IN THE HIGH COURT OF DELHI AT NEW DELHI

SUBJECT : INCOME TAX ACT

Date of decision: 11th August, 2014

INCOME TAX APPEAL 257/2012

OMNIGLOBE INFORMATION TECH INDIA PVT LTD
. .... Appellant
Through Mr. Ajay Vohra and Ms. Kavita Jha, Advocates.

versus

CIT ..... Respondent
Through Mr. Sanjeev Sabharwal, Sr. Standing Counsel.

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE V. KAMESWAR RAO

SANJIV KHANNA, J. (ORAL)

1. This appeal by the assessee pertains to assessment year 2005-06 and was admitted for hearing vide order dated 19th October, 2012, on the following substantial question of law:-
"Did the Tribunal fall into error in holding that the assessee had setup its business w.e.f. 1.6.2004 and not w.e.f. 1.4.2004, as held in the impugned order."

2. The appellant-assessee was incorporated on 19th March, 2004, as a subsidiary of one M/s Omniglobe International, USA, as a business process service provider. The appellant-assessee had claimed deduction under section 10B, of the Income Tax Act ("Act", for short), for a period commencing from 1.4.2004 to 31.5.2004, contending that it had obtained approval as a 100% Export Oriented Unit under STPI scheme and had commenced operations from 1.4.2004. The Assessing Officer as well as the Tribunal have held that the appellant assessee had commenced its operations only from 1.6.2004, i.e. the date on which the appellant assessee entered into "service agreement" with its parent company and, therefore, the expenditure incurred between 1.4.2004 to 31.5.2004 should be capitalised. Tribunal, in its impugned order had also observed that the appellant assessee had entered into a lease agreement and had hired premises as its office, only on 15.6.2005. Commissioner of Income Tax (Appeals), however, had decided the issue/question in favour of the respondent assessee.

3. In order to determine and decide the controversy, we must examine the nature of the business activity undertaken by the appellant-assessee and the operation/activities between 1.4.2004 to 31.5.2004, when the expenditure of Rs 59,02,448/- was incurred.

4. The appellant-assessee, as recorded above, was in the business of voice activation and local number portability, i.e. Business Process Outsourcing (BPO) services, which were made available to M/s Omniglobe International, USA. The Activities fall in the category of 'service industry'. The appellant-assessee had placed on record, before the Commissioner of Income Tax (Appeals), a copy of the agreement dated 30th March, 2004, between M/s Agilis Information Technologies International Pvt. Ltd ("M/s Agilis", for short) and the appellant company. Under the said agreement, the appellant assessee was entitled to use to use the premises taken on lease by M/s Agilis, during 2000 hrs to 0800 hrs. It stipulated that the appellant assessee was entitled to use personal computers of M/s Agilis or install their new personal computers in the premises, but upon termination of the agreement, personal computers belonging to the assessee would be removed. The appellant-assessee could use furniture and fixtures of M/s Agilis. However, the appellant asseessee was to pay on pro rata basis, charges for water, electricity, energy, or power consumed. Lastly, it was agreed that the appellant-assessee would not use the internet facility of the provider, i.e. M/s Agilis, but would install a separate internet link from an internet service provider.

5. The break-up of the amount of Rs.59,02,448/-, which was disallowed as revenue expenditure but capitalised, is as under:-

"S.No. Expenses Head
Amount
01.
Salary & Wages
2283936
02
Employer Contribution to PF
46658
03
Employer Contribution to ESI
46919
04
Admin Charges PF/EDLI
4316
05
ESLI Charges
1943
06
Medical Expenses
151
07
Books & Periodicals
986
08
House Keeping Expenses
42493
09

Generator Running Maintt.
25121
10
Employee Activities
13200
11
Uniform expenses
324692
12
Professional Charges
935308
13
Projector Hire Charges
3000
14
Electricity Charges / water / Sewerage Charges
92070
15
Recruitment charges
447646
16
Computer hire charges
244355
17
Bank charges
50
18
Filing charges
1000
19
Computer maintenance
2740
20
Pantry Charges
170485
21
Printer Cartridge
22800
22
Office Maintenance
23724
23
Transportation charges
628284
24
Stationery

18375
25
Lease Line Charges
274331
26
Telephone Expenses
68182
27.
Printing Charges
7350

28.
Travelling Expenses International
7732

Total expen
Expenses pertaining to April & May 04
5902448/-
”

This break-up was noticed in the assessment order itself and is not disputed.

