R

IN THE HIGH COURT OF KARNATAKA, BENGALURU

DATED THIS THE 25TH DAY OF SEPTEMBER 2018

PRESENT

THE HON'BLE Dr.JUSTICE VINEET KOTHARI

AND

THE HON'BLE Mrs.JUSTICE S.SUJATHA

I.T.A.No.155/2016
C/W
I.T.A.No.458/2013, I.T.A.No.467/2015
I.T.A.No.173/2017, I.T.A.No.172/2017

I.T.A.No.155/2016

Between:

1. The Pr. Commissioner of Income Tax
C.R. Building, Queens Road
Bangalore-560001.

2. The Income Tax Officer
Ward-4(3), Bangalore.

...Appellants

(By Mr. E.R. Indrakumar, Sr. Counsel for
Mr. E.I. Sanmathi, Advocate)

And:

M/s. Chamundi Winery and Distillery
1313, 9th Cross, 27th Main, 1st Phase
J.P. Nagar, Bangalore-560 078
PAN; AAEFC5505C.

...Respondent

(By Mr. A. Shankar & Mr. M. Lava, Advocates)

****

This I.T.A. is filed under Section 260-A of Income Tax Act 1961, praying to: 1. Decide the question of law and/or such other questions of law as may be formulated by the Hon'ble Court as deemed fit. 2. Set aside the appellate order dated 26/08/2015 passed by the ITAT, 'C' Bench, Bengaluru, as sought for, in the respondent-assessee's case, in Appeal proceedings in ITA No.908/Bang/2014 dated 26/08/2015 for A.Y. 2010-2011 & etc.

I.T.A.No.458/2013

Between:

1. The Commissioner of Income-tax
C.R. Building, Queens Road
Bangalore.

2. The Income-Tax Officer
Ward-4(3), C.R. Building
Queens Road, Bangalore.

...Appellants

**(By Mr. E.R. Indrakumar, Sr. Counsel for
Mr. K.V. Aravind, Advocate)**

And:

M/s. Chamundi Winery and Distillery
No.1313, 9th Cross, 27th Main
1st Phase, J.P. Nagar
Bangalore-560 078.

...Respondent

**(By Mr. A. Shankar, Mr. M. Lava &
Mr. K. Kiran Kumar, Advocates)**

****

This I.T.A. is filed under Section 260-A of Income Tax Act 1961, praying to: 1. formulate the substantial questions of law stated therein. 2. allow the appeal and set aside the

order passed by the ITAT, Bangalore in ITA No.1260/Bang/2012 dated 05/04/2013 and confirm the order of the Appellate Commissioner confirming the order passed by the Income Tax Officer, Ward-4(3), Bangalore.

I.T.A.No.467/2015

Between:

1. Pr. Commissioner of Income Tax
Central Revenue Buildings
Queens Road, Bangalore-560 001.

2. The Income Tax Officer
Ward-4(3), Bangalore.

...Appellants

**(By Mr. E.R. Indrakumar, Sr. Counsel for
Mr. E.I. Sanmathi, Advocate)**

And:

M/s. Chamundi Winery and Distillery
No.1313, 9th Cross, 27th Main
1st Phase, J.P. Nagar, Bangalore-560 078
PAN No.AAAEFC 5505C.

...Respondent

(By Mr. A. Shankar & Mr. M. Lava, Advocates)

****

This I.T.A. is filed under Section 260-A of Income Tax Act 1961, praying to decide the foregoing question of law and/or such other questions of law as may be formulate by the Hon'ble Court as deemed fit and set aside the appellate order dated 17/04/2015 passed by the ITAT, 'B' Bench, Bangalore, in appeal proceedings in ITA No.1149/Bang/2014 for assessment year 2011-12, as sought for in this appeal and grant such other relief as deemed fit, in the interest of justice.

****

I.T.A.No.173/2017

Between:

1. The Pr. Commissioner of Income Tax(4)
BMTC Complex, Kormangala
Bangalore-560 001.

2. The Income Tax Officer
Ward-4(3)(3), Bangalore.

...Appellants

**(By Mr. E.R. Indrakumar, Sr. Counsel for
Mr. E.I. Sanmathi, Advocate)**

And:

M/s. Chamundi Winery and Distillery
1313, 9th Cross, 27th Main
1st Phase, J.P. Nagar, Bangalore-560 078
PAN No.AAEFC 3505C.

...Respondent

(By Mr. A. Shankar & Mr. M. Lava, Advocates)

****

This I.T.A. is filed under Section 260-A of Income Tax Act 1961, praying to: 1. decide the question of law and/or such other questions of law as may be formulate by the Hon'ble Court as deemed fit. 2. set aside the appellate order dated 16/09/2016 passed by the ITAT, 'C' Bench, Bengaluru, as sought for, in the respondent-assessee's case, in Appeal proceedings in ITA No.47/Bang/2016 for A.Y.2012-13 & etc.

I.T.A.No.172/2017

Between:

1. The Pr. Commissioner of Income Tax(4)
BMTC Complex, Kormangala
Bangalore-560 001.

2. The Income Tax Officer
Ward-4(3)(3), Bangalore.

...Appellants

**(By Mr. E.R. Indrakumar, Sr. Counsel for
Mr. E.I. Sanmathi, Advocate)**

And:

M/s. Chamundi Winery and Distillery
1313, 9th Cross, 27th Main
1st Phase, J.P. Nagar, Bangalore-560 078
PAN No.AAEFC 3505C.

...Respondent

(By Mr. A. Shankar & Mr. M. Lava, Advocates)

****

This I.T.A. is filed under Section 260-A of Income Tax Act 1961, praying to: 1. decide the foregoing question of law and/or such other questions of law as may be formulate by the Hon'ble Court as deemed fit. 2. set aside the appellate order dated 16/09/2016 passed by the ITAT, 'C' Bench, Bengaluru, as sought for, in the respondent-assessee's case, in Appeal proceedings in ITA No.46/Bang/2016 for A.Y.2008-09 & etc.

These I.T.As. having been heard and reserved on **21-08-2018,** coming on for Pronouncement of Judgment, this day, ***Dr Vineet Kothari, J***, delivered the following:

J U D G M E N T

Mr E.R. Indrakumar, Sr. Counsel for
Mr. E.I. Sanmathi, Adv. for Appellants - Revenue
Mr. A. Shankar, Mr. M. Lava. &
Mr. K. Kiran Kumar, Adv. for Respondent- Assessee

1. The Revenue has filed these five Appeals under **Section 260-A** of the **Income Tax Act, 1961** (**'Act'** for short) against the Respondent Assessee **m/S. CHAMUNDI WINERY AND DISTILLERY, BANGALORE** (hereinafter referred to as "**CHAMUNDI"** for short) for **A.Y.2008-09 to 2012-13** raising the Substantial Questions of law, which we have re-framed.

2. The Tribunal as well as the first Appellate Authority, Commissioner of Income Tax (Appeals) decided in favour of the Respondent Assessee that the "**Distributable Surplus"** paid by the Respondent Assessee **CHAMUNDI** to **DIAGEO INDIA PRIVATE LIMITED** (hereinafter referred to as '**DIAGEO'** for short), a subsidiary and Group Company of **DIAGEO Plc,** a United Kingdom based Liquor Conglomerate, was an

'allowable expenditure' in the hands of the Respondent Assessee under **Section 37** of the Act.

3. The following Substantial Questions of law do arise in the present set of appeals which we have reframed as below:-

[1] Whether the Tribunal was justified in holding that the Distributable Surplus paid by the Respondent Assessee ***M/s. CHAMUNDI WINERY AND DISTILLERY*** *to* ***DIAGEO INDIA PRIVATE LIMITED*** *in pursuance of the Agreement dated* ***30/10/2007*** *between these two parties was not 'application of income', but an 'allowable expenditure' in the hands of the Respondent Assessee under* ***Section 37*** *of the Act ?*

[ii] Whether the terms and conditions of the Agreement dated ***30/10/2007*** *between* ***M/S. CHAMUNDI WINERY AND DISTILLERY***

and ***DIAGEO INDIA PRIVATE LIMITED*** *amount to 'Diversion of Income at source by over riding title' in favour of* ***DIAGEO INDIA PRIVATE LIMITED*** *even though the Excise Licence under the provisions of the* ***Karnataka Excise Act, 1965*** *during the relevant period was taken in the name of Respondent Assessee* ***CHAMUNDI*** *and therefore, such profits and gains from the said business of manufacture and sale of liquor by* ***M/S. CHAMUNDI WINERY AND DISTILLERY*** *was not assessable in its hands ?*

[iii] Whether the method of Accounting or entries made in the Books of Accounts by the Respondent Assessee or maintaining the Bank Accounts under the close control and supervision of ***DIAGEO INDIA PRIVATE***

LIMITED *will determine the taxability of business income in the hands of* ***DIAGEO INDIA PRIVATE LIMITED*** *who under the said Agreement dated* ***30/10/2007*** *supplied the Working Capital, Raw Materials and concentrates and right of user of Trade Marks and Brands to the Respondent Assessee on whether the income earned out of the said liquor business will still be taxable in the hands of the Respondent Assessee* ***CHAMUNDI*** *?*

4. The brief factual matrix of the case is as under:-

5. The Assessing Authority in the first instance in all these five Assessment Years, **A.Y.2008-09 to 2012-13,** disallowed the said "Distributable Surplus" paid by the Respondent Assessee **CHAMUNDI** to **DIAGEO** under

Section 37 of the Act and also held that the said income earned out of manufacture and sale of liquor by the Respondent Assessee which held the Excise Licence from the State Government, which has the monopoly and exclusive privilege of carrying on the trade of liquor and gives only licences under the provisions of the Karnataka Excise Act to certain persons upon the terms and conditions stipulated in the Licence under the said Act and there is no 'diversion of such income' from the Respondent Assessee **CHAMUNDI** to **DIAGEO** by overriding title and the Respondent Assessee **CHAMUNDI** has to meet its Income-Tax obligations under the Act before applying the net income after tax in meeting its contractual obligations under the Agreement dated **30/10/2007** with **DIAGEO.**

6. The first Appellate Authority however, allowed the Appeal of the Assessee **CHAMUNDI** and the Revenue's second Appeal before the Income Tax

Appellate Tribunal also failed and hence, the Revenue has preferred these Appeals before this Court under **Section 260-A** of the Act, raising the substantial questions of Law.

7. The crux of the matter revolves round the Terms of the Conditions of the Agreement dated **30/10/2007** and therefore, a brief extraction of the relevant terms and conditions and its background are necessary to understand as the said Agreement has held the field throughout the aforesaid five Assessment Years. The **DIAGEO** is a Subsidiary and Group Company of **DIAGEO Plc.,** a UK based Corporate entity and it owns several Trade Marks and Brands specified in the Schedule III of the said Agreement and the popular amongst them are SMIRNOFF (Vodka), VAT 69 (Scotch Whisky), CAPTAIN MORGAN (Rum), SMIRNOFF ORANGE TWIST (Vodka), SHARK TOOTH(Vodka) and HAIG GOLD LABEL (Scotch Whisky) and the Preamble

of the said Agreement dated **30/10/2007** is quoted below:-

"WHEREAS:

A. DIAGEO INDIA *is engaged inter alia in the manufacture and marketing of alcoholic beverages and* ***is a subsidiary of Diageo Plc.***

B. DIAGEO INDIA *has valid and subsisting* ***licence agreements with the respective Brand Owners of the Products*** *listed in Schedule III to use the trade marks and reproduce the copyright works in India on the labels, caps of bottles, Packaging Materials and other support materials in respect of the Products to be manufactured and or bottled in India.*

C. CHAMUNDI *is engaged in* ***the manufacture, bottling and labeling of alcoholic beverages*** *and had expressed its desire of carrying out manufacturing of the Products at its Plant at 56, Chollapanahalli Village, B C Road, Hoskote Taluka, Bangalore Rural District.*

D. CHAMUNDI *has represented to* ***DIAGEO INDIA*** *that it has a fully operational Plant and has all requisite consents and facilities to manufacture the Products at the Plant.*

E. CHAMUNDI has agreed to manufacture and sell the Products under control and supervision of DIAGEO INDIA *for the period and subject to the terms and conditions hereinafter recorded.*

F. *The Parties acknowledge and confirm that each Party will undertake its responsibilities as clearly defined herein. Therefore,* ***nothing in this arrangement*** *shall be construed as either Party has representative rights for the other Party or one Party acts* ***as an agent*** *of the other Party or one Party grants any licence or right, for whatsoever, in favour of the other Party. Further, there should not be any claim or obligation of one Party on the other Party with respect to anything herein mentioned except for the specific claims provided hereunder.*

G. *The parties acknowledge that* ***they will be independently responsible*** *for their profits and losses, if any under this Agreement.* ***CHAMUNDI*** *is entitled to receive certain amount subject to fulfilling its obligations under this Agreement while* ***DIAGEO INDIA*** *would mainly undertake major risks and rewards under this Agreement. However, there is no intention to carry on any business in common or to earn income jointly.* ***CHAMUNDI*** *would carry out its obligations under the direction and supervision of* ***DIAGEO INDIA*** *as specified in this Agreement.*

H. *Each Party hereby acknowledges that it would continue to operate in its own capacity and the* ***Agreement does not constitute a partnership or joint venture*** *between the Parties."*

8. The said Agreement therefore, clearly rules out the Contract between the parties to be that of a Partnership, Agency or even a Quasi partnership

because, the concept of mutuality is specifically negatived in the said Agreement.

