

Under this agreement the assessee has developed land admeasuring 770 Sq.Mts. belonging to the Seth Group. The completed portions have been let out to Atlas Capco and rent received from them during the year is Rs.67,500/-. The assessee has also done further construction on this property during this year incurring Rs.4,18,938/- for such construction work. The assessee has set off the construction expenditure of Rs.4,18,938/-, brokerage of Rs.7,500/- and compensation of Rs.28,800/- to Seth group against the rent received of Rs.67,500/-.

The assessee is not correct in setting off the construction expenditure of Rs.4,18,938/- against the rents received. The construction expenditure is clearly capital expenditure and hence cannot be claimed as a allowable expenditure against the rents received. The assessee was asked to explain how the construction expenditure was allowable as revenue expenditure. The assessee's arguments in support of its claim that construction expenditure is on revenue count are as follows:-

- 1) The expenditure is incurred in the ordinary course of the business.

- ii) The ownership of the property passes brick by brick to the owner of the land. The assessee does not have any permanent or lasting interest in the property constructed. Hence it cannot be said that the assessee has created a capital asset for itself of enduring benefit.
- iii) The expenditure, though resulting in enduring benefit over a long period, was incurred with a view to conduct its business in a more profitable way and hence in the light of the decisions of the Supreme Court in *EMPIRE JUTE CO. LTD. Vs. C.I.T.* (124 ITR 1) and *C.I.T. Vs. ASSOCIATED CEMENT COMPANY LTD.* (172 ITR 257) was clearly allowable as revenue expenditure.

The question of whether a particular expenditure is capital expenditure or revenue expenditure has come up before the Courts on numerous occasions and certain broad principles have evolved over a period of years. It is pertinent here to recount these principles and view the assessee's case in the light of these principles.

The following principles emerging from the case of *Benarsi Das Jagan Nath, Re* (15 ITR 185) received the seal of approval of the Supreme Court in the case of *Assam Bengal Cement Company Limited V C.I.T.* (27 ITR 34).

1. Outlay is deemed to be capital when it is made for the initiation of a business, for extension of a business or for a substantial replacement of equipment.

In *City of London Contract Corporation V Styles, Bowen LJ* observed as to the capital expenditure as follows:

'You do not use it for the purpose of your concern, which means, for the purpose of carrying on your concern, but you use it to acquire the concern'.

2. Expenditure may be treated as properly attributable to capital when it is made not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade.

3. It is to be seen whether the expenditure incurred is part of the fixed capital or out of circulating capital.

These principles serve as touchstones for deciding whether a particular item of expenditure is in the capital or revenue field. Further (quoting from "Law of Income Tax", Sampath Iyengar, 7th edition, page No. 1717) Lord Clyde in *Robert Addie & Sons Collieries Ltd. V IRC* (8 TC 671) stated the principle thus: "Is it part of the company's working expenses, is it expenditure laid out as part of the process of profit-earning? - or, on the other hand, is it a capital outlay, is it expenditure necessary for the acquisition of property or of rights of a permanent character, the possession of which is a condition of carrying on its trade at all?"

In the case of the assessee, the true nature of the construction expenditure of Rs.4,18,938/- under the agreement with Seth Group has to be ascertained from the documents and all the surrounding circumstances and then it should be tested against the above narrated principles in order to decide whether the said expenditure is capital expenditure or revenue expenditure.

The facts regarding the agreement with Seth Group is briefly stated here. Seth Group comprises ^{four} persons viz., Shri Chimanlal Jagjivandas Seth, Shri Shanti Kumar J. Sheth, Shri Laxmikanth C. Sheth and Shri Beeren S. Sheth. Sheth Group are the owners of the land admeasuring 2628 Sq. Metres in Survey No. 8 & 9, situated at Rasoolpura, Police Hockey Stadium, Secunderabad Gantonment. An agreement was made on 1-1-1984 between the Sheth Group on the one hand and M/s Central India Engineering and M/s Meera Industries (of which the assessee is a partner) on the other, separately by which Sheth Group gave the right to develop the property by putting up buildings or other structures to M/s Central India Engineering and M/s Meera Industries. Later since M/s Central India Engineering and M/s Meera Industries could not complete the development undertaken by them, the assessee i.e. Mr. Satish Modi joined the project as a co-developer and M/s Central India Engineering, M/s Meera Industries and the assessee in his individual capacity together developed the property. This arrangement was also reduced to writing by executing an agreement on 13-10-1988 between Sheth Group, M/s Central India Engineering and M/s Meera Industries and the assessee himself in his individual capacity. This agreement dated 13-10-1988 clearly mentions that the assessee has developed the property to an extent of 770 Sq. metres while the balance was developed by M/s Central India Engineering and M/s Meera Industries. It also stipulates that all the parties shall abide by all the terms and conditions of the first agreement dated 1-1-1984. Thus the terms and conditions of the agreement dated 1-1-1984 would also apply to the development of property to an extent of 770 Sq. metres by the assessee in his individual capacity. Now the terms and conditions of the agreement dated 1-1-1984 would throw light on the nature of the arrangement between Sheth Group and the assessee. The relevant terms and conditions are given below:

1. The Owners hereby agree and allow the Developer to develop the said property and to construct on the said property a building or structures for being used for any purpose or purposes as may be permissible by law and as may be planned

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and/ or designed by the Developer.

2. The Developer shall get the building plans prepared, at the cost of the Developer, for constructing such building and structures as may be planned or desired by the Developer but it shall be the responsibility of the Owners to get such building plans sanctioned and/or approved or get the construction of the building or structures in accordance with such building plans regularised by the authorities concerned, the cost in this connection to be borne and paid by the Developer.

3. It is clearly and distinctly understood and agreed as a vital part and integral term and condition of this Agreement

(a) though the cost of construction of the said building and structures shall be borne and paid by the Developer alone, such construction shall be carried out and completed by the Developer for and on behalf of and in the name of the Owners.

(b) As and when such construction is put up and progresses, the same shall belong and form part of the property of the Owners and shall be the asset of the Owners and such completed structures shall also belong to the Owners.

(c) The Developer shall not have or claim any proprietary rights in or to such building or structures or any part thereof.

4. The Developer shall pay the Owners (to be shared by the Owners in their respective determined shares) compensation calculated at the rate of 15 paise (fifteen paise) per Sq.Ft per month of the area of construction that may be put up by the Developer on the said property, commencing from the date the construction in question is completed and put to use.

5. Property tax and all other outgoings and dues in respect of the said property and/or the development thereof shall be borne and paid by the Developer for the duration of this Agreement.

6. This Agreement shall be valid and operative for a period of 11 years from 1st January, 1984.

7. During the period of this Agreement, the Developer shall be at liberty to give out on rental or on any other basis, to persons and/or concerns and/or bodies to be selected and of the choice of the Developer, the new building and structures to be so constructed by the Developer on the

said property or portions of such building and structures, at such rental and/or on such terms and conditions as the Developer may choose or decide, it being clearly understood that

- (a) the right of the Developer to receive such rent and/ or other benefit or realisation shall be limited to the period of this Agreement but no further.
- (b) Since such building and structures to be put up by the Developer on the said property is to form part of the said property and is to belong to the Owners and is to be the asset of the Owners, all such rents and/or benefit shall belong to the Owners for the period commencing from the expiry of the aforesaid term of 11 years.
- (c) Any advance rent and/or deposit and/or other consideration that may be received or obtained by the Developer from the tenants or others shall be on condition that the same would be adjusted and/or appropriated and/or exhausted latest by the expiry of the term or period of this Agreement viz. latest by the end of 11 years so that after the expiry of the aforesaid period of 11 years, there would be no outstanding right from the tenant or other occupant of the said building and structures or any part thereof which could be claimable against the Owners.
- (d) For the period commencing from the expiry of the aforesaid period of 11 years all property taxes, dues and other outgoings shall be borne and paid by the Owners.
- (e) The Owners would be entitled to vacant possession of the said property viz. of the land with building and structures on the expiry of the aforesaid period of 11 years.

8. It is also clearly understood and agreed that the Developer shall not be required to obtain consent or concurrence of the Owners for the arrangement which may be negotiated and/or entered into by the Developer with outsiders viz., prospective tenants and/or occupants, the intention being that the Developer shall be at liberty and be entitled directly to enter into agreements with outsiders

i.e. tenants/occupants in respect of the building and structures to be so constructed by the Developer on the said property or any portion of such building or structures PROVIDED HOWEVER if so desired by the Developer or tenant/occupant, the Owners shall be obliged to endorse on such document the consent and concurrence thereto of the Owners.

