

**आयकर अपीलीय अधिकरण, मुंबई ‘के’ खंडपीठ**  
**Income-tax Appellate Tribunal -“K”Bench Mumbai**

सर्वश्री राजेन्द्र,लेखा सदस्य एवं सी. एन. प्रसाद,न्यायिक सदस्य

Before S/Sh.Rajendra,Accountant Member and C.N. Prasad,Judicial Member

**आयकर अपील सं./ITA/7978/Mum/2010,निर्धारण वर्ष/AY.2006-07**

M/s. Bayer CropScience Limited Bayer House, Central Avenue, Hiranandani Gardens, Powai Mumbai-400 076. <b>PAN:AAACB 9651 K</b>	Vs.	ACIT -10(3) Aayakar Bhavan, 4 <sup>th</sup> floor, M.K. Road Mumbai-400 020.
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(अपीलार्थी /Appellant)

(प्रत्यर्थी / Respondent)

**Revenue by:**Shri G.M. Doss

**Assessee by:** S/Shri Paras Savla; Harsh Shah & Viraj Mehta

सुनवाई की तारीख / **Date of Hearing:** 18.04.2016

घोषणा की तारीख / **Date of Pronouncement:** 25.05.2016

**आयकर अधिनियम,1961 की धारा 254(1)के अन्तर्गत आदेश**

**Order u/s.254(1)of the Income-tax Act,1961(Act)**

**लेखा सदस्य राजेन्द्र के अनुसार PER RAJENDRA, AM-**

Challenging the order dated 14/10/2010 of the Assessing Officer (AO),passed u/s.143(3)r.w. s.144C(13)of the Act, the assessee has filed the present appeal. Assessee-company,engaged in the business of manufacturing of insecticides and other chemicals for Plant protection,filed its return of income on 30/11/2006, declaring income of Rs. 51.18 crores.During the assessment proceedings,the AO found that assessee had entered into International Transactions (IT.s) with its Associated Enterprises(AEs).So,he made a reference to the Transfer Pricing Officer (TPO)to determine the Arm’s Length Price(ALP) of such transactions. After receiving the order of the TPO,the AO sent the draft assessment order to the assessee, who challenged it before the Dispute Resolution Panel (DRP).The DRP issue directions to the AO wide its order dated 28/09/2010.In pursuance of the said directions, the AO completed the assessment, determining the income of the assessee had Rs. 59.89 crores.

**2.**First ground of appeal relates to Transfer Pricing (TP)adjustments of Rs. 2.80 crores.During the TP proceedings,the TPO found that the assessee had entered into the following IT.s with its AEs:

Sr.No.	Nature of Transaction	Amount(Rs.)
1.	Import of raw material	112,95,51,398
<b>2.</b>	<b>Import of traded products</b>	<b>7,75,70,764</b>
3.	Export of finished products	80,60,91,048
4.	Sale of Asset	26,29,000
5.	Payment of indenting commission	38,84,001
6.	Import of Software	55,62,236
7.	Provision of SAP support services	2,03,49,405
8.	Recovery of expenses	48,65,599
9.	Reimbursement of expenses	10,38,28,884

He found that the assessee had used the Internal Transaction Net Margin Method(TNMM),that net profit margin(operating profits/sales)was the Profit Level Indicator(PLI)for computing ALP of the above transactions,that the assessee had selected comparables from Prowess Data Base.While going through the Transfer Pricing Report (TPR), the TPO found that the assessee had comparable uncontrolled manufacturing functions,that it had no related party transactions, that it was possible to segment the financials of the company, that the margin of the assessee's MS could be compared with margin of internal transaction segment,that a similar statement had been made in respect of the trading activities.