9. The relevant Parties' Obligations contained in para 3 of the said Agreement to the relevant extent are also quoted below for ready reference:-

> ***"3. PARTIES' OBLIGATIONS***
>
> ***3.1 CHAMUNDI*** *shall primarily be responsible for providing* ***manufacturing facility, raising purchase orders, supplying and delivering the Products as per Delivery Orders, completing excise formalities*** *in relation to import of Raw Materials and despatches of the Products, obtaining necessary approval from the requisites authorities, raising necessary invoice in respect of sales effected, making Sales Tax/VAT payments, making payments of all other expenses relating to the manufacturing of the Products, as per the directions of* ***DIAGEO INDIA.***

3.2 ***DIAGEO INDIA*** *shall procure orders for the Products from the distributors.* ***DIAGEO INDIA*** *shall submit to* ***CHAMUNDI*** *a Delivery Order for delivery of the Products by* ***CHAMUNDI*** *directly to the distributor as mentioned on Delivery Order.* ***CHAMUNDI*** *shall package the Products using the Packaging Materials purchased in accordance with* ***DIAGEO INDIA's*** *instructions/specifications and regulations of the appropriate Governmental Authority.* ***DIAGEO INDIA*** *would take all the commercial decisions with regard to selling price of the Products and communicate to* ***CHAMUNDI.*** ***CHAMUNDI*** *shall supply and deliver the Products on the Date of Delivery by loading the Products on to the transport vehicles at the Plant and raise its invoice, at the selling price communicated by* ***DIAGEO INDIA****, on the distributors for the Products so delivered. It is expressly clarified and*

*reiterated that **CHAMUNDI** is dispatching the Products at the direction of **DIAGEO INDIA** and **CHAMUNDI** undertakes not to dispatch the Products without written authorisation from **DIAGEO INDIA.**"*

10. The responsibilities of **DIAGEO** to provide the Working Capital, Raw Materials and to take important commercial decisions about the quality, quantity, price, delivery schedule, etc. as given in para 7.1 with no right to **CHAMUNDI WINERY AND DISTILLERY** to use the Intellectual Property of **DIAGEO** are also quoted below for ready reference:-

"7. DIAGEO INDIA RESPOSIBILITIES

*7.1 **DIAGEO INDIA** shall be responsible for:*

(i) Providing working capital as outlined in Clause 15 below;

(ii) Identifying the suppliers for Raw Materials, Packaging Materials and commercial decisions as to quality,

quantity, price, delivery schedule, etc.;

(iii) Identifying appropriate insurance company, type of insurance, quantum of insurance coverage, etc. and obtaining insurance in the name of ***CHAMUNDI*** *with* ***DIAGEO INDIA****'s beneficial interest;*

(iv) Procurement of sales order from the distributors;

(v) Appointment of sales force and other administration staff;

(vi) Carrying out marketing and sales promotion activities.

8. NO RIGHT TO USE INTELLECTUAL PROPERTY

8.1 ***CHAMUNDI*** *acknowledges that the members of the Diageo Group which are listed as the brand owners of the Products in Schedule III are at the date of this Agreement the sole proprietors of the trade marks, copyright works and other intellectual property rights relating to their respective Products, and* ***DIAGEO INDIA, being a***

member of the Diageo Group, is the authorised licensee and user of such trade marks, copyright works and other intellectual property rights in India. ***CHAMUNDI*** *agrees that nothing in this Agreement shall give it any right, title, claim or interest in or to the trade marks, copyright works or any other intellectual property rights relating to the Products and there is no transfer by* ***DIAGEO INDIA*** *of any right whatsoever."*

11. Para 9 of the Agreement enjoins upon **CHAMUNDI WINERY AND DISTILLERY** to obtain all Licences and Consents required under the Statutes at its own cost and expenses.

Clause 9 is also quoted below for ready reference:-

"9. LICENSES AND CONSENTS

CHAMUNDI *shall, at its own cost and expense be responsible for all Consents necessary for the Manufacturing, storage and delivery of the Products and shall also renew and keep valid all such Consents at its own*

cost from time to time. ***CHAMUNDI shall also be responsible for the timely and full payment of annual licence fees*** *as may be levied or imposed from time to time, by the Governmental Authorities under the relevant Karnataka State Excise Rules for manufacture of liquor products.* ***CHAMUNDI*** *shall prompt proof of all payments made in respect of Consents, including any annual licence fees."*

12. Para 15 of the Agreement makes DIAGEO responsible for providing Working Capital Finances for Operations envisaged in the said Agreement and the Bank Accounts to be operated by the persons duly authorised by the DIAGEO**.** The most important **Clauses 16 and 17** providing for Distribution of Revenues between the two parties to the said Agreement are also quoted below for ready reference:-

"15. WORKING CAPITAL FINANCES

15.1 DIAGEO INDIA *shall be responsible for providing* ***working capital finance*** *for*

operations envisaged in this Agreement and ***CHAMUNDI*** *shall open a separate bank account(s) in* ***CHAMUNDI's*** *name for the purpose of this Agreement. The bank account(s) shall be operated jointly by any two* ***DIAGEO INDIA*** *representatives as may be intimated to* ***CHAMUNDI*** *in writing. The bank account(s) will be used for working capital requirements of* ***CHAMUNDI. DIAGEO INDIA shall ensure that sufficient funds are available in this account especially at the time of issuing cheques.***

The said bank account(s) shall be used for:

(a) the payment for all ***Raw Materials*** *and Packaging Materials purchased for the purposes of this Agreement as set out in Clause 4.1;*

(b) the payment of ***excise duties,*** *sales taxes and excise adhesive labels in relation to Products sold by* ***CHAMUNDI****;*

(c) ***transportation costs*** *in relation to Products despatched by* ***CHAMUNDI*** *in accordance with Clause 3.6;*

(d) ***insurances*** *required to be maintained by* ***DIAGEO INDIA*** *pursuant to Clause 5.2; and*

(e) such other costs as ***DIAGEO INDIA*** *may require to be paid from such account(s).*

All monies received from the distributors in respect of Products, delivered and invoiced by ***CHAMUNDI*** *or Raw Materials and Packaging Materials sold pursuant to Clause 3.10 or scrap sold pursuant to Clause 14.2 shall be paid into the accounts.* ***DIAGEO INDIA shall be entitled to have transferred out to itself any surplus balance from time to time into these account(s).***

15.2 ***CHAMUNDI*** *shall not create any Encumbrances on any Raw Materials or Packaging Materials purchased with the working capital financed by* ***DIAGEO INDIA****.*

CHAMUNDI *shall provide* ***DIAGEO INDIA*** *an annual certificate from its bankers to this effect.*

15.3 In this regard, ***CHAMUNDI*** *represents warrants and undertakes that:*

a) the said bank account(s) shall not be operated by any persons other than nominated by ***DIAGEO INDIA****.*

b) No resolution will be passed changing the approved authorised signatories without ***DIAGEO INDIA's*** *prior approval in writing.*

15.4 In this regard ***DIAGEO INDIA*** *and the persons nominated by* ***DIAGEO INDIA*** *for the operations of the bank accounts shall be responsible for the conduct of the bank accounts including the violations under the Negotiable Instrument Act, 1881, if any.*

16. CHAMUNDI ENTITLEMENTS

16.1 CHAMUNDI *shall be entitled for a sum of* ***Rs.45 per Case produced*** *as a* ***consideration for its manufacturing obligations under this Agreement.***

16.2 The sums as mentioned in Clause 16.1 shall remain in force for the period upto 31st May, 2010 unless otherwise mutually agreed by the Parties.

16.3 ***DIAGEO INDIA guarantees*** *the minimum volume of* ***15,000 cases per month*** *for the Products.*

17. DIAGEO INDIA'S ENTITLEMENTS

17.1 ***DIAGEO INDIA*** *entitlements under this Agreement shall be calculated on the following basis:*

a) Gross Sales (On the basis of sales invoices raised)

	Gross Sales as determined in (a) above	*xxx*
Less	*Excise duty*	*xxx*
	Sales Tax/VAT	*xxx*
	Cost of Excise Adhesive labels	*xxx*
	Cost of all Raw Materials and Packaging Materials (including the wastages as per norms provided in clause 12 above) used in the Manufacturing of the Products;	*xxx*
	Distribution cost including freight, transit, insurance, bond/depot charges incurred by ***CHAMUNDI*** *in respect of the Products;*	*xxx*
	Any other expenses (including debts written off) if and when agreed upon by ***DIAGEO INDIA*** *in writing as deductible;*	*xxx*
	Balance before the sum as entitled under Clause 16	*xxx*
Less	*The sum as entitled under Clause-16.*	*xxx*
	DIAGEO INDIA Entitlements	*xxx*

*17.2 If **CHAMUNDI** is unable to produce and service the Delivery Orders, **CHAMUNDI shall compensate DIAGEO INDIA for a sum equal to the Gross Contribution lost on account of such failure.** For this purpose, "**Gross Contribution**" means the difference between the then current selling price of the Products and the cost of Raw Materials and Packaging Materials in relation to the quantity not delivered timeously by **CHAMUNDI**. It is agreed to between the Parties that the Gross Contribution is a pre-estimate of genuine liquidated damages and is not by way of penalty. Additionally, in the event the various state excise permits have to be sent for revalidation due to failure on the part of **CHAMUNDI** to deliver the Products in accordance with the permit, then **CHAMUNDI** shall be liable to compensate **DIAGEO INDIA** the cost of such revalidation. However, if due to Force Majeure or reasons attributable to*

DIAGEO INDIA *(like delayed supply of raw or packing material)* ***CHAMUNDI*** *is unable to produce/service the orders, then* ***CHAMUNDI*** *would not be liable to compensate* ***DIAGEO INDIA****.*

17.3 Compensation as per Clause 17.2 shall be paid by ***CHAMUNDI*** *to* ***DIAGEO INDIA*** *within 30 days of intimation by* ***DIAGEO INDIA*** *to* ***CHAMUNDI****.*

17.4 The statement of entitlements shall be computed on a financial year of April 1-March 31 basis each year with both the Parties signing off the statement as a proof of agreement and the account will be settled within three months from the close of that financial year.

17.5 ***CHAMUNDI*** *shall:*

a) Keep true and accurate records of all necessary for the ***computation of DIAGEO INDIA Entitlements*** *and submit to* ***DIAGEO INDIA every month*** *a statement of computation of* ***DIAGEO INDIA*** *Entitlements;*

*b) Supply **DIAGEO INDIA** at the time of making such payments with a statement in writing showing the number of cases of the products sold by **CHAMUNDI** during the accounting period in respect of which such income has accrued;*

*c) Permit a representative/auditors of **DIAGEO INDIA** from time to time and at reasonable times to inspect at **DIAGEO INDIA**'s expenses the records referred above and for the purpose of verifying the accuracy of such reports to inspect any other pertinent records, documents or books of accounts kept by **CHAMUNDI**;*

*d) Prepare various reports and to submit the same within the stipulated time periods as required by **DIAGEO INDIA** from time to time;*

e) Be responsible for engaging/ providing staff at their cost for providing the above information/reports and including maintenance of book of

accounts related to ***DIAGEO INDIA*** *operations."*

13. **Clause 24** of the Agreement under the heading "Miscellaneous" *inter alia* provides for each Party to bear its own Income-Tax and other Tax liabilities. **Clause 24.2** clearly stipulates that it is neither a Partnership nor a Joint Venture between the two Parties. **Clause 24.3** allows DIAGEO to assign its benefits and burden under the said Agreement to any Third Party, however, **CHAMUNDI WINERY AND DISTILLERY** shall not assign either the benefit or the burden under the said Agreement to any Third Party without any prior consent of the DIAGEO**.**

14. The said relevant Clauses of the Agreement are also quoted below for ready reference:-

"24. MISCELLANEOUS

24.1 Costs & Expenses

a) ***Each Party agrees that it shall bear*** *its own costs and expenses incurred by it in connection with any discussions,*

negotiations, investigations and due diligence undertaken in connection with the project, including costs and expenses associated with retention of financial, legal, tax and other professional advisers.

b) ***Each Party shall bear its own income tax and other tax liabilities.*** ***DIAGEO INDIA*** *shall ensure that sufficient bank balance is maintained to discharge sales tax/VAT liability. However, should there be any tax liability incurred by* ***CHAMUNDI*** *as a direct result of* ***DIAGEO INDIA*** *failing to perform any of its obligations under this Agreement,* ***DIAGEO INDIA*** *shall be liable to the extent of such tax liability actually incurred by CHAMUDI, provided that* ***CHAMUNDI*** *establishes to the reasonable satisfaction of* ***DIAGEO INDIA*** *the actual amount paid by* ***CHAMUNDI*** *towards satisfaction of such tax liability.*

24.2 No Partnership/Joint Venture

a) Nothing in this agreement shall be deemed to constitute ***CHAMUNDI*** *as partner, or a joint venture or a legal representative of* ***DIAGEO***

***INDIA**, or to create any fiduciary relationship between **CHAMUNDI** and **DIAGEO INDIA**. Both Parties acknowledge that they are personally and not jointly liable in respect of their obligations under the agreement.*

24.3 Assignment

*The benefit and burden under this Agreement shall be fully assignable and transferable by **DIAGEO INDIA** to any Third Party. However, **CHAMUNDI** shall not assign either the benefit or burden under the agreement to any Third Party without the prior written consent of **DIAGEO INDIA**."*

15. In the perspective of the aforesaid Agreement, it would be appropriate to first discuss the findings in brief of all the three Authorities below.