A reading of the terms and conditions reveals the real nature of arrangement between the Sheth Group and the assessee. The Sheth group allows the assessee to develop the property putting up buildings and structures according to the assessee's plan and design and also the right to give out such constructed buildings or structures on rent to parties of the assessee's own choice and receive such rent himself during the period of the agreement with Seth group. In return, the Sheth group becomes owner of a fully developed, commercial property i.e. building or structures constructed by the assessee at his own cost and also receives compensation at a fixed rate related to the area of constructed property which is let out by the assessee to parties of his choice.

Viewed from the assessee's side, he receives the right to receive rent from tenants of his choice which right will come to him on the condition that he constructs at his own cost buildings or structures which would nevertheless belong to Sheth group only. And, during the use of this right he will pay compensation at a stipulated rate to Sheth group. Thus, in effect, the assessee acquires from Sheth group an asset, an intangible asset, in the form of the right to receive rent and in consideration for this he has to give fully developed property to Sheth group. During the use of this asset he has to pay compensation to Sheth group at a stipulated rate.

In Abdul Kayoom (KTMKA) V C.I.T. (1962) 44 I.T.R. 689 (SC) the assessee was engaged in buying and selling conch shells. In connection with that business, the assessee obtained on lease from the Government of Madras the exclusive right, liberty and authority to fish for and take and carry away all conch-shells in the sea off the coastline of a certain area specified for a period of three years on a yearly rent of Rs.6,111/-. The assessee claimed that in computing its annual income from the sale of conch-shells it was entitled to deduct the yearly rent paid to the government as business expenditure. It was held by the Supreme Court that the annual rent paid by the assessee was paid to obtain

an enduring asset in the shape of an exclusive right to fish and that the payment was not related to the conch shells, which the sea might or might not bring to the surface. The expenses of fishing the shells were the assessee's current expenses, but to say that the payment of lease money for reserving an exclusive right to fish was on par with payments of the other character is to err.

In the assessee's case also the consideration given to Sheth group in the form of a fully constructed building was to obtain an enduring asset in the shape of an exclusive right to lease out the property and receive rent and the consideration was not related to the area constructed and let out. Thus the expenditure on construction was not in the process of earning its rental income but was to obtain the right to lease out and receive rent. The revenue expenditure in earning the rental income would be only the compensation paid to Sheth group which is related to the area constructed and used, property taxes paid etc.

The discussion above boils down to the following:

i) The assessee acquires an asset of enduring benefit by incurring construction expenditure for developing the property—the asset acquired being the right to let out the property and receive rent.

ii) The construction expenditure to be incurred by the assessee is the very condition on which he can acquire the asset and initiate or carry on his business — this is very clear from the terms and conditions of the agreement with Sheth group. Each time the assessee enters into an agreement of this nature, and incurs construction expenditure, the assessee acquires a new asset of enduring benefit and thereby there is extension of the assessee's business. Each agreement is an independent ^{venture} nature, unconnected with other agreements, initiating a fresh source of income to the assessee and the construction expenditure is a pre-condition for commencing the venture.

iii) The construction expenditure incurred by the assessee is thus a capital outlay, an expenditure for acquisition of property or of rights of long-term, enduring benefit, the possession of which is a condition for carrying out his business. It is common knowledge and accepted ^{axiom} that the benefits of a

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revenue expenditure would normally be reaped within a period of one year and that a capital expenditure will be of enduring benefit spreading beyond a period of one year. In the assessee's case the right acquired would yield benefit in the form of rental income over a period of nine years.

The construction expenditure incurred by the assessee can be likened to premium paid to acquire a lease and the compensation paid by the assessee to Sheth group can be likened to rent paid during the period of a lease.

The reliance placed on the decisions of the Supreme Court in *Empire Jute Co. Ltd., V C.I.T.* and in *C.I.T. V Associated Cement Companies Ltd.* is misplaced. In those cases the expenditure in question was for the purpose of facilitating the carrying on of business and was not a pre-condition for initiation or extension of the business. But in the case of the assessee, the construction expenditure in question was not in the ordinary course of the business as contended by him. It was an essential pre-condition on which his business as a developer is begun and extended.

Without prejudice to my arguments above, I have to state that by couching the real nature of the business in misleading language the assessee is depriving the Revenue of taxes due to it and in the interests of public policy this should not be allowed.