**2.1.**After going through the segmental details,filed vide letter dated 27/8/2009, the TPO held that the total income appearing in the statement was Rs.73522.64 crores,that the income allocated between MSings(MS)and TSings(TS)included not just that total turnover(Rs.64858.62 crores)but also other income in the nature of intending commission,intending business would vary as compared to normal trading activity, that it was not correct on part of the assessee to include them in turnover for the purpose of calculating independent margin,that many of the expenses were distributed on the basis of turnover ratio, that consideration of only the commission amount and not the overall turnover of intending was bound to affect the segmental margins,that manufacturing services would cost the company use of plant and machinery, technology and other utilities,that for proper analysis the turnover manufactured should have been included in the total turnover for proper location of overheads and Manufacturing expenses,that

it had also rendered certain manufacturing services, that the total income received in respect of the same was 700.33 crores, that the assessee had disclosed income of Rs. 22.07 crores only, that the assessee had also rendered SAP support services.

The TPO asked the assessee to explain as to why the internal TNMM should not be rejected. The assessee filed by revised segmental analysis on 07/10/2009 and stated that the company used SAP ERP system which capture all the financials for various segments, that the information was compartmentalised into various cost-centers based on certain predetermined parameters, that the audited financial reports prepared on entity wise level would not provide financial information pertaining to various business segments, that while preparing the segment financials it would place reliance on the data captured in the SAP system using various allocation keys, that the income pertaining to MS and TS had been identified by the company based on products sold as captured in the audited sales register, that it employed standard cost system for capturing the cost of manufactured goods sold, that in determining the standard cost the company would take into account all the budgeted material cost and manufacturing overheads to arrive at a standard cost per product, that the assessee's system would capture various expenses for determining the standard cost of products sold, that use of such costing data gave a more reliable picture of the business segment, that it had scientifically determined the costing data, that the balance operating expenses which did not form part of the costs of goods sold and which could not be directly identified and allocated to various business segments had been apportioned to the MS and TS on prudent and relational basis using logical allocation keys.

	Manufacturing			Trading			SAP-Support Service Segment	(Rs.in'000)
	Transactions with third parties	Transactions with associated enterprise(AE)	Total	Transactions with third parties	Transactions with associated enterprise(AE)	Total		Grand Total
Income	3,665,55	3,233,617	6,899,173	342,031	111,060	453,091	20,350	7,372,614

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Expenses	3,318,082	2,868,860	6,186,942	343,070	109,232	452,302		(6,655,728)
Net operating profit	347,474	364,757	712,231	(1,039)	1,828	789	3,866	716,886
Net operating profit(%)	9.48	11.28%	10.32%	-0.30%	1.65%	0.17%		
Net Cost plus mark-up(%)							23.45%	

With respect to the MS it was stated that the margin of the assessee from MS-having no ITs (Non-AE Segment)-was 9.48%,that margin from its MS-having international transaction-was .32%,that the IT.s of MS were at arm's length based on internal TNMM.With respect to the TS it was stated that its margin from that segment -having no IT(Non AE Segment)-was (-)0.30%,that margin from its TS -having IT(AE segment) was 1.65% against the non-AE segment at the rate of 0.30%,that the ITs of TS were at arm's length.The assessee had compared the margin of non-AE TS results with external comparables and even on that basis it was claimed that IT.s of TS were at arm's length.

**2.2.**However,the TPO was not convinced with the explanation. The TPO held that for a proper internal comparison between the margins of AE or non-AE segment it was necessary that there should be identity of products, that a high percentage of higher margin items in the AE segment would distort the results, that a careful approach had to be followed because the margins in both the segments would be very close, that the assessee had not shown such identities, that the internal TNMM based on a standard costing model/allocation of cost model could not be considered a valid basis for internal comparisons, that the internal comparison could be made only in a situation where separate units/divisions were capped for preparing products relating to the AE and the non-AE.s., that where separate books of accounts were maintained in respect of the direct and indirect costs and a location had been made in respect of the head

office expenses, that an absorption costing system could be used where each cost was absorbed accurately and allocated to a product, that in absence of the same allocations on the basis of turnover had to be rejected, that the variation on account of contract manufacturing ,rendering manufacturing services, sourcing services the internal TNMM could not ensure the working of exact operating margin for an internal comparison. The assessee carried out search to identify the external comparable for benchmarking its MS and TS. Under the head MS the OM was worked out. So, he held that import of raw material was at arm's length. For TS the assessee furnished margins of comparable as under identifying eleven comparables and the table read as under:

<i>Company Name</i>	<i>Sales</i>	<i>NPM</i>	<i>Source</i>
Anukaran Commercial Enterprises Ltd.	5.38	0.29	Annual Report
Chembond Drew Treat Ltd.	28.38	12.30	Prowess
Dhoot Industrial Finance Ltd.	54.08	-0.43	Annual Report
Guljag Industries Ltd.	65.61	3.97	Prowess
Hiran Orgochem Ltd.	39.95	0.72	Annual Report
Indokem Ltd.	42.37	6.17	Annual Report
K.P.L International Ltd.	26.43	17.26	Annual Report
Nikhil Adhesives Ltd.	28.41	1.65	Annual Report
P.H. Trading Ltd.	49.11	2.50	Annual Report
Priya International Ltd.	4.18	-3.06	Annual Report
Roselabs Ltd.	1.0	3.29	Annual Report
<b>Arithmetic Mean</b>		4.06	

As per the TPO ACEL, PIL and RL had very little turnover as compared to the assessee which had turnover of Rs.45 crores. He rejected these companies on the criteria of turnover. He rejected DIFL, as it did not show separate margin for chemical category. Final comparable were taken as under:

<i>Company Name</i>	<i>Sales</i>	<i>NPM</i>	<i>Source</i>
Chembond Drew Treat Ltd.	28.38	12.30	Prowess
Guljag Industries Ltd.	65.61	3.97	Prowess
Hiran Orgochem Ltd.	39.95	0.72	Annual Report
Indokem Ltd.	42.37	6.17	Annual Report
K.P.L International Ltd.	26.43	17.26	Annual Report
Nikhil Adhesives Ltd.	28.41	1.65	Annual Report
P.H. Trading Ltd.	49.11	2.50	Annual Report
<b>Arithmetic Mean</b>		<b>6.37</b>	

Considering the above, he held that margins of comparable companies engaged in trading of chemicals was 6.37 as against the margin shown by the assessee at 0.17%, that TP adjustments were to be made at Rs.2.80 cores. In his draft order, the AO made an addition of the said amount to the total income of the assessee.

**2.3.** Aggrieved by the draft order of the AO, the assessee filed objections before the DRP. It made elaborate submissions. But, the DRP, in a very brief order, confirmed the adjustment suggested by the TPO. The DRP observed that the TPO had taken comparable otherwise selected by the assessee, that there was no justification for interfering with the ALP determined by the TPO. Except these two sentences the DPR did not observe anything. In pursuance of the directions of the DRP the AO made an addition of Rs.2,80,07,290/- to the total income of the assessee.

**2.4.** Before us, the Authorised Representative (AR) submitted that the assessee had applied turnover criteria of greater than Rs.1 crores, that the TPO on an ad hoc basis rejected companies stating little turnover, that he did not dispute the functional similarity of the comparables, that he wrongly rejected companies in the range of Rs.4 to Rs.6 crores despite turnover of TS of assessee being Rs.11 crores without appreciating that this range of turnover was in fact quiet comparable. With regard to ACEL the AR contended that the turnover of the company was Rs.5.38 crores, that he arbitrarily rejected the said comparables, that the TPO had not challenged FAR, that it was a valid comparable as far as trading of chemicals is concerned. About PIL, he stated that turnover of the company was Rs.4.18 crores, that the TPO had arbitrarily rejected it as a valid comparable. Referring to RL it was argued that the turnover of the company was Rs.3.35 crores. Rest of the arguments were similar to the arguments advanced for the first comparable. He stated that if ACEL, PIL and RL were included in the final seven comparables of the TP order the margin of the 10 comparables would work out to be 4.51% even if combined trading margin of the assessee i.e. 0.17% was considered, that the same would fall within +5% range, that internal TNMM was the MAM, that Dhoot was into trading of chemicals and other products, that while applying TNMM product similarity was not required,