FINDINGS OF THE ASSESSING AUTHORITY:

16. For **A.Y.2010-11,** the Assessing Authority in the Assessment Order dated **31/03/2013** under **Section 143(3)** of the Act, held as under:-

*"As evident from the above clause 3.1 the company M/s **DIAGEO INDIA** is holding M/s*

CHAMUNDI *Winery and Distillery to carry out* ***all activities of the business that include manufacture purchases, sales, dispatches approval from authorities and to make sale tax and VAT payments.*** *By this it is very clear that the business carried out by the assessee firm is recognized in hands of the firm itself. The firm has complied to its statutory obligation by paying the excise duty to confirm its role as an assessee.*

3.9 *The firm M/s* ***CHAMUNDI*** *is the assessee for Sales tax/VAT purposes, then for all other purposes involving statutory obligation such as income-tax, the same firm is responsible. Initially the assessee during the course of assessment proceedings took a stand that the payment made to M/s Diageo was covered u/s.60 of the Income-tax Act, 1961. But it was brought to its notice that the* ***nature of business as discussed in detail already does not permit any creation of charge by over riding title for diversion of income.*** *The state excise department is*

the licensing authority to allow anybody to create a charge or indulge in liquor business. ***Hence the expenditure claimed is only an application of income and could not be allowed as deductible expense.***

3.10 *As evident from the above clause 15 of the said agreement the* ***working capital finance*** *was to be adequately made available by M/s Diageo. If this was the case* ***the assessee could have booked finance charges or interest charges*** *on the working capital and debit the same to the P & L account.* ***Instead the assessee has transferred the profit of the business in the form of distributable surplus to the company M/s Diageo*** *which is unacceptable* ***since no parties can enter into an agreement to alienate their tax obligation from profit of the licensed and permitted business*** *since tax is an integral part of the business.*

3.11 *In his submission vide para 2.1. assessee states that manufacturing operations, are supervised by personnel of*

brand owners, who are stationed in the distillery and if that were to be the case the assessee could have booked supervision charges in the P & L account. The Brands of the liquor manufacturer belonged to M/s Diageo, ***then the assessee could have booked royalty or technical knowhow fees.*** *Since* ***the excise Department granted the license to M/s CHAMUNDI Winery and Distillery and the entire business has been carried out duly by*** *booking sales and purchases in its name and now to* ***claim the business does not belong to it, is totally unacceptable.*** *The surplus transferred is nothing but the profit of M/s* ***CHAMUNDI*** *and this firm* ***is free to transfer the surplus after taxation but not before the charge to tax.***

3.12 *The Clause 17 of the agreement dated 30.10.2007 entered into by M/s* ***CHAMUNDI*** *and M/s Diageo to separate the element of profit from the business is not acceptable since tax is an integral part of business and the* ***discretion to alienate statutory***

obligation is not available to these parties. *Hence the stand of the firm M/s* ***CHAMUNDI*** *to run a licensed business but to take away the surplus or profit away without making itself liable to income-tax is wrong and unacceptable. At the same time there is no justification to allow the surplus to be transferred out of the business under the pretext of expenditure since this expenditure is not incurred by the assessee wholly and exclusively for the purpose of business.*

4. Conclusion:

In view of the discussion made in the para 3, ***I hold that expenditure claim under the head distributable surplus is only an application of income of the assessee.*** *As per the return of income, the amount of expenditure claimed under the head distributor's surplus is of* ***Rs.31,75,95,815/- and this claim is discussed above is disallowed.*** *Hence an amount of Rs.31,75,95,815/- is brought to tax.*

5 *Penalty proceedings u/s.271(1)(c) for concealment of particulars of income is separately initiated."*

COMMISSIONER OF INCOME TAX (APPEALS):

17. The Commissioner of Income Tax (Appeals) however, allowed the Appeal of the Assessee with the following observations:-

"3.3 I have carefully considered the appellant's submissions and also perused the assessment order. I find that a similar issue was involved in the appellant's own case for the assessment year 2009-10 wherein the appellant had claimed deduction in respect of transfer of distributable surplus amounting to Rs.30,51,18,500/-. The AO, who had made the assessment for that assessment year, had disallowed the appellant's claim for deduction of the amount as distributable surplus and treated the same as the appellant's income. The appellant had filed an appeal against the said assessment order. ***My predecessor vide*** *appellate order in ITA.No.795/W-4(3)/CIT(A)-II/11-12 dated*

23/8/2012 had confirmed the AO's action in treating the said amount as the appellant's income and dismissed the appellant's appeal. *The appellant went in appeal to the Hon'ble ITAT, Bangalore against the said appellate order. By its order in ITA.No.1260/Bang/ 2012 dated 5/4/2013,* ***the Hon'ble ITAT, Bangalore Bench 'C' allowed the appellant's claim,*** *holding that the distributable surplus cannot be considered as application of income but an expenditure incurred by the appellant in the course of its business and allowable u/s 37 of the Act. The relevant passages from the said decision are reproduced below:*

> *"5.3.3 In this factual matrix of the matter, as discussed above,* ***we are of the considered opinion that the example of theatre business cited by the learned counsel for the assessee is quite appropriate and applicable in*** *understanding the true nature of the transactions entered into by the assessee and Diageo by virtue of*

Agreement dt.30.10.2007. *From an application of the totality of the facts and circumstances of the case, we are of the view that the distributable surplus paid by the assessee in terms of clause 17 of the said Agreement is nothing but the amounts to which Diageo is entitled to receive over the expenses to be borne by them, leaving behind the real income to which the assessee is entitled to in accordance with the relevant clauses of the governing agreements and therefore cannot be disallowed on the ground that the same is to be considered as application of income. We hold that it is expenditure incurred in the course of business and therefore allowable under section 37 of the Act.*

5.4 The above aspect of the matter can also be viewed from another angle. Though as per the ***Agreement dt.30.10.2007, the assessee undertook to raise sale invoices in***

its name, it is not entitled to the said sale proceeds as the same is deposited in the designated bank account supervised and operated by authorized personnel of Diageo. *The funds in the said bank account are required to be utilized for making various payments like purchase of raw materials, payment of Excise Duty and payment of bottling charges to the assessee in terms of the said agreement. Thus the surplus in terms of clause 17 of the said Agreement may either be a profit or a loss depending on the extent of sales and the expenses incurred in the business operation. Assuming that there is a loss that is incurred or arrived at in terms of the formula under the said agreement, Diageo will have already provided the working capital for running the operations and would not be entitled to any entitlement for that year. The assessee, however, cannot claim that*

the loss incurred in business will have to be set off against the bottling charges of Rs.45 per Case to which it is legitimately entitled under clause 16 of the said agreement. Thus, viewed from any angle, ***the distributable surplus, to which Diageo is entitled to as per the said agreement, cannot be considered as application of income. Rather, it is a case of expenditure*** *incurred by the assessee in the course of its business which is* ***allowable under section 37 of the Act.*** *In this view of the matter, we hold that the addition/disallowance of the surplus transfer of Rs.30,51,18,500 is not sustainable in law and on facts of the case and accordingly delete the same....”*

3.4 The facts in the appeal under consideration are similar in all respects to those in the appeal for the assessment year 2009-10. ***Respectfully following the decision of the Hon’ble ITAT,*** *Bangalore*

Bench 'C' for the assessment year 2009-10 in the appellant's own case, ***I hold that the distributable surplus amounting to*** *Rs.31,75,95,820/- to which M/s* ***DIAGEO INDIA*** *Pvt. Ltd.* ***is entitled as per the agreement*** *dated 30/10/2007* ***cannot be considered as application of income*** *by the appellant but constitutes expenditure incurred by it in the course of its business allowable u/s 37 of the Act. Accordingly,* ***I delete the disallowance of Rs.31,75,95,820/- made by the AO."***

18. The second appeal filed by the Revenue before the learned Income Tax Appellate Tribunal (ITAT) also came to be dismissed on **26/08/2015** in favour of the Respondent Assessee with the following observations:-

"It is clear from the above grounds that Revenue is aggrieved on the CIT (A) placing reliance on Tribunal's order in assessee's own case for A.Y.2009-10.

02. Issue involved is a claim of Rs.31,75,95,820/- by the assessee as payment to M/s. ***DIAGEO INDIA*** *Pvt.Ltd. Payment was effected by the assessee pursuance to an agreement under which assessee was manufacturing and bottling liquor under the brand names of the said company. As per the AO, it was only utlisation of surplus of the assessee since assessee was billing for the sales in its books of account and the turnover was accounted for by it in full. Similar disallowance was there for A.Y.2009-10 also. In the said year, assessee had moved in appeal before the CIT (A) against such disallowance which was allowed by CIT(A).*

03. Aggrieved by the CIT (A)'s decision, Revenue had moved in appeal before this Tribunal and this Tribunal in ITA.1260/Bang/2012, dt.05.04.2013, for A.Y.2009-10 had held as under:

> *(para 5.3.3. & para 5.4 of ITAT order already quoted above as an extract in the Order of the CIT (Appeals) hence not quoted again)*

Thus what we find is that CIT (A) had followed only the directions of the Tribunal for A.Y.2009-10. Fact-situation was the very same for the impugned assessment year also. We, therefore, do not find any merit in the appeal filed by the Revenue.

04. In the result, appeal of the Revenue stands dismissed."

19. We have heard the learned counsels at length on both sides and have considered the large number of case laws cited by both the sides and before coming to the discussion thereon, the contentions of both the sides may be noted as below:-

CONTENTIONS OF THE APPELLANT – REVENUE:

20. The learned counsel for the appellant – Revenue, Mr. E.R. Indra Kumar, Senior Counsel appearing for Mr. E.I. Sanmathi made the following submissions:-

[I] That since the Respondent **CHAMUNDI** is doing the entire manufacturing and sale of Liquor under

the exclusive Licence given to it by the State Excise Department under the provisions of the **Karnataka Excise Act, 1965**, even though with the Brands and Labels were issued by the **DIAGEO** and it also manufactures its own Brand OXYGEN (which is not a Brand of **DIAGEO)** under the same Excise Licence therefore, the entire business profits earned out of the said business activity of the manufacture and sale would be taxable as the real income of the Respondent Assessee **CHAMUNDI** and it is not assessable merely to the extent of Bottling charges of **`45/- per Case** received by it under the aforesaid Agreement dated **30/10/2007.**

[II] The learned Senior Counsel for the Revenue submitted that the source of Business Income in the present case is Manufacture and Sale of Liquor which is a restricted business activity and **DIAGEO** does not hold any Excise Licence under the said Excise Act, 1965

and therefore by a mutual arrangement or Agreement between the parties, the income taxable in the hands of the Respondent Assessee **CHAMUNDI** could not be made over to the **DIAGEO** without being first brought to tax under the provisions of the Income Tax Act, 1961.

[III] The learned counsel for the Revenue submitted that for providing the Working Capital Finances by the **DIAGEO** and allowing the Respondent Assessee **CHAMUNDI** to use its Brands whatever could be payable as interest to the financier or as Royalty charges for using such Brands and Trade Marks could only to be allowed as business expenses in the hands of the Respondent Assessee **CHAMUNDI,** but the whole of the profit earned by **CHAMUNDI** during the relevant period from the liquor manufacture and sale under the Excise Licence could not be assessed in the hands of **DIAGEO.**

[IV] The learned counsel for the Revenue, Mr. Indra kumar has also submitted that there is no 'Diversion of Income' from **CHAMUNDI** to **DIAGEO** by overriding title in favour of **DIAGEO** and such private arrangements are nothing but Tax Avoidance and Tax Evasion tactics and the Respondent Assessee could not avoid its Income-Tax liability by claiming that it is only doing job work of Bottling of liquor manufactured for and on behalf of the **DIAGEO** and its entire profits belong to **DIAGEO.**

[V] He submitted that even though such profits or 'distributable surplus' paid by **CHAMUNDI** to **DIAGEO** might have been taxed in the hands of **DIAGEO** within India itself, subject to claim of expenses or deductions claimed in its own hands with which we are not concerned presently, it would not affect the taxable character of income in the hands of the Respondent

Assessee **CHAMUNDI** and the same cannot be said to be double taxation.

[VI] The learned counsel for the Appellant Revenue submitted that the Respondent Assessee **CHAMUNDI** is neither the Agent of the **DIAGEO** nor a sub-Partner nor it is the case of assignment of any interest by a Partner in favour of another party, as is clear in the Agreement dated **30/10/2007** itself and therefore, the tax obligations of Respondent Assessee in respect of its income earned out of whole activity of manufacture and sale of liquor cannot be avoided and shifted on to **DIAGEO.**

[VII] He submitted under the provisions of the Karnataka Excise Act, the entire liquor manufactured by the licencee has to be sold exclusively to **Karnataka State Beverage Corporation Limited (KSBCL)** with which **DIAGEO** has no privity of Contract and only the Respondent Assessee **CHAMUNDI** is liable to sell the

entire liquor manufactured by it to KSBCL and it receives all payments from KSBCL against such sale of liquor and therefore, the profits arising out of such sale have to be taxed as 'real income' of the Respondent Assessee, irrespective of the fact whether it is charging bottling charges to the extent of **`45 per Case** as per the said Agreement dated **30/10/2007** and over and above that, the entire surplus has to be made over to **DIAGEO** but which is nothing but 'application of its income' and which can be made only after meeting its own income tax liability in respect of the entire Business Profit for the year in question.