Thus I hold that the construction expenditure of Rs.4,18,938/- incurred by the assessee is capital expenditure which cannot be set off against the rents received of Rs.67,500. The only permissible allowances are towards the compensation paid to Sheth group of Rs.28,800 and brokerage of Rs.7,500. I, therefore, compute the income arising from the agreement with Sheth group as Rs.31,200/-.

Rs.31,200.

3. Agreement with Durgaprasad:-

The assessee has not derived any income from this agreement during the year. But he has set off an expenditure of Rs.60,000/- for property development against rents received under the agreement with Sheth group. This agreement is slightly different from the agreement with Sheth group but very similar. In this agreement the assessee is referred to as "Underwriter". Durgaprasad is the owner of an immovable property bearing No.1-20-248, Rasoolpura, Secunderabad

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together with building. Under the agreement the assessee underwrites the letting out of the property for a gross monthly rent of Rs.2,500 with an escalation of Rs.1,000/- every five years. The assessee gets the right to have the property let out by Durgaprasad to parties nominated by the assessee. The assessee will negotiate the monthly rent, premium etc. with the parties concerned. If the assessee is able to negotiate a monthly rent in excess of the underwritten amount, the excess receivable would belong to and shall be receivable by the assessee himself. It is also an integral part of the agreement that the assessee would carry out certain "Optional work" for more effectively marketing the property and the cost of such work will be borne by the assessee only. The term "Optional work" actually refers to construction of work for renovating or modifying the property for more effectively marketing it. It is this "Optional work" which has resulted in an expenditure of Rs.60,000/- to the assessee. Here again, this expenditure is for acquiring an asset, the right to have the property let out to assessee's own nominees and the right to receive the rent receivable in excess of the underwritten amount. This asset is again of enduring benefit to the assessee. Hence the assessee cannot claim this as allowable since it is in the nature of capital expenditure.

4. Agreement with RS & Co.:-

Income returned under this is accepted ...

Rs.36,000

5. Agreement with Purushottam

Under this the assessee has received rent of Rs.10,500/- and has set off property development expenditure of Rs.2,44,730/- against it. Under this agreement dated 1-4-1985, Shri Purushottam gives his property at Survey No.4, Begumpet village, to the assessee for developing it and letting out and receiving rent. The property developed would be at the assessee's cost but its ownership would pass on brick by brick to Shri Purushottam. Shri Purushottam would be entitled to receive compensation at a stipulated rate related to area developed and let out.

Thus the facts here almost identical to that under the agreement with Sheth group and the discussion

made in that connection would equally and fully apply here. I therefore hold the expenditure of Rs.2,44,730 as Capital Expenditure and hence not allowable against the rent received of Rs.10,500/-. The income thus arising to the assessee herein is Rs.10,500.

6. S.M.Modi Commercial Complex:


| | | |
|--|--------------|-----------------|
| | ... | 10,500 |
| (Profit declared here is accepted). | ... | <u>8,93,174</u> |
| | | 10,52,878 |
| Less: Net interest expenses incurred for the business: | | <u>2,44,664</u> |
| | | 8,08,214 |
| Less: Legal expenses: | | <u>16,000</u> |
| Income from business: | | 7,92,214 |
| II. Income from Capital Gains as returned: | | 67,529 |
| III. Income from other sources as returned: | | <u>47,750</u> |
| GROSS TOTAL INCOME: | | <u>9,07,493</u> |
| Less: Deduction u/s 80-C | 654 | |
| Deduction u/s 80-L | 7,000 | |
| Deduction u/s 80-F | <u>6,798</u> | |
| | | <u>14,452</u> |
| | | 8,93,041 or |
| | | <u>8,93,040</u> |

(Rupees Eight Lakhs Nintythree Thousands and Forty only).

| | | |
|-----------------------------------|--|--------------------|
| Tax there on: | | Rs.4,25,770 |
| Less: Adv.Tax paid: | | <u>Rs.1,19,250</u> |
| | | Rs.3,06,520 |
| Add: Int. u/s 139 215: | | Rs. 12,400 |
| Int. u/s 215 | | <u>Rs.1,47,120</u> |
| Total Tax payable: | | <u>Rs.4,72,796</u> |
| | | 4,53,640 |

Tax should be paid as per Demand Notice and Challan enclosed.

Penalty proceedings u/s ~~273(2)(a)~~, 273(2)(a) are initiated separately.


 (J. ALBERT)
 Asst. Commissioner of Incometax,
 Circle 1(2):Hyderabad.

Copy to the assessee.