that KPLIL was also into various business, that for the purpose of consistency if Dhoot was to be rejected KPLIL should have also been rejected, that segmental results for KPLIL for indenting and trading showed an income of Rs.32.24 crores of which traded chemicals revenue was only Rs.17 crores, that if KPLIL was rejected from the final seven comparables in TP order the margin of the six comparables works out to be 3.09%, that even if combined trading margin of assessee was (0.17%) was considered, that the same would fall within  $\pm 5\%$  range. On the proposition that Product similarity not relevant in TNMM, he relied upon the cases of GE India Technology Centre (P) Ltd. (30 taxmann.com 249) and Diageo India (P) Ltd. 34 taxmann.com 284).

He further argued that the DRP erred in upholding the action of TPO in rejecting segmental accounts of TS prepared by assessee and thereby disregarding internal TNMM & adopting external TNMM, that the assessee's segmental data was tied up with the audited financials that the allocations were worked out based on the SAP/ ERP system, that due to that certain expenses shown separately in the P&L were grouped in preparation of segmental data, that there was only re grouping of amounts, that the argument of the TPO that the transaction pertaining to toll manufacturing was of special nature was not correct, that toll manufacturing transaction was part of normal routine operations of the assessee and was not a transaction of special nature, that the transaction pertaining to toll manufacturing was more closely aligned to manufacturing activity and trading activity as it pertained to goods manufactured by a toll manufacturer appointed by the assessee to manufacture certain specified goods under its direction and supervision, that the goods were received from the toll manufacturer in a completed state the same had been classified as cost of traded goods in the financial statements, that based on the actual facts it was evident that the toll manufacturing cost pertained to the MS, that the toll manufacturing cost had been appropriately considered by the assessee under the MS, that the income relevant to the cost pertaining to toll manufacturing transaction had also

been allocated to the MS, that the TPO had accepted the stand of the assessee's allocation method based on the SAP system in the subsequent AY.s.i.e. 2007-08, 2008-09 and 2009-10, that certain expenses were grouped in segmental together, that on the total level the net profit was tying up with financials, that standard costs were used for the purpose of segmentation variance, that COGS was based on Standard and Actual. He referred to paragraph 13 of AS-17 and argued that the assessee had fairly and reasonably prepared the segmental profit and loss account between the manufacturing and TS based on the financial information captured by the internal financial reporting system of the Company for those segments, that the assessee had given a proper reconciliation to the TPO of the profit as per the segmental financial split and the profit as per audited financials which clearly evidenced that all the items of operating income and expenses had been considered and accounted while preparing segmental financial split, that for application of TNMM it was not necessary that there had to be identity of products-rather functional comparability was essential, that the AE and non-AE segment of the assessee dealt in manufacture of agro chemicals, that both the segment under the manufacturing function were functionally similar, that the internal TNMM analysis conducted by the assessee was correct. , that the TPO had accepted the broad segmentation of the assessee between Manufacturing and Trading activities, that on the very same basis it had further dissected the Manufacturing and Trading activities into AE (associated enterprises) and Non AE segments, that he did not considered the AE and Non AE segmentation made by the assessee in the Manufacturing and Trading activities, that the MS was accepted, that TS should have been accepted, that in the subsequent years the TPO had accepted the system, that indenting commission and export incentives formed only 0.2% total turnover, that those expenses were not at all material to vitiate the segmental profitability, that the transaction of indenting commission was closely interlinked with that of TS hence could be benchmarked together