[VIII] He submitted that unless the Respondent Assessee cannot be said to have a right to receive such income before it reaches **DIAGEO**, and which is not the case here, the entire income is liable to be taxed in the hands of the Respondent Assessee and by a colourable device adopted by these two parties, the liability of

payment of Income-Tax in the hands of the Respondent Assessee cannot be avoided.

[IX] Regarding the allowability of the said 'distributable surplus' paid by the Respondent Assessee **CHAMUNDI0** to DIAGEO under **Section 37** of the Act, the learned counsel for the Revenue submitted that there is no question of the same being allowed as an expenditure in the hands of the Respondent Assessee as it is not a business expenditure, but the 'distributable surplus' of the business which after payment of tax was required to be made over to the **DIAGEO** as per the terms of the contract and it is not a 'business expenditure' incurred by the Respondent Assessee **CHAMUNDI** to earn an income and therefore, **Section 37** of the Act simply does not get attracted in the present case and therefore, the Tribunal clearly erred in allowing the same as a 'business expenditure' under **Section 37** of the Act.

CONTENTIONS OF THE RESPONDENT – ASSESSEE:

21. On the other hand, Mr. A. Shankar, the learned counsel for the Respondent Assessee **CHAMUNDI** raised the following contentions before the Court.

[I] The learned counsel for the Respondent Assessee urged that the 'real assessable income' in the hands of the Assessee **CHAMUNDI** was only the bottling charges of **`45 per Case** and as per the Agreement dated **30/10/2007** and except the bottling charges, the Assessee was not entitled to receive anything in respect of the said manufacture and sale of liquor activity carried out by it wholly and exclusively for and on behalf of **DIAGEO,** who not only provided the Working Capital, Raw Materials, Brands and Trade Marks but also on day-to-day basis, all Receipts of sales by the **DIAGEO** as per the sale price were made over to **DIAGEO** and for meeting day-to-day operating

expenses, every day, the funds was to be received from **DIAGEO** out of which, the Assessee **CHAMUNDI** could meet its operating costs and meet the day-to-day administrative expenses. The Bank Accounts were not only maintained, though in the name of Assessee **CHAMUNDI** but could be operated only by the authorized signatories as nominated by **DIAGEO.**

He therefore submitted that except the Excise Licence being in the name of the Assessee **CHAMUNDI,** the entire business activity was governed and controlled by **DIAGEO** under the said Business Agreement dated **30/10/2007** which is not only perfectly legal and a valid Agreement in the eye of law but has an over riding impact and therefore the entire income from the said manufacturing business belonged to DIAGEO and Respondent Assessee **CHAMUNDI** was only earning its Bottling charges for the job work of bottling at the rate of **`45/- per Case** and which income has been duly

offered for taxation in the Income Tax Return filed by the Assessee with due payment of tax thereon.

[II] He also submitted that the surplus of the said business paid by the Assessee to **DIAGEO** has already been offered to taxation by **DIAGEO** and due tax is paid by it and therefore the same income cannot be doubly taxed in the hands of the Assessee **CHAMUNDI** also.

[III] Mr. Shankar further argued that the 'distributable surplus' of the said business which was closely monitored on day-to-day basis by **DIAGEO**, not only amounted to 'diversion of income' in favour of **DIAGEO** by overriding title at source and therefore, the said income could not be taxed in the hands of the Respondent Assessee and it is not a case of mere 'application of income' by the Assessee but a 'diversion at source' and therefore the Assessing Authority had erred in imposing tax in the hands of the Assessee on the entire gross receipts of such business other than

mere bottling charges in the hands of the Respondent Assessee and the ITAT was right in holding in favour of the Respondent Assessee **CHAMUNDI**.

[IV] The learned counsel for the Respondent Assessee further argued that in the alternative, the entire 'distributable surplus' made over to **DIAGEO** should be allowed as 'business expenditure' in the hands of the Assessee because, in any case, the said amount was made over and paid to **DIAGEO** to meet the contractual obligations of the Assessee under the Agreement dated **30/10/2007** and **Section 37** of the Act permits such general deduction of any business expenditure incurred by the Assessee in meeting its contractual obligations under a legal, valid and enforceable contract.

[V] Mr. Shankar though fairly submitted that Books of Accounts, method of Accounting and entries in Books do not determine and decide the fate of taxability

of income in the hands of the Assessee, but in the present case, the day-to-day entries in the Books of Accounts maintained in the ordinary course of business by the Respondent Assessee clearly indicated that the Assessee in **Clause 17** of the Agreement was only entitled to bottling charges of **`45/- per Case** and nothing more and therefore there was no occasion for the Assessing Authority to tax the entire income or rather gross receipts of the business in the hands of the Assessee.

[VI] Lastly, Mr. Shankar also submitted that as an alternative, the said 'distributable surplus' paid to **DIAGEO** should be allowed as a 'trading loss' under **Sections 28/29** of the Act as the said money has not been retained by the Assessee nor it has accrued as savings to the Assessee and having lost that amount in favour of the **DIAGEO**, the same should be allowed as a

Trading loss while computing the business profits in **Chapter III** and **Sections 28/29** of the Act.

[VII] He relied upon several case laws in support of these contentions, which would be discussed at a later stage.

REASONS FOR OUR CONCLUSION:

22. Having heard the learned counsels at length and having given our earnest consideration to the rival contentions, the material placed on record and case laws, we find ourselves unable to agree with the submissions made by the learned counsel for the Assessee and we are of the considered opinion that the Income Tax Appellate Tribunal as well as the Commissioner of Income Tax (Appeals) fell in error while the Assessing Authority was justified in holding that the income derived out of the business of manufacture and sale of liquor under the Excise Licence obtained by the

Respondent Assessee was taxable in the hands of the Respondent Assessee **CHAMUNDI.**

23. There is no dispute in principle that only real income of the Assessee can be brought to tax under the provisions of the Income Tax Act, but what is real assessable income is an intricate mixed question of fact and law. The trade of liquor and its manufacture and sale is unlike any other trade or business in India. It is a monopoly of the State and the State Legislatures have framed separate excise enactments for control and regulating such business of its own monopoly and therefore, under the stringent and strict conditions the Excise lincences are issued upon payment of high privilege fees to the State to manufacture and sell liquor of various types.

24. Admittedly, the Assessee **CHAMUNDI** in the present case was the Excise Licencee under the provisions of the **Karnataka Excise Act, 1965** and

DIAGEO had no Excise Licence in its name from the State during the relevant assessment period. The business of manufacture and sale of liquor is closely controlled and regulated by the State Government including its storage, bottling, wastage, retail and wholesale sales thereof. The exclusive purchaser in the present case was a State Corporation, namely, KSBCL and therefore, such end to end control of the State Government under whose licence, the Respondent Assessee **CHAMUNDI** alone was to manufacture and sell the liquor, it cannot be said by any stretch of imagination that such a business was being done exclusively for and on behalf of the third party, viz. **DIAGEO,** who was not at all subject to any control under the Excise Act. The income or business profits taxable under the Income Tax Act, 1961 naturally arose out of the said business activity of manufacture and sale of liquor only. Merely because the **DIAGEO** is a

Brand owner and a big liquor business entity of United Kingdom, whose Indian Subsidiary, **DIAGEO** had a private arrangement or Agreement like the one under the Agreement dated **30/10/2007** with the Respondent Assessee and many other such Agreements with others and it provided not only right of user of Brands, Trademarks and Labels, but also provided some Raw Materials and concentrates and the Working Capital etc., and the Bank Accounts were to be operated by the Respondent Assessees were also closely monitored, it does not mean that the present Assessee was either only an agent or a benami of **DIAGEO.** For all practical and legal purposes, *de facto* and *de jure*, the Respondent Assessee was the Excise Licencee engaged in the business of manufacture and sale of liquor during the relevant period and must therefore account for its all profits subject to income tax during the relevant years.

25. The question therefore, that the '**distributable surplus'** arising out of that business which is liable to be paid or made over to **DIAGEO** by way of compensation or benefit to **DIAGEO** under the said Agreement is nothing but an **'application of income'** by **CHAMUNDI** and not a **'diversion of income at source by over riding title'** in favour of **DIAGEO.**

26. In our considered opinion, it is only '**application of income'** and not **'diversion of income'** by overriding title at source. The terms of the Agreement are very carefully crafted and intelligently drafted and they may at first blush give an impression of an overriding title over income in favour of **DIAGEO,** but on a closer and deeper scrutiny, it is nothing but a devious diversion, falling short of the legal prerequisites for taking it out of the ambit and charge of the Income Tax Act in the hands of the Respondent Assessee, **CHAMUNDI.**

27. The source of income as indicated above is the manufacture and sale of liquor under the Excise Licence, where **DIAGEO** has no *privity* or *locus*. Therefore, whatever income is generated out of the said business has to be first taxed in the hands of the Excise Licencee and after payment of the Income-tax, the '**distribution of surplus'** between the two parties, is their discretion and if the Assessee gets its share of total profits only to the extent of **`45/- per Case** in the name of bottling charges and **DIAGEO** takes the entire remaining balance as per **Clauses 16 and 17** of the Agreement dated **30/10/2007,** that distribution of surplus between the two parties to the contract has no effect and overriding impact on the taxability part of the entire income arising or accruing firstly, in the hands of the Respondent Assessee **CHAMUNDI** for the period in question.

28. We cannot appreciate the argument of the learned counsel for the Assessee that if it is not a case of **'diversion of income at source'**, it should be allowed as a '**business expenditure'** under **Section 37** of the Act or as a trading loss under **Section 29** of the Act.

29. In our opinion, the '**diversion of income at source'** and '**business expenditure**' under **Section 37** are contradiction in terms and both contradictory claims cannot be made by the Assessee even in the alternative. The **'diversion of income'** or rather 'distribution of surplus' under the Agreement dated **30/10/2007** required to be made by the Assessee **CHAMUNDI** to **DIAGEO** is only after the income is brought to tax in the hands of the Respondent Assessee and therefore the '**distributable surplus'** which the Assessee has debited in the Profit and Loss Account and credited to the Account of the **DIAGEO** for first four

Assessment Years, viz.**A.Y.2008-09 to 2011-12**, cannot be claimed as a '**business expenditure'** under **Section 37** of the Act. It is nothing but just the '**application of income'** by the Assessee under the Agreement dated **30/10/2007** of course which has to be done after payment of due tax under the Income Tax Act which has not been done by the Assessee in the present case.

30. For **A.Y. 2012-13,** the debit of 'Distributable Surplus' to Profit and Loss Account of the Assessee was not made because by change of Accounting method, in the Escrow Bank Account opened in the name of **DIAGEO** to which Receipts on Sales were automatically swiped and credited in their Bank Account and after the operating expenses paid out of it, the Assessee did not have to separately pay such 'Distributable Surplus' to **DIAGEO**. However, again the said change of Accounting Method, the diversion of Receipts to **DIAGEO** will not

escape the taxability in the hands of the Assessee **CHAMUNDI.**

31. The meeting of the contractual obligations by the Respondent Assessee under the said Agreement dated **30/10/2007** is not in the form of expenditure but day- to-day swipe of the Receipts from the business activity but that swipe of Receipts also does not amount to '**diversion of income by overriding title'** from **CHAMUNDI** to **DIAGEO.**

32. The charge of Income-tax on the income arising and accruing in the hands of the Respondent Assessee **CHAMUNDI** cannot be allowed to fail either by the manner of bank accounts to be operated or by the entries made in the Books of Accounts or the method of Accounting adopted by the two parties to the contract. Therefore, such '**distributable surplus'** made over by the Respondent Assessee **CHAMUNDI** to **DIAGEO** is neither an '**allowable expenditure**' under **Section 37** of

the Act nor a 'trade loss' allowable as a deduction in the hands of the Respondent Assessee **CHAMUNDI under Section 29 of the Act,** but is merely an '**application of income**' or the compensation paid by the Assessee to the **DIAGEO** in terms of the Agreement dated **30/10/2007.**

33. The two Appellate Authorities therefore clearly fell in error in not correctly, fully and comprehensively appreciating the legal effect of the peculiar nature of business under the State control and the effect of the Agreement in the given set of facts and circumstances of the case. The Tribunal was swayed by the terms of the said Contract, which are so intelligently drafted so as to give a make-believe impression that the Respondent Assessee is a mere job worker doing the bottling work only, whereas in the eyes of law, it being the exclusive Excise Licencee, was undertaking the entire business activity of manufacture and sale of liquor in its name

and ownership. It not only had Bank Accounts in its name, purchased raw materials from market, sold entire liquor to KSBCL and in open market under its own Invoices, collected all gross Sale Receipts, met the day-to-day expenses, met all sales tax, excise duty, VAT, labour charges, as its operating costs and therefore the entire business activity done by **CHAMUNDI** in the name of the Respondent Assessee **CHAMUNDI** itself, therefore, it could not be said to be giving rise to the profits taxable in the hands of the **DIAGEO.**

34. We make it clear that neither the Assessing Authority nor this Court is concerned about the manner in which **DIAGEO** has offered the Receipts of the said '**distributable surplus'** from **CHAMUNDI** for Indian Income Tax in its own hands, which of course was liable to tax for the net Receipts after being taxed in the hands of **CHAMUNDI.** Even otherwise an income taxable in the hands of the Assessee, could always be received

from a person who has paid tax on income in his hands **before** paying such amount to another person under the contractual obligations.