6. What is clearly noticeable is that the appellant-assessee had incurred substantial expenses on wages and salary in addition to recruitment and housekeeping expenses. Payments were also made towards generator running maintenance, water, electricity, sewerage and transportation charges and, importantly, the lease line charges, which were in respect of the internet connection. The agreement between the appellant-assessee and M/s Agilis was taken on record by the Commissioner of Income Tax (Appeals) under Rule 46A of the Income Tax Rules, 1962. The Tribunal has not given any adverse finding or held that the said evidence should not have been admitted and taken on record under the said Rules. Revenue had thereafter, filed an appeal before the Tribunal and it was their duty to place the said agreement on record in case they wanted to challenge the findings/observations of the Commissioner of Income Tax (Appeals). It appears that the Revenue did not file the said agreement and the Tribunal has recorded that they did not have the benefit of reading the agreement. Thus, finding of the Tribunal are without examining a vital and an important document. It is obvious that between 1.4.2004 and 31.4.2004 the appellant assessee was operating from some premises and therefore, they had incurred expenditure, like electricity, water, computer hire, pantry charges, etc.

7. As per the case of the appellant-assessee, expenses incurred during the months of April and May, 2004, were on account of training given to the recruited employees. This is clear from the reply given by the appellant assessee, dated 14.11.2007. The issue which arises is, whether the business had been setup as on 1st April, 2004 or was it setup

only on 1st June, 2004. There is a distinction between “setting up of business” and “commencement of business”. In Western Indian Vegetable Products Ltd. Vs. Commissioner of Income Tax (Bom.), [1954] 26 ITR 151, this distinction was highlighted and elucidated in the following words:-

“.....That is why it is important to consider whether the expression used in the Indian statute for setting up a business is different from the expression Mr. Justice Rowlatt was considering, viz., "commencing of the business." It seems to us, that the expression "setting up" means, as is defined in the Oxford English Dictionary, "to place on foot" or "to establish", and in contradistinction to "commence". The distinction is this that when a business is established and is ready to commence business then it can be said of that business that it is set up. But before it is ready to commence business it is not set up. But there may be an interregnum, there may be an interval between a business which is set up and a business which is commenced and all expenses incurred after the setting up of the business and before the commencement of the business, all expenses during the interregnum, would be permissible deductions under Section 10(2). Now, applying that test to the facts here, the company actually commenced business only on the 1st of November, 1946, when it purchased a ground-nut oil mill and was in a position to crush ground-nuts and produce oil. But prior to this there was a period when the business could be said to have been set up and the company was ready to commence business, and in the view of the Tribunal one of the main factors was the purchase of raw materials from which an inference could be drawn that the company had set up its business; but that is not the only factor that the Tribunal has taken into consideration. The Tribunal has, as pointed out in the statement of the case, scrutinised the various details of the expenses given in the order of the Appellate Assistant Commissioner and having scrutinised those expenses the Tribunal has come to the conclusion even on an interpretation more favourable to the assessee than the one we are giving to the expression "setting up" that these expenses do not show that the business was set up prior to the 1st of September, 1946. In our opinion, it would be difficult to say that the decision of the Tribunal is based upon a total absence of any evidence. As we have often said, we are not concerned with the sufficiency of evidence on a reference. It is only if there is no evidence which would justify the decision of the Tribunal that a question of law would arise which would invoke our advisory jurisdiction which after all is a very limited jurisdiction.”

The said case, related to an assessee, who was engaged in the business of manufacturing of edible oils and was in the process of setting up of a groundnut oil mill. In that case, the moment the ground nuts, a raw material, was purchased, it was held that business had been setup and accordingly the expenditure incurred should be allowed as a revenue expenditure.

8. It would be appropriate in this regard to refer to the proviso to Section 3 of the Act, which refers to and defines the term, “previous year” in relation to newly setup business or profession and not with reference to the date of commencement. Section 28 of the Act postulates that profit and gains of business or profession carried out at any time during the previous year, shall be taxed under the head “profits and gains of business or profession".

9. Delhi High Court in Commissioner of Income Tax Vs. Samsung India Electronics Ltd. (ITA 131/2010) decided on July 9, 2013, had held as under:-
"7. The aforesaid distinction is relevant when we examine and refers to the definition of 'previous year'. Following the said judgment, in the case of CIT v. L.G. Electronic (India) Ltd. [2006] 282 ITR 545 (Delhi), it has been observed that the date of setting up of business and date of commencement of business may be two separate dates. This decision in the case of L.G. Electronics (supra) has been followed in CIT v. ESPN Software India P. Ltd., [2008] 301 ITR 368 (Delhi) wherein it has been held that a business will "commence" with the first purchase of stock-in-trade and the date on which the first sale is made is immaterial. Similarly, for manufacturing, several activities in order to bring or produce finished products have to be undertaken, but business commences when the first of such activities is taken."