35. **DIAGEO** is admittedly a Subsidiary and Group Company of a UK based **DIAGEO Plc.** How much of its profits have been made subject to tax here in India, how much has been diverted to other Group Companies or Foreign Parent Company in UK, **DIAGEO Plc.** is neither before us nor is really relevant to decide the taxability in the hands of the Respondent Assessee **CHAMUNDI,** but if the income out of such a major liquor business is allowed to be diverted without being taxed in the hands of the Respondent Assessee, it could easily be a glaring case of **"Base Erosion and Profit Shifting**" by a Multi National Company. However we are not concerned with **Chapter X** of the Income Tax Act about the International Taxation and transactions of remittances to UK Company in the present case and

therefore, we are not going into the question of taxability in the hands of **DIAGEO** in the present case.

36. Now let us deal with the case laws cited by Revenue at the Bar for fortifying our conclusions and distinguishing those case laws which were heavily relied upon by the learned counsel for the Respondent – Assessee.

CASE LAWS RELIED UPON BY THE LEARNED COUNSEL APPEARING FOR THE REVENUE

37. In **Commissioner of Income Tax, Punjab, Himachal Pradesh and Bilaspur Vs. Thakar Das Bhargava [1960] 60 ITR 301 (SC),** the Hon'ble Supreme Court dealing with the case of a leading Advocate who reluctantly accepted to appear in a Criminal trial on the condition that the monies or Fees paid to him will be paid for a Charitable Trust created by him. Despite the fact that the Trust was so created out of the Fees received by him, the Hon'ble

Supreme Court held that the said Fees was first taxable in his hands as Professional Fees and there was no **'diversion of income by overriding title at source'.**

The relevant extract is quoted below for ready reference:-

> *" The assessee, an advocate, who had been originally reluctant, agreed to defend certain accused persons in a criminal trial, on condition that he would be provided with the sum of Rs.40,000 for a public charitable trust which he would create. When the trial was over the assessee was paid a sum of Rs.32,000 and he created a trust deed. The question was whether the sum of Rs.32,000 was the assessee's professional income:.*
> *Held, that on the facts,* ***the proper legal inference was that the sum of Rs.32,000 paid to the assessee was his professional income at the time when it was paid to him*** *and no trust or obligation in the nature of a trust was created at that time and when the assessee created a trust by executing the trust deed he applied part of his professional*

income as trust property. The desire on the part of the assessee to create a trust out of the moneys paid to him created no trust; nor did it give rise to any legally enforceable obligation. ***The sum of Rs.32,000 was taxable in the hands of the assessee. The rule in Bejoy Singh Dudhuria's case did not apply****."*

38. Further explaining the background in which the case was decided by the Appellate Authority, the Hon'ble Apex Court emphasized that unless the money paid was earmarked for charity *ab initio* once such amount was received as his Professional Income, it would be so taxable in his hands.

The relevant extract from the body of the judgment is also quoted below:-

"In the circumstances the Appellate Assistant Commissioner rightly pointed out that ***"if the accused persons had themselves resolved to create a charitable trust*** *in memory of the*

professional aid rendered to them by the appellant and had made the assessee trustee for the money so paid to him for that purpose, ***it could, perhaps, be argued that the money paid was earmarked for charity ab initio*** *but of this there was no indication any where." In our opinion, the view taken by the Appellate Assistant Commissioner was the correct view. The money when it was received by the assessee was his professional income, though the assessee had expressed a desire earlier to create a charitable trust out of the money when received by him. Once it is held that the amount was received as his professional income, the assessee is clearly liable to pay tax thereon. In our opinion, the correct answer to the question referred to the High Court is that the amount of Rs.32,500 received by the assessee was professional income taxable in his hands."*

39. In another judgment of **1960s** only, the Three Judges' Bench of the Hon'ble Supreme Court in **Provat Kumar Mitter Vs. Commissioner of Income Tax**

[1961] 41 ITR 624 (SC) dealing with the case of the Assessee, who by a written instrument assigned the Shares of a Company in favour of his wife, held that the Dividends received from such Shares would continue to be taxed in the hands of the Settlor-husband, since the Assessee merely applied his income, since he has entered into a legal obligation to apply it in that way, nonetheless the Dividends will remain his income. The Privy Council decision in the case of **Bejoy Singh Dudhuria Vs. Commissioner of Income-tax [1933]1 ITR135** was held to be not applicable.

The relevant extract of the said judgment is also quoted below for ready reference:-

> *"The assessee was a registered holder of 500 ordinary shares of a company. By a* ***written instrument, dated 19-1-1953 he assigned to his wife, the right, title and interest to all dividends and sums of money*** *which might be declared or might become due on account or in respect of those*

shares for the term of her natural life. However, ***under the terms of the instrument, the shares themselves remained the property of the assessee and it was only the income arising therefrom which was sought to be settled or assigned to his wife.***

During relevant previous year assessee's wife received dividends on those shares. In course of assessment, the ITO included dividend amount in the total income of assessee. Against the said inclusion, the assessee contended that since the settlement was for the lifetime of his wife, the third proviso to section 16(1)(c) applied and the dividend which his wife received could not be deemed to be his income under section 16(1)(c) and that in his case section 16(3) did not apply, because there was no transfer of the shares to his wife.

... ...

... ...

In this view of the matter, it is not necessary to decide the further question if a contract of this nature operates only as a contract to be performed in future which may be specifically enforced as soon as the property comes into existence or is a contract which fastens upon the property as soon as the property comes into existence or is a contract which fastens upon the property as soon as the settler acquires it. ***In either view, the incomes from the shares will first accrue to the settler before the beneficiary can get it. Such income will undoubtedly be assessable in the hands of the settler despite the contract.*** *We think that the true position is that if a person has alienated or assigned the source of his income so that it is no longer his, he may not be taxed upon the income arising after the assignment of the source, apart from special statutory provisions like section 16(1)c) or section 16(3) which artificially deem it to be the assignor's income. But if the assessee merely applies the income so that it passes*

through him and goes on to an ultimate purpose, even though he may have entered into a legal obligation to apply it in that way, it remains his income. This is exactly what has happened in the present case. We need only add that ***the principle laid down by the Privy Council in Bejoy Singh Dudhuria v. Commissioner of Income-tax [1993] 1 ITR 135 does not apply to this case;*** *because this is not a case of an allocation of a sum out of revenue before it becomes income in the hands of the assessee. In other words, this is not a case of diversion of income before it accrues but of application of income after it accrues."*

40. We feel this judgment applies on all fours to the case on hand, because here also, not only the Excise Licence and entire business is done in the name of the Assessee **CHAMUNDI** by itself, but only the income is sought to be assigned and transferred to

DIAGEO which will distract the Income-Tax liability in the hands of the Assessee.

41. The Hon'ble Supreme Court in **2003** in the case of **Commissioner of Income-Tax Vs. Sunil J. Kinariwala [2003] 259 ITR 10 (SC)** again succinctly dealt with the earlier case laws on the issue of '**Diversion of Income by over riding title at source'** and in a case where the Assessee, a partner in a Firm having **10%** share in the profits of the Firm, created a Trust by a Deed of Settlement assigning **50%** of his **10%** share of profits in favour of that Trust of which his other relatives were the beneficiaries and the Assessee claimed that there was a diversion at source of **50%** of his share of profit of **10%,** the Court negatived the said plea and held that the entire **10%** share in the Partnership Firm was taxable in his hands.

42. The Hon'ble Supreme Court following the leading judgment in the case of **Commissioner of**

Income-Tax Vs. Sitaldas Tirathdas [1961] 041 ITR 367 (SC) held that the true test is, where by the contractual obligation, the income is diverted **before** it reaches the Assessee, it is deductible, but where the income is required to be only applied to discharge the contractual obligations, it will not escape taxation in the hands of the Assessee so diverting his income.

43. The relevant extract of the said judgment which in the opinion of this Court covers the case in hand before us also is quoted below for ready reference:-

> *"The assessee was a partner in a firm having a 10 per cent. share therein. He created a trust by a deed of settlement assigning 50 per cent. out of his 10 per cent. right, title and interest (excluding capital) as a partner in the firm and a sum of Rs.5,000 out of his capital in the firm in favour of the trust. The beneficiaries were the assessee's brother's wife, the assessee's niece and his mother. The question was whether 50 per cent. of the income attributable to his share*

from the firm stood transferred to the trust resulting in diversion of income at source. The Appellate Tribunal held that there was no diversion of income and that section 60 of the Income-tax Act, 1961, applied. On a reference, the High Court held that on assignment of 50 per cent. of the share of the assessee in the firm it became the income of the trust by overriding title and it could not be added to the income of the assessee. On appeal to the Supreme Court:

... ...

... ...

Held: *The principle is simple enough but more often than not, as in the instant case, the question arises as to what is the criteria to determine, when does the income attributable to an assessee get diverted by overriding title? The determinative factor, in our view, is the nature and effect of the assessee's obligation in regard to the amount in question. When a third person becomes entitled to receive the amount under an obligation of an assessee* ***even before he could lay a claim***

to receive it as his income, there would be a diversion of income by overriding title; ***but when after receipt of the income by the assessee, the same is passed on to a third person in dis-charge of the obligation of the assessee, it will be a case of application of income*** *by the assessee and not of diversion of income by overriding title. The decisions of the Privy Council* ***in Raja Bejoy Singh Dudhuria v. CIT [1993] 1 ITR 135 and P.C.Mullick v. CIT [1938] 6 ITR 206*** *together are illustrative of the principle of diversion of income by overriding title.*

In Raja Bejoy Singh Dudhuria's case [1933] 1 ITR 135 (PC), *under a com-promise decree of maintenance obtained by the step-mother of the assessee, a charge was created on the properties in his hand. The Law Lords of the Privy Council, reversing the judgment of the Calcutta High Court, held that the amount of maintenance recovered by the step-mother was not a case of application of the income of the assessee.*

In contrast, ***in P.C. Mullick's case [1933] 1 ITR 135(PC),*** *under a Will, certain payments had to be made to the beneficiaries by the executors and the trustees (assessees) from the property of the testator. It was held by the Privy Council that such payments could only be out of the income received by the assessees and there was no diversion of income at source. Whereas in the former case, the step-mother of the assessee acquired the right to get the maintenance by virtue of the charge created by the decree of the Court on the properties of the assessee even before he could lay his hands on the income from the proper-ties, but in the latter case, the obligation of the assessee to pay amounts to the beneficiaries was required to be discharged after receipt of the income from the properties.*

In CIT v. Sitaldas Tirathdas [1961] 41 ITR 367, *speaking for a Bench of three learned judges of this Court, Hidayatullah J. (as he then was) having considered, among others, the aforesaid two judgments of the*

Privy Council laid down the test as follows (page 374):

> *"In our opinion,* ***the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligations, no doubt, there are in every case,*** *but it is the nature of the obligation which is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his income and an* ***amount which by the nature of the obligation cannot be said to be a part of the income of the assessee.*** *Where by the obligation income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow.* ***It is the first kind of payment which can truly be***

> ***excused and not the second.*** *The second payment is merely an obligation to pay another a portion of one's own income, which has been received and is since applied. The first is a case in which the income never reaches the assessee, who even if he were to collect it, does so, not as part of his income, but for and on behalf of the person to whom it is payable."*

44. In a recent decision rendered in April **2018**, the Two Judges' Bench of the Hon'ble Supreme Court in the case of **Deputy Commissioner of Income-Tax, Chennai Vs. T. Jayachandran [2018] 406 ITR 1 (SC)** upholding the decision of the Madras High Court reported in **[2013] 263 CTR 629 (Mad)** dealt with an interesting case of a Share Broker who was working on behalf of the Indian Bank and got only his Commission Income but was sought to be taxed for the gross receipts for the sale of Shares and Securities dealt with by him

on behalf of the Indian Bank, held in favour of the Assessee that he was not liable to be taxed, except for his Commission Income received from the Indian Bank.

45. This judgment relied upon before us by both the Revenue and the Assessee also reiterates the aforesaid principles about the '**Diversion of Income'** by an over riding title at source in the following manner:-

> *"(a) The Respondent - an individual and the proprietor of M/s Chandrakala and Company, is a stock broker registered with the Madras Stock Exchange. He is stated to be an approved broker of the Indian Bank. The assessment years under consideration herein are 1991-92, 1992-93 and 1993-94 respectively. During all these relevant assessment years* ***the Respondent acted as a broker to the Indian Bank in purchase of the securities from different financial institutions.***
>
> *(b) It is the case of the Revenue that the Indian Bank, in order to save itself from being*

charged unusually high rate of interest on borrowing money from the market, lured Public Sector Undertaking (PSUs) to make fixed term deposit with it on higher rate of interest. The rate of interest offered to the PSUs for making huge term deposits was to the extent of 12.75% of interest on fixed deposits against the approved 8% rate of interest in accordance with the RBI directions.

(c) In order to pay higher interest to the PSUs who made a fixed term deposit with the Indian Bank, ***the bank requested the Respondent to purchase securities on its behalf at a prescribed price which was unusually high but adequate to cover the market price of the securities, brokerage/incidental charges to be levied by the Respondent on these transactions, apart from covering the extra interest payable to the PSUs.*** *The Respondent, on the instructions of Indian Bank,* ***purchased securities*** *at a particular rate quoted by the Bank* ***and sold them to Indian Railways***

Finance Corporation. *Bank of Madura was the routing bank through which the securities were purchased and sold to Indian Bank for which Bank of Madura charged service charges.* ***The Respondent was paid commission in respect of transactions*** *done on behalf of Indian Bank. Under instructions from Indian Bank, a portion of the amount realized from the security transactions carried on behalf of Indian Bank was paid by way of additional interest to certain Public Sector Undertakings (PSU) on the deposits made with the Indian Bank and out of eight PSUs three has confirmed the receipt of such additional interest through demand drafts.*

(d) The Respondent filed his return of income for the Assessment Year 1991-92 on 01.11.1993 and declared his income at Rs. 4,82,83,620/-. The total income was determined at 4,85,46,120/- vide order dated 30.06.1994. However, later on, the case was taken up for scrutiny and assessment was framed under Sec 143(3) of the Income Tax

Act, 1961 (in short 'the Act'). The Assessing Officer, vide order dated 25.01.1996, raised a demand for a sum of Rs. 14,73,91,000/- with regard to the sum payable to the PSUs while holding that the ***Respondent has not acted as a broker in the transactions carried out for the Indian Bank rather as an independent dealer and that there was no overriding title in favour of the PSU's with regard to the additional amount earned out of the securities transactions and it is a case of application of income after accrual*** *and, hence, the said amount is liable to be assessed as the income of the Respondent.*

... ...

... ...

The ***relationship between the Indian Bank and the Respondent is very much clear by the evidence led*** *during the criminal proceedings. The Executive Director of the Bank has specifically spoken about the* ***role of the Respondent as a broker specifically engaged*** *by the Bank for the purchase of securities and that the Bank has*

included the interest money too in the consideration paid, for the purpose of taking demand drafts in favour of PSUs. Further, the evidence led by other bank officials points out that the price of securities itself were fixed by the bank authorities and as per their directions the Respondent had purchased the securities at the market price and the differential amount was directed to be used for taking demand drafts from the bank itself for paying additional interest to the PSUs. Further, the letter dated 25.03.1994 by the Bank wherein the Bank had acknowledged the receipt of Demand Drafts taken by the Respondent gives an unblurred picture about the capacity of the Respondent in holding the amount in question. Consequently, the conduct of the parties, as is recorded in the criminal proceedings showing the receipt of amount by the broker, the purpose of receipt and the demand drafts taken by the broker at the instance of the bank are sufficient to prove the fact that the Respondent acted as a broker to the Bank and, hence, the additional

interest payable to the PSUs could not be held to be his property or income.

13) ***The income that has actually accrued to the Respondent is taxable. What income has really occurred to be decided, not by reference to physical receipt of income, but by the receipt of income in reality.*** *Given the fact that the Respondent had acted only as a broker and could not claim any ownership on the sum of Rs. 14,73,91,000/- and that the receipt of money was only for the purpose of taking demand drafts for the payment of the differential interest payable by Indian Bank and that the Respondent had actually handed over the said money to the Bank itself, we have no hesitation in holding that the Respondent held the said amount in trust to be paid to the public sector units on behalf of the Indian Bank based on prior understanding reached with the bank at the time of sale of securities and, hence, the said sum of Rs. 14,73,91,000/- cannot be termed as the income of the Respondent."*

46. This judgment does not help the Assessee, though the Contract/Agreement dated **30/10/2007** in the present case may *prima facie* reflect that the Assessee **CHAMUNDI** was only entitled to get only the Bottling charges of **Rs.45/- per Case**, but that is precisely what is hoodwinking of Revenue, in the face of the fact that the entire business is carried on by **CHAMUNDI** only and finally profit or income is applied by way of distribution of income between **CHAMUNDI** getting the apportionment at the rate of **Rs.45/- per Case** of Bottles and balance amount going to **DIAGEO**. The entire real income is earned by **CHAMUNDI** only, therefore such '**application of income**' in the aforesaid agreed portions can be made only after meeting the tax obligations in the hands of **CHAMUNDI** itself.

47. **Clause 24** of the Agreement dated **30/10/2007** itself says respective income tax

obligations will be discharged by both the parties independently.

48. The Division Bench of the Rajasthan High Court in the case of **Commissioner of Income Tax Vs. Jodhpur Co-operative Marketing Society [2005] 275 ITR 372 [Raj]** dealt with a case of Co-operative Society which under the statutory obligations was liable to transfer 25% of its net profits to the specified funds and the Assessee Society claimed that such diversion was not taxable in its hands. Even negativing this plea of the Assessee - Co-operative Society, the Court explained the concept of '**Diversion of Income by over riding title at source'** after discussing several case laws, some of which were cited before us also, in the following manner:-

> *"The obligation to carry a part of net profit to a reserve fund does not envisage diversion of any part of profits in person other than society itself. There is no overriding title*

vesting in a third party other than the assessee to lay claim to the reserve fund independent of co-operative society. ***The reserve fund remains part of the assessee-society's corpus and is to be applied for assessee's business only,*** *albeit its application is being regulated by the Registrar under the provisions of the Act but the statue does not give any power even to the Registrar to utlise the reserve fund so created out of the profits of the society for any purpose other than for the purpose of the society. Even on dissolution of the society the first obligation of the assets of the society including the reserve fund as part of the total assets and not specifically, is to the discharge of its debts outstanding and obligation towards the shareholders to pay their contribution with interest and dividend payable to them for the period such dividends are not paid.* ***Surplus, if any, left thereafter, is to be applied according to the resolution of the general body of the members of the society only.*** *Therefore,*

there is no insignia of diversion of income through an overriding title vesting in a third party outside the corpus of the society itself so as to consider it to be a case of diversion of income by overriding title to somebody other than the assessee. It is also to be noticed that the question of transferring any amount to the reserve fund arises only in the case the assessee society received its net profit, after paying off all its expenses"

49. The Division Bench of the Madras High Court in the case of **Commissioner of Income Tax Vs. Madras Race Club [2003] 126 Taxman 6 (Mad),** dealt with a similar controversy involved before them in the following manner:-

"The payments made are compulsory exactions, which if not complied with will result in the disqualification *altogether of the person, who has subjected himself to the levy of penalty, fine or the requirement to take out a licence from participating in the assessee's*

racing activity. The power to collect these amounts is the power of the stewards and of the club generally to regulate racing and to ensure that it is carried on in an orderly fashion only with persons, who are considered competent and desirable, being allowed to take part, subject to their complying with the rules of racing. ***The amount of the penalties, licence fees and fines collected are amounts which are received by the club as part of income, which it derives by conducting races.*** *These amounts are not paid to the club by any of those, who become liable to the payment of licence fees, penalties or fines, by way of voluntary contribution from them to the benevolent fund. The amounts are not paid by them with the intention that it be a contribution to the charitable or benevolent fund. The race club itself is under no statutory compulsion to earmark or divert any part of its income for the benefit of the jockeys, apprentices, stable boys, etc.*

The race club was under no statutory obligation to create a trust fund for their benefit. *The fact that the club has done so and had done so with the best of intentions, does not on that score result in what is actually the income of the club, a part of which has been applied for benevolent purposes by having those amounts credited to the benevolent fund, becoming the income of the benevolent fund even at the inception. The income which the benevolent fund receives is by way of the amounts which the race club has allowed to be credited to that fund, the amounts so allowed by the club to be so credited being the amounts which it has collected from the jockeys, trainers and others, who are required to take out licences and pay licence fees and the penalties and fines, which it has levied and collected from those who are participants in racing but who have not complied with the rules and had therefore become liable for a penalty or fine.*

The amounts received by the club by way of licence fees, fines and penalties

are amounts which reach the club as part of its income and which amounts after they reach the club are applied by the club for benevolent purposes by allowing the benevolent fund to have the benefit of all those amounts. *The licence fees, penalties and fines at the time the payments were made by those, who are required to make those payments were, at the time the payments, not regarded by them as amounts, which were earmarked for charity and they did not regard those amounts as having been paid as contributions for a benevolent or charitable purpose. The levy as also the payment was by reason of the regulatory power vested in the assessee-club to regulate racing in accordance with the rules framed by it, non-compliance with which would result in the jockeys, trainers and others being excluded from participating in racing. The levy had direct nexus with their activity as participants in racing and the levies were designed to ensure compliance with the requirement of the rules. There was no*

earmarking of those amounts for the benevolent fund ab initio. The amounts collected by the club as licence fees, fines and penalties were therefore, amounts which form part of its income.

The execution of a trust deed and the inclusion of a provision in the rules of racing for crediting the sums to the benevolent fund was merely the application of a part of the income of the assessee for benevolent purpose. ***Creation of the benevolent fund by the trust deed and the provision made for the benevolent fund in the rules did not result in the amounts which the club was to credit to that fund being diverted at source by the overriding title of the benevolent fund to those sums.*** *The concept of diversion of income by overriding title is to be applied in situations which are clear and where the existence of the title in the legal or natural person in whom an overriding title is to be recognized is also certain, and the facts are such as to warrant the conclusion that the income is not that of the recipient, but*

in fact the income of the person in whose favour an overriding title is to be recognized. ***A rule framed by an assessee for its own internal management cannot be elevated to the level of statutory rule*** *and the decision on the part of the club to apply a portion of what it receives for benevolent purposes cannot be regarded as an instance of diversion by overriding title when the amounts received by the club and allowed by it to be used by the fund were not amounts, which had been paid voluntarily with the object of making those payments for charitable purposes. Diversion of the income took place after, and not before the income had reached the assessee. –* ***CIT vs. Bangalore Turf Club Benevolent Fund (1984) 38 CTR (Kar) 235: (1984) 145 ITR 323 (Kar): TC 44R. 1060 distinguished****"*

CASE LAWS RELIED UPON BY THE RESPONDENT – ASSESSEE:

50. Mr. A. Shankar, the learned counsel appearing for the Respondent Assessee who has not

only painstakingly prepared the said case and wonderfully argued on behalf of the Respondent Assessee has cited a large number of case laws under five broad headings which are enlisted below for ready reference, some of them are of greater significance and relevance and some are of lesser relevance and therefore, the selected case laws from the said List which were read in little more detail by Mr. A. Shankar before the Court are dealt with herein below:-

Sl.No	***CASE LAWS ON REAL INCOME***	*Page No.*
1.	*CIT Vs. Shoorji Vallabhdas & Co. 46 ITR 144 (SC)*	*01-03*
2.	*Godhra Electricity Co. Ltd Vs. CIT 225 ITR 746 (SC)*	*04-11*
13.	*CIT Vs. Chemosyn Ltd 371 ITR 427 (Bom)*	*75-79*
14.	*Poorna Electric Supply Co. Ltd Vs. CIT [1965] 56 ITR 521 (SC)*	*80-85*
17.	*CIT Vs. Chamanlal Mangaldas & Co. 39 ITR 8 (SC)*	*101-104*
18.	*CIT Vs. Chamanlal Mangaldas & Co. 29 ITR 987 (Bom)*	*105-110*
19.	*CIT Vs. Harivallabhadas Kalidas & Co. 39 ITR 1 (SC)*	*111-115*
28.	*CIT Vs. Virtual Soft Systems Ltd 404 ITR 409 (SC)*	*172-184*
29.	*CIT Vs. Lakshmi Machine Works 290 ITR 667 (SC)*	*185-196*
30.	*Miss Dhun Dadbhoy Kapadia Vs. CIT 63 ITR 651 (SC)*	*197-200*

51. A brief discussion of some of the case laws selected from the above List is given below:-

52. On the concept of taxability of “real income” under the provisions of the Income Tax Act, 1961 and on the principles of which there is no quarrel, are cited below for ready reference:-

53. In **Commissioner of Income-Tax Vs. Virtual Soft Systems Ltd. [2018] 404 ITR 409(SC)**, a Two Judges’ Bench of the Hon’ble Supreme Court dealt with a case of taxability of Lease Rentals recovered by the

Assessee, where a portion of it was recovery of the capital cost and part of it was in the nature of a 'Revenue Income" and the Assessee made such bifurcation relying upon the Guidance Note on 'Accounting for Leases' prepared by the Institute of Chartered Accountants of India, the Hon'ble Supreme Court upheld that method of Accounting and held that only the "Revenue Income" part of the Lease Rentals could be taxed in the hands of the Assessees on the concept of taxability of "real income" only under the Act.