10. In Commissioner of Income Tax: Delhi-I Vs. Arcane Developers Pvt. Ltd (ITA 41/2013), decided on October 8, 2013, it was observed:-
"7……Setting up of business takes place when the business is ready and first steps are taken. In case of real estate business, the said setting up of business was complete when first steps were taken by the respondent-assessee to look around and negotiate with parties. There can be a gap between setting up and when first steps were taken by the respondent and finalisation of the first written agreement. Business activities of the respondent did not require construction of a factory, machinery etc. Negotiations are required to enter into a written understanding and it is obvious that the loan was taken for business and to proceed further and conclude the deal. The aforesaid facts have been examined and highlighted by the first appellate authority. The said findings of fact have been affirmed by the tribunal. A pragmatic and a practical view has to be taken."

11. In Century SPG and Mfg. Co.Ltd Vs. Commissioner of Wealth Tax [1978]112 ITR 497(Bom), it has been observed:-
"This interpretation put by this court upon the expression "set up" has been followed by the Madras High Court in the case of Ramaraju Surgical Cotton Mills Ltd. v. Commissioner of Wealth-tax [1962] 46 ITR 820.This is a case under the Wealth-tax Act and the expression " set up " came to be interpreted in the context of section 5(1)(xxi) as exemption was claimed as a new and separate unit set up after the commencement of the Act. The Madras High Court at page 824 observes :

"Unless a factory is erected and the plant and machinery installed therein, it cannot be said to have been set up. The resolutions of the board of directors, the orders placed for purchasing the machinery, the licence obtained from the Government for constructing the factory, are merely initial stages toward, setting up, however necessary and essential they may be to further the achievement of the end. It is not, however, the actual functioning of the factory or its going into production that can alone be called setting up of the factory. The setting up is perhaps a stage anterior to the commencement of the factory."

12. This brings us to the moot question: whether the business of the BPO (Business Process Outsourcing) had been setup by the respondent-assessee on 1st April, 2004 or

was it setup only on 1st June, 2004? We have already quoted factual position elucidated in the assessment order to the effect that the appellant had employed several employees and salary and wages were paid to them. However, these employees were given training in the months of April and May, 2004 and expenditure was incurred on various heads, During the months of April and May, 2004, the actual BPO services to the parent company were not rendered. When the said services actually were rendered or the assessee did start rendering of services to a third party, the business commenced. This, according to us, does not mean that business had not been setup by the appellant assessee. In order to determine whether business had been setup or not, we have to look at the factual matrix of the case, especially, the nature and character of the business activity with the activities actually undertaken. The appellant-assessee had entered into an agreement with their sister concern, M/s Agilis, to use their premises between 2000 hours to 0800 hours between 1.4.2004 and 30.6.2004. M/s Agilis was paid on pro rata basis for water, electricity, energy and power consumption charges. Further, the appellant assessee had to install a separate internet link from the Internet Service Provider. The appellant-assessee had a choice to use the personal computers of M/s Agilis or install their own. Break-up of the expenditure of Rs.59,02,448/-, incurred during this period included expenses for lease line charges of Rs.2,74,331/-, telephone expenses of Rs.68,182/-, computer hire charges of Rs.2,44,355/- and some small amounts towards computer maintenance. In addition, the appellant-assessee had paid a substantial amount of Rs.22,83,936/- as salary and wages to its employees. Keeping in view the nature of business activity of the appellant-assessee, we do not think that it can be held that training, imparting skills to employees recruited, or, testing their performance can be treated as a pre-setup expenditure. The appellant assessee had either employed or taken help of trainers/seniors for the said purpose. The moment employees were recruited and enrolled, and infrastructure to use their service was in place, setup was complete. It was indicative of the fact that business operations had been setup. In the BPO industry, training of employees is an important, essential and integral element of the business activities and when the assessee has the infrastructure in place, the business can be treated as set-up. As a service industry, the first step is to recruit right kind of employees, then to interact, train or check their performance. Unlike the manufacturing activity, where requisite plant and machinery has to be procured, installed and then business operations start, in the BPO industry, the process starts with the recruitment of employees, who are to work in the said industry. Training or introduction after recruitment would be akin to the trial production or the first step in production undertaken by a manufacturer of goods. Of course it has to be seen, whether the infrastructure to utilize their services was in place or not. One may postpone actual rendering of services to be a zero error company. In CIT Vs. E-Funds International India, (2007) 162 Taxman 1 (Del), the assessee was engaged in the business of information technology like software development/consultany, business process management and electronic banking schemes. The claim of the assessee therein was that business of software development was setup the moment they had employed 30-40 employees in the relevant previous year. This claim was accepted by the High Court after noticing that the assessee had certain infrastructure facilities at the relevant time.