The relevant extract from the said judgment is quoted below for ready reference:-

> *" The Guidance Note on Accounting for Leases, revised in 1995, adjusts the inflated cost of interest of the assets in the balance-sheet. Secondly,* ***it captures "real income" by separating the element of capital recovery*** *(essentially representing repayment of principal by the lessee, the principal amount being the* ***net investment in the***

lease), and the finance income, *which is the revenue receipt of the lessor as remuneration for the lessor's investment. According to the Guidance Note, the annual lease charge represents recovery of the net investment/fair value of the asset lease term. The finance income reflects a constant periodic rate of return of the net investment of the lessor outstanding in respect of the finance lease. While the finance income represent a revenue receipt to be included in income for the purpose of taxation, the capital recovery element (annual lease charge) is not classifiable as income, as it is not, in essence, a revenue receipt chargeable to income-tax.*

The ***method of accounting*** *as derived from the Institute's Guidance Note* ***is a valid method of capturing real income based on the substance of finance lease transaction.*** *The rule of substance over form is a fundamental principle of accounting, and is in fact, incorporated in the Institute's Accounting Standards on Disclosure of Accounting Policies being accounting*

standards which are a kind of guidelines for accounting periods starting from April 1, 1991. ***It is a cardinal principle of law that the difference between capital recovery and interest of finance income is essential for accounting for such a transaction with reference to its substance.*** *If this was not carried out, the assessee would be assessed for income-tax not merely on revenue receipts but also on non-revenue items which is completely contrary to the principle of the Income-tax Act, 1961 and to its scheme and spirit.*

... ...

... ...

Held accordingly, that the assessee could be charged only on real income which could be calculated only on a real income which could be calculated only after applying the prescribed method. *The Act is silent on such deduction. For such calculation, the assessee had to have recourse to the Guidance Note prescribed by the Institute of Chartered Accountants of India.*

Only after applying such method which was prescribed in the Guidance Note, could the assessee show fair and real income liable to tax under the Act. Therefore, it could not be said that the assessee claimed deduction by virtue of the Guidance Note: it only applied the method of bifurcation as prescribed by the expert team of the Institute of Chartered Accountants of India. The assessee was entitled to bifurcate the lease rental in accordance with the accounting standards prescribed by the Institute. There was no express bar in the Act regarding the application of such accounting standards."

54. In another case relied upon for the said principles by the learned counsel in the case of **Commissioner of Income-Tax Vs. Lakshmi Machine Works [2007[290 ITR 667 (SC),** the Hon'ble Supreme Court dealt with the case of deduction under **Section 80HHC** of the Act and while holding that Commission, Interest, Rent etc. as also the excise duty and sales tax

being indirect taxes are not part of total turnover of the Assessee for computing the benefit under **Section 80HHC** of the Act, the Court observed the following with regard to taxability of 'real income" and the income tax not being a tax on gross receipts by the assessee.

> *"Section 80HHC of the Income-tax Act, 1961, is a beneficial section; it was intended to provide incentive to promote exports. The intention was to exempt profits relatable to exports. Just as commission received by the assessee is relatable to exports and yet it cannot form part of "turnover" for the purpose of section 80HHC, excise duty and sales tax also cannot form part of "turnover".* ***Just as interest, commissioner, etc., do not emanate from the "turnover" so also excise duty and sales tax do not emanate from such turnover.*** *Since excise duty and sales tax did not involve any such turnover such taxes had to be excluded. Commission, interest, rent, etc., do yield profits, but they do not partake of the character of turnover and therefore they are not includible in the*

"total turnover". If so, excise duty and sales tax also cannot form part of the "total turnover" under section 80HHC(3).

... ...

... ...

We do not find any merit in the above contentions advanced on behalf of the Department. It is important to note that tax under the Act is upon income, profits and gains. It is not a tax on gross receipts. Under section 2(24) of the Act the word "income" includes profits and gains. The charge is not on gross receipts but on profits and gains properly so called. Gross receipts or sale proceeds, however, include profits. According to The Law and Practice of Income Tax by Kanga and Palkhivala, the word "profits" in section 28 should be understood in normal and proper sense. However, subject to special requirements of the income-tax, profits have got to be assessed provided they are real profits. Such profits have got to be ascertained on ordinary principles of commercial trading and accounting.

However, the Income-tax Act has laid down certain rules to be applied in deciding how the tax should be assessed and even if the result is to tax as profits what cannot be construed as profits, still the requirements of the Income-tax Act must be complied with. ***Where a deduction is necessary in order to ascertain the profits and gains, such deductions should be allowed.*** *Profits should be computed after deducting the expenses incurred for business though such expenses may not be admissible expressly under the Act, unless such expenses are expressly disallowed by the Act."*

55. On the principles of "Diversion of Income by overriding title at source", the learned counsel for the Assessee mainly relied upon the decisions of the Hon'ble Supreme Court in the case of (i) **Commissioner of Income Tax Vs. Sitaldas Tirathdas 41 ITR 367 (SC);** (ii) **Raja Bejoy Singh Dudhuria Vs. Commissioner of Income-Tax 1 ITR 135 (Privy Council(;** (iii) **Deputy**

Commissioner of Income-Tax Vs. T. Jayachandran [2018]406 ITR 1 (SC); (iv) **Commissioner of Income-Tax Vs. Madras Race Club [1996] 219 ITR 39 (Mad).**

56. These four case laws have already been discussed above as they were relied upon by the learned counsel for the Revenue also and our analysis of the same has also been given above at the appropriate places.

57. The other case law which requires a mention here from the side of the Respondent Assessee is one in the case of **Poona Electric Supply Co.Ltd. Vs. Commissioner of Income-Tax [1965]56 ITR 521(SC)** in which case, the Assessee, an Electric Supply Company under the statutory Regulations made provisions for distributing or setting apart for distribution to the consumers, a part of excess over clear profits to be refunded to the consumers by way of rebate, the Court held that the amounts credited by the

Electricity Supply Company to the **"Consumers' Benefit Reserve Account"** being a part of the excess amount paid to it and reserved to be returned to the consumers, did not form part of the 'real profits' of the Company and they were diverted at source by over riding title.

The relevant extracts from the said judgment are quoted below for ready reference:

> *"The appellant-company is a commercial undertaking. It does business of the supply of electricity subject to the provisions of the Act. As a business concern its real profit has to be ascertained on the principles of commercial accountancy.* ***As a licensee governed by the statute its clear profit is ascertained in terms of the statute and the schedule annexed thereto.*** *The two profits are for different purposes – one is for commercial and tax purposes and other is for statutory purposes in order to maintain a reasonable level of rates. For the purposes of the Act, during the accounting years the*

assessee credited the said amounts to the ***"Consumers' Benefit Reserve Account". They were a part of the excess amount paid to it and reserved to be returned to the consumers. They did not form part of the assessee's real profits.*** *So, to arrive at the taxable income of the assessee from the business under section 10(I) of the Act, the said amounts have to be deducted from its total income.*

Income-tax is a tax on the real income, *i.e., the profits arrived at on commercial principles subject to the provisions of the Income-tax Act. The real profit can be ascertained only by making the permissible deductions.* ***There is a clear-cut distinction between deductions made for ascertaining the profits and distributions made out of profits.*** *In a given case whether the outgoings fall in one or the other of the heads* ***is a question of fact to be found on the relevant circumstances,*** *having regard to business principles. Another distinction that shall be*

borne in mind is that between the real and the statutory profits, i.e., between the commercial profits and statutory profits. The latter are statutorily fixed for a specified purpose. If we bear in mind these two principles there will be no difficulty in answering the question raised."

58. Similarly in another case of Electricity Supply Company only, in the case of **Godhra Electricity Co. Ltd. Vs. Commissioner of Income-Tax 225 ITR 746 (SC),** the Hon'ble Supreme Court held that the enhanced rate of the Electricity Supplies, which amount could not be realized by the Assessee due to litigation and subsequent take-over of the Undertaking by the Government, such amount due on account of the enhancement of rates had not really accrued to the Assessee Company and therefore, was not taxable in the hands of the Assessee Company. More so touching the concept of taxability of the "real income" rather than

the "diversion of income", the Court thus held in favour of the Assessee in the said case.

59. Both the aforesaid cases really have no application to the facts of the present case. There is no doubt that only "real income" can be brought to tax under the Act but as we have said above, what is "real income" itself is a mixed question of fact and law and therefore, it will depend upon the facts and circumstances of each case and the law of precedents cannot be blindly applied to all the facts alike.

60. On the issue of "diversion of income at source", the learned counsel for the Assessee also relied upon a Division Bench decision of this Court in the case of **Commissioner of Income-Tax Vs. Pompei Tile Works 175 ITR 1 (Kar),** wherein the Division Bench of this Court held that in case of a Partnership, where the Partnership Deed provided that an outgoing Partner had to give a three months' Notice in writing of his intention

to severe his/her connection with the Partnership and the continuing partners had an option to purchase his/her share at a price as provided in the Deed. On account of the disputes between the partners, one partner M was excluded from the Partnership and the new Partnership Deed provided that M should be compensated by giving 25% of the profits or if no profits were earned, 6% on the amount standing to her credit. The new Partnership Firm claimed that the amount paid to M stood "diverted at source by overriding title" and the same could not be taxed in the hands of the new Partnership Firm.

61. Upholding the said contention, the Division Bench of this Court held as under:-

> *"Held, that on the date when the new partnership was entered into, M had pre-existing rights in the partnership and its assets. Therefore, without settling her rights, the other partners could not exclude her from the partnership. The partners other*

than M decided to exclude her and provide her compensation for the user in the new partnership of the assets of the firm to the extent of her share in the old partnership. Such a position did not result from her retirement nor severance from the partnership but from her exclusion by the other partners. Though M was not a party to the deed dated April 1, 1975, the partners of the assessee firm had to confer the benefit on M. The firm was carrying on the business of manufacture and sale of tiles; the factory was not easily divisible and the new partnership had to utilise the assets of the firm as a whole including the interest of M in the same. The business could not have been carried on without providing for such utilisation. The assessee-firm came into existence only by creating a pre-existing charge at source. The amount paid to M was diverted at source and did not form part of the assessee's income.

CIT v. Sitalda Tirathdas [1961] 41 ITR 367 (SC) applied."

62. The said judgment is of little help to the Respondent Assessee in the present case before us as *firstly,* it is not a case of Partnership before us as the concept of mutuality and partnership has been specifically negatived and excluded in the Agreement dated **30/10/2007** between the parties before us and *secondly,* there is no such "diversion of profits at source" by a overriding contractual obligation. It is more of a self agreed swipe of profits from **CHAMUNDI** to **DIAGEO**, retaining only the portion of the profits in the name of the bottling charges at the rate of **Rs.45/- per Case** and therefore, the said judgment is of no help to the Assessee in the present case.

63. In another Division Bench decision of the Karnataka High Court relied upon by the Assessee in the case of **Commissioner of Income-Tax Vs. Nagarbail Salt-Owners Co-operative Society Ltd.**

[2017] 291 CTR 287 (Kar.), a Co-operative Society manufacturing and selling Salt on lands belonging to the land owners who were known as “Maliks” and who are the Members of the Society where the activity of manufacturing and sale of Salt was undertaken by the Society and a large portion of sale proceeds were transferred to an account called “Distribution Pool Fund Account” which was paid to its Members commensurate with their land holdings and the remaining income was offered to tax, the Court held that logically the amount transferred to the “Distribution Pool Fund Account” cannot be taxed in the hands of the Society as income in its hands as the land in question belonged to the different Members in their own rights.

64. This judgment, in our opinion, can actually be of help to the Revenue rather than the Respondent Assessee when applied to the facts of the present case. Since the Excise Licence and the Liquor manufacture

and sale business entirely belongs to **CHAMUNDI** and not **DIAGEO**, the income should naturally be taxed in the hands of **CHAMUNDI** and thereafter the "Distribution of surplus" to the extent as envisaged under the contract going to **DIAGEO** is nothing but only application of profits and there is no "diversion of income at source by overriding title" as was the fact before the Division Bench of this Court in the aforesaid case, viz. ***Nagarbail Salt-owners Co-operative Society Ltd.(supra).***

65. On the question of allowability of the said surplus paid by the **CHAMUNDI** to **DIAGEO** under **Section 37** of the Act, the learned counsel for the Assessee relied upon the decision in the case of **Commissioner of Income-Tax Vs. Chandulal Keshavlal & Co. [1960] 38 ITR 601 (SC),** in which enumerating the principles with regard to **Section 10(2) (xv)** equivalent to **Section 37** of the 1961 Act, the

Hon'ble Supreme Court held that in deciding whether a payment of money is a "deductible expenditure", one has to take into consideration the questions of commercial expediency and the principles of ordinary commercial trading. If the payment or expenditure is incurred for the purpose of the trade of the assessee, it does not matter that the payment may inure to the benefit of a third party.

The relevant extract is quoted below for ready reference.

> *"In deciding whether a payment of money is a deductible expenditure one has to take into consideration questions of* ***commercial expediency and the principle of ordinary commercial trading.*** *If the payment or expenditure is incurred for the purpose of the trade of the assessee it does not matter that the payment may inure to the benefit of a third party. Another test is whether the transaction is properly entered into as a part of the assessee's legitimate commercial*

undertaking in order to facilitate the carrying on of its business; and ***it is immaterial that a third partly also benefits thereby.*** *But in every case it is a question of fact whether the expenditure was expended wholly and exclusively for the purpose of the trade or business of the assessee."*

66. We respectfully agree and there is no dispute about these principles but the question before us is that the "distribution of surplus" by **CHAMUNDI** to **DIAGEO** cannot be treated as an expenditure at all, because on the own admission and showing of the parties in the Agreement, it is nothing but "distribution of profits and sharing of surpluses" between the parties and not an expenditure.

67. As we have already indicated above, had **CHAMUNDI** paid the royalty, finance charges, cost of raw materials, etc. to **DIAGEO,** then these expenses could naturally be allowed as 'business expenses' but in

the present case, instead of taking these specified charges, the **DIAGEO** has taken the whole of the profits leaving the margin of only **Rs.45/- per Case** for **CHAMUNDI** and this, in our opinion, was more a device for Tax Avoidance rather than amounting to a "diversion of income by overriding title at source". Such a Contract even though legally permissible, can be pierced and looked into by the Courts for seeing the overall and actual purpose beyond such façade.

68. On the issue of 'Tax Avoidance and Tax Evasion' and the water shed dividing line between the 'tax planning', and 'tax avoidance and tax evasion', volumes have already been written by Courts all over the World and therefore, it should not bear any repetition here. But, since the learned counsel also relied upon the decision of the Hon'ble Supreme Court in the case of **Union of India Vs. Azadi Bachao Andolan & Another [2003] 263 ITR 706 (SC),** which

dealt with the case of Mauritius Income-Tax Treaties (DTAA) which dealt with the concept of Treaty shopping in that case, in the process, the Foreign case laws and the land mark decision in the case of ***McDowell' and Co.Ltd. Vs. Commercial Tax Officer [1985] 154 ITR 148,*** rendered by the Hon'ble Supreme Court of India were discussed in the following manner touching the aspects of 'Tax Avoidance' etc., in the following manner.

> *"In the classic words of* ***Lord Sumner in IRC v. Fisher's Executors [1926] AC 395 at 412 (HL):***
>
> > *"My Lords, the highest authorities have always recognized that the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any expressed terms or of any omissions that he can find in his favour in taxing*

Acts. In so doing, he neither comes under liability nor incurs blame".

Similar views were expressed by ***Lord Tomlin in IRC v. Duke of Westminster [1963] AC 1 (HL); 19 TC 490, 520 (HL)*** *which reflected the prevalent attitude towards tax avoidance:*

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however, unappreciative the Commissioners of Inland revenue or his fellow tax payers may be of his ingenuity, he cannot be compelled to pay an increased tax".

These were the pre-Second World War sentiments expressed by the British courts. It is urged that ***McDowell's case [1985] 154 ITR 148 (SC)*** *has taken a new look at fiscal jurisprudence and* ***"the ghost of Fisher's case [1926] AC 395 at 412 (HL) and***

Westminster's case [1936] AC 1 (HL); 19 TC 490, *have been exorcised in the country of its origin". It is also urged that* ***McDowell's case [1985] 154 ITR 148 (SC)*** *radical departure was in tune with the changed thinking on fiscal jurisprudence by the English courts, as evidenced in* ***W.T. Ramsay Ltd. v. IRC [1982] AC 300, Inland Revenue Commissioner v. Burmah Oil Company Ltd. [1982] Simon's Tax Cases 30 and Furniss v. Dawson [1984] 1 All ER 530 (HL).***

As we shall show presently, far from being exorcised in its country of origin, ***Duke of Westminster's case [1936] AC 1 (HL); 19 TC 490*** *continues to be alive and kicking in England. Interestingly, even in* ***McDowell's case [1985] 154 ITR 148 (SC),*** *though Chinnappa Reddy J. dismissed the observation of* ***J. C. Shah J. in CIT v. A. Raman and Company [1968] 67 ITR 11 (SC)*** *based on* ***Westminster's case [1936] AC 1 (HL); 19 TC 490 [68] and Fisher's Executors case [1926] AC 395 at 412 (HL),***

by saying (page 160 of [1985] 154 ITR) *"we think that the time has come for us to depart from the Westminster principle as emphatically as the British courts have done and to dissociate ourselves from the observations of Shah J. and similar observations made elsewhere", it does not appear that the rest of the learned judges of the Constitutional Bench contributed to this radical thinking. Speaking for the majority, Ranganath Mishra J. (as he then was) says in* ***McDowell's case [1985] 154 ITR 148, 171 (SC).***

> ***"Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief*** *that it is honourable to avoid the payment of tax by restoring to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges". (emphasis supplied)*

*This **opinion of the majority is a far cry from the view of Chinnappa Reddy J.** (page 160):*

> *"In our view the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether a provision should be construed literally or liberally nor whether the transaction is not unreal and not prohibited by the statute, **but whether the transaction is a device to avoid tax,** and whether the transaction is such that the judicial process may accord its approval to it". We are afraid that we are unable to read or comprehend the majority judgment in **McDowell's case [1985] 154 ITR 148 (SC)** as having endorsed this extreme view of Chinnappa Reddy J., which, in our considered opinion, actually militates against the observations of the majority of the judges which we have just extracted from the leading judgment*

of Ranganath Mishra J. (as he then was).

The basic assumption made in the judgment of Chinnappa Reddy J. ***in McDowell's case [1985] 154 ITR 148 (SC)*** *that the principle in* ***Duke of Westminster's case [1936] AC 1 (HL)*** *has been departed from subsequently by the House of Lords in England, with respect, is not correct.* ***In Craven v. White [1988] 3 All ER 495; [1900] 183 ITR 216,*** *the House of Lords pointedly considered the impact of* ***Furniss case [1984] 1 All ER 530 (HL), Burma Oil's case [1982] Simon's Tax Cases 30 and Ramsay's case [1982] AC 300 (HL)****. The Law Lords were at great pains to explain away each of these judgments. Lord Keith of Kinkel says, with reference to the trilogy of these cases,* ***(at page 225 of [1990] 183 ITR)"***

69. In a recent decision, the Court of Appeal (Civil Division) in England in the case of **Chappell Vs. Revenue and Customs Commissioners [2017] 1 All**

ER 550 again discussed elaborately the transactions which have no commercial business purpose apart from the avoidance of a liability to tax and the propositions in this regard emanating from the Ramsay principles and which is found relevant for the present case also and therefore, the relevant extract from this judgment is also quoted below for ready reference:-

> *"[30] A useful and extremely interesting description of how the Ramsay principle or approach to construction has developed through the case law can be found in the judgment of Lord Millett NPJ in the decision of the Hong Kong Court of Final Appeal in Collector of Stamp Revenue v Arrowtown Assets Ltd [2003] HKCFA 46, (2003) 6 ITLR 454. The structural approach I have described led to controversy in cases like Furniss (Inspector of Taxes) v Dawson [1984] 1 All ER 530, [1984] AC 474 as to whether Ramsay applied in cases where the scheme transactions were more linear in nature as opposed to the circular, self-cancelling type of*

transactions which existed in Ramsay itself. Lord Brightman went so far as to say that for Ramsay to apply:

> *'.... there must be a preordained series of transactions, or, if one likes, one single composite transaction... **Second, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax, not "no business effect".** If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. (See [1984] 1 All ER 530 at 543, [1984] AC 474 at 527.)*

[31] This approach has given way in recent decisions to a much broader, less formulistic approach to the analysis of the scheme. In Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes) [2004] UKHL 51, [2005] 1 All ER 97, [2005] 1 AC 684, Lord Nicholls (at [32]) referred to the decision in Ramsay in these terms:

'The essence of the new approach was to give a statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. Of course this does not mean that the courts have to put their reasoning into the straitjacket of first construing the statute in the abstract and then looking at the facts. It might be more convenient to analyse the facts and then ask whether they satisfy the requirements of the statute. But however one approaches the matter, the question is always whether the relevant provision of statute, upon its true construction, applies to the facts as found."

[32]-[67]

... ...
... ...

[66] The position was summarized by Ribeiro PJ in Arrowtonw Assets, at [35], in a passage cited in Barclays Mercantile:

> *"The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically".*

[67] Reference to "reality" should not, however, be misunderstood. In the first place, the approach described in Barclays Mercantile and the earlier cases in this line of authority has nothing to do with the concept of a sham, as explained in Snook. On the contrary, as Lord Steyn observed in McGuckian [1997] 3 All ER 817 at 826, [1997] 1 WLR 991 at 1001, ***tax avoidance is the spur to executing genuine documents and entering into genuine arrangements.***

[68] Secondly, it might be said that transactions must always be viewed realistically, if the alternative is to view them unrealistically. The point is that the facts must be analysed in the light of the statutory provision being applied. If a fact is of no

relevance to the application of the statute, then it can be disregarded for that purpose. If, as in Ramsay, the relevant fact is the overall economic outcome of a series of commercially linked transactions, then that is the fact upon which it is necessary to focus. If, on the other hand, the legislation requires the Court to focus on a specific transaction, as in MacNiven and Barclays Mercantile, then other transactions, although related, are unlikely to have any bearing on its application'."

70. In view of this also, it is clear that the Courts and the Tax Authorities can look into the real purpose of the commercial arrangements and transactions to reach the truth and the transactions having the sole purpose of tax avoidance may be held to be having no effect on the actual tax liability of the tax payer.

71. Thus, we feel that there is no need of multiplying the authorities and some of which we have discussed above, we are fortified in our view that in the

present case, the entire income from manufacture and sale of Liquor in the present case by **CHAMUNDI** was taxable in the hands of the Assessee **CHAMUNDI** and the application of income in the form of "distribution of surplus" from **CHAMUNDI** to **DIAGEO** was neither an "allowable expenditure" under **Section 37** of the Act nor as a "trade loss" under **Section 28/29** of the Act, and only after payment of income tax by **CHAMUNDI** on the entire profits earned from such business, such "distribution of surplus" could be made by **CHAMUNDI** to **DIAGEO** by way of application of income under the Agreement dated **30/10/2007.**

72. We therefore, feel that upon the overall reading of the Agreement dated **30/10/2007** in para 17 defining **DIAGEO INDIA's** entitlements before deducting entitlements of **CHAMUNDI** under **Clause 16**, the said Agreement in the correct perspective of applicability of Indian Tax laws on the income and profits of

CHAMUNDI, ought to have provided for deduction of Income-tax payable on its profits and gains taxable in the hands of **CHAMUNDI** and thereafter from the net balance after deducting entitlements of **CHAMUNDI** under **Clause 16,** the balance surplus could only be taken as entitlement of **DIAGEO INDIA Pvt.Ltd**.

73. We further hold clearly and firmly that Book entries and Method of Accounting is not determinative and conclusive for deciding the computation of 'taxable income' in the hands of the Assessee though they may be relevant to be considered.

74. This is where we feel the tax avoidance effort has been made by the parties and we cannot uphold the same in the overall analysis of the facts and legal position applicable to the facts of the present case.

75. What we further feel is that the "diversion of income by transfer of overriding title at source" should normally have the support of the statutory requirements

or some decretal binding character of Courts of law and even though the private contractual obligations can also bring about such “diversion of income at source” but in this last sphere of private contractual obligations, the Courts and the Income Tax Authorities have to examine such aspects carefully in comparison to the above two other categories of statutory requirements and the Court decrees and then examine the real purport and object of such private arrangements and Contracts.

76. Besides the issues of the legality of the Agreement, the real intention of the parties should be ascertained as to see whether such arrangements and contracts have been entered into to deflect and divert the applicability of Income-Tax laws on the Assessee who has really earned the “real income”, profits and gains under such Contract or whether such diversion is only an arrangement to suit the purposes of tax avoidance in such cases.

77. Therefore, we reiterate that it will depend upon the facts and circumstances of each and individual case whether in those circumstances, it would amount to a “diversion of income by overriding title at source” or an arrangement to serve the purposes of tax avoidance, as is the case before us.

78. With these observations and analysis, we are of the considered opinion that these Appeals filed by the Revenue deserve to be allowed and the substantial questions of law framed above deserve to be answered in favour of the Revenue and against the Assessee. We therefore proceed to answer the aforesaid questions in the following manner:-

[1] The substantial question No.1 is answered in favour of the Revenue and against the Assessee and we hold that the “distribution of surplus” by the Assessee **CHAMUNDI WINERY AND DISTILLERY** to

DIAGEO INDIA PRIVATE LIMITED in pursuance of the Agreement dated **30/10/2007** was an "application of income" by the Assessee **CHAMUNDI** and the same was not an 'allowable expenditure' under **Section 37** of the Income Tax Act of 1961.

[2] The substantial question No.2 is also answered in favour of the Revenue and against the Assessee and we hold that the terms and conditions of the Agreement dated **30/10/2007** between **CHAMUNDI WINERY AND DISTILLERY** and **DIAGEO INDIA PRIVATE LIMITED** did not amount to "diversion of income at source by overriding title" in favour of **DIAGEO INDIA PRIVATE LIMITED** because, the entire business under Excise licence in favour of the Respondent Assessee **CHAMUNDI** was in fact carried on

by **CHAMUNDI** only and the profits and gains arising out of such business were liable to tax in the hands of the Assessee **CHAMUNDI WINERY AND DISTILLERY**.

[3] The substantial question No.3 is also answered in the following manner that the manner of accounting entries and the Method of Accounting in the Books of Accounts maintained by the Assessee **CHAMUNDI WINERY AND DISTILLERY** as well as **DIAGEO INDIA PRIVATE LIMITED** will not alter and determine the taxability and character of "real income" arising and accruing in the hands of the Assessee **CHAMUNDI WINERY AND DISTILLERY** in the present case and irrespective of any change of Method of Accounting, in all the Assessment Years in the present Appeals,

the income from business of manufacture and sale of Liquor will be taxable in the hands of the Assessee **CHAMUNDI WINERY AND DISTILLERY**.

79. The present Appeals of the Revenue are thus allowed with no order as to costs.

(Dr.VINEET KOTHARI)
JUDGE

(S.SUJATHA)
JUDGE

BMV*