13. In CIT Vs. Hughes Escorts Communications Ltd., (2009) 311 ITR 253 (Delhi), the assessee was in the business of setting up of satellite communication systems. It was

held that the first step required was the purchase of VSAT equipment. The said purchase order was placed on 28th July, 1994, and thereafter the assessee had obtained license from the Department of Telecommunications, and, started receiving satellite signals. It was held that the moment the assessee purchased VSAT equipment, it could be said that the business had been setup. This, it was held, was the relevant date for determining the nature and character of expenses incurred and whether they were revenue or capital in nature.

14. Similarly, in CIT Vs. Whirlpool of India Ltd. (2009) 318 ITR 347 (Del), the assessee was engaged in the business of providing financial services and the same question i.e. whether the business had been setup or not, came for consideration. It was observed that this question could only be answered by looking at, and was dependent on, the facts of each case. Different considerations would apply and the answer would depend on whether the business was for manufacture of a product or for providing services. Even in the case of services, it would depend upon the nature of service to be rendered. In case of a financial company authorised to advance loans for interest to facilitate customers to purchase consumer durables, the business was setup when directors were appointed; staff, such as regional and branch managers were appointed; and their salaries were paid. In other words, it can be said that at that time, the company was ready to commence business. There need not be an actual commencement of business as such.

15. It would be appropriate, in this regard, to reproduce findings recorded by the CIT (Appeals), who had called for the remand report from the Assessing Officer in view of the contentions raised:-

"I have considered the comments of the AO given by him in the remand report and the rejoinder filed by the appellant on the same. During the course of remand proceedings, it is seen that appellant has submitted a note on the training imparted to the employees during the month of April and May, 2004 in the premises taken from M/s Agilis Information Technologies International Private Limited. The appellant also filed copies of the ledger accounts of pantry expenses, professional expenses, recruitment expenses, computer hire charges, transportation charges, lease line charges. Copies of the audited balance sheet of M/s Agilis Information Technologies International Private Limited and addresses of the employees who are still working with the appellant company to whom the salaries were paid in the months of April and May, 2004. The appellant has also filed the name and address of the parties to whom the expenses of pantry, professional charges, recruitment expenses, computer hire charges were paid and TDS deducted. The appellant has also filed copy of the ESI/PF paid for the month of April and May, 2004. All these comments prove that the appellant had started its business during this period and the employees and staffs were being trained to handle the business of call centre which cannot be done by a novice. The BPO business requires trained and skillful persons who cannot commence full scale on live tele-calling with the end clients till the time employees get proper training and adequate skills sets have been developed by the staffs and employees. Further, the employees have to go through the process of making and operating in a developing environment before final call etc can be made and end client

can be handled. All these skills are possible only if proper training to the staff is imparted. The fact that salaries, transportation charges, traveling expenses etc. were incurred during these two months is itself the evidence that company has started its business."

16. Before the first appellate authority, the appellant-assessee had filed full particulars with explanation along with details of the each employee. Bio-data of 17 employees have been enclosed. They had also enclosed details of the recruitment agencies engaged for recruitment of employees along with the copy of the ledger account of recruitment charges. Details of pantry expenses and other professional expenses including the name of the parties to whom the said expenses were paid were filed. Details of the party to whom computer hire charges and transportation charges were paid during the months of April and May, 2004 were also furnished. Copy of the ledger account along with tax deducted at source was made available. CIT (Appeals) held that, keeping in view the nature of business, the training itself was an integral part of the business activity and the moment training commenced on the infrastructure that was made available by M/s Agilis, the business was setup. The agreement between the appellant-assessee and M/s Agilis was a genuine agreement, which was clear from the nature of expenses incurred, which included pantry expenses, computer hire charges, transportation charges, etc.

17. The Tribunal after referring to Whirlpool of India Ltd. (supra) allowed the appeal of the Revenue observing:-
"4.7 When we look to the facts of our case, it is clear that although the staff had been recruited, it was not ready for rendering services as the staff had to be trained with the systems. The assessee had not taken premises on rent and, therefore, installation of computer therein had not been done. Therefore, the assessee was not in a position to solicit custom till the end of May, 2004. The advances were received from the parent company but these were used for training the personnel and paying salaries and incidental charges, necessary for setting up the business. Thus, in a nutshell, it is held that a business is set up when it reaches a stage where it is in a position to procure business and not before. However, the expenditure becomes deductible from such stage irrespective of the date of actual receipt of the business. Therefore, it is held that the business had not been set up till the end of May, 2004. Accordingly, the assessee is not entitled to deduction of these expenses. It is held accordingly."

18. In view of the aforesaid discussion, we do not think that the reasoning given by the Tribunal and the Assessing Officer shows that the business of the appellant-assessee had not been setup. The business of the appellant had been setup as the appellant-assessee had acquired the necessary infrastructure from their sister concern, M/s Agilis, and had also started making payment of salary and wages. This training was given by professional experts under the supervision and control of the appellant-assessee. The moment the said operations were commenced, the business had been setup and the subsequent rendering of service to third parties would be at a later date when the actual services were rendered to the parent/holding company. In CIT Vs. Saurashtra Cement and Chemical Industries Limited, (1973) 91 ITR 170 (Guj.), the assessee had obtained

mining lease for quarrying limestone and had started mining operation, but installation of the plant and machinery for manufacture and sale of cement was directed to be capitalised. Looking into the business of the assessee, the High Court approved the approach of the Tribunal that the business activities could be classified into three stages i.e procurement of raw material; manufacture of cement; and, sale of manufactured cement. Extraction of limestone was in the nature of acquiring raw material, to be utilised for the manufacture of cement and was the foundation for the second activity, i.e manufacture of cement. Thus, depreciation allowance and development rebate was allowed for machinery employed for extraction of limestone. The test laid down was that the business would commence when the activity, which is first in point of time, must necessarily precede other activities is started; as business connotes continuous course of activity and all activities which go up to make the business, need not be started simultaneously.

19. Similar view was again taken in Prem Conductors Private Limited Vs. CIT, (1997) 108 ITR 654 (Guj.) wherein it has been elucidated that one business activity might precede another and what was required to be seen was whether one of the essential activities for carrying on the business as a whole had or had not commenced. When the assessee had commenced business of securing orders first and then production, then activity of securing business actively commenced when the said steps were taken and it did not get postponed to the date of actual production. Referring to these decisions and other decisions, Andhra Pradesh High Court in Commissioner of Income Tax Vs. Sponge Iron India Limited, (1993) 201 ITR 770 observed that whether business had commenced or not was a question of fact, but what activities constitute commencement of business was a mixed question of law and fact. Secondly, there was a distinction drawn between "setting up of business" and "commencement of the business". Business is said to be 'set up' when it is ready to commence. Thirdly, when business consists of continuous course of activity, all activities which go to make up the business need not be started simultaneously. As soon as the activity which is essential in the course of carrying on business is started, business is said to be set up, if not commenced.

20. Upon recruitment of employees, the factum that expenditure under the different heads, as noticed above, was incurred is indicative that business was set up. Training to the employees was given to ensure that when the work was undertaken and performed, there were no glitches, trouble or problems. It is not indicative of the fact that necessary infrastructure was not there and actual business could not have commenced or was not set up. Training was post set up as the employees were recruited. In case of service industry, training and up gradation of skills of employees is a part and parcel of the business activity, a continuous process. The business as a service provider, cannot exist without the said activity being undertaken both at the very initial stage and after business has commenced. Training is done to ensure proper performance and to provide services of acceptable quality or ensure zero or minimal errors. It is to ensure proper standards and optimum utilisation of human resources already employed. It helps in improving productivity, maintaining team work and strengthening bonds inter-se. In the present case, substantial and large numbers of employees after recruitment were kept on payroll, the appellant-assessee paid for their Provident Fund, Employees Insurance Charges;

maintenance charges; distributed uniforms, and, pantry charges were incurred. The details and quantum itself is indicative that the business was set up, as training itself was integral to the setting up of business line of the appellant-assessee. The said training continued even when the business was in operation. It was part and parcel of the business activities as a service provider.

21. In view of the facts of the present case, the question of law has to be answered in favour of the appellant-assessee and against the respondent-Revenue. No costs.

Sd./-
SANJIV KHANNA, J.

Sd./-
V. KAMESWAR RAO, J.

AUGUST 11, 2014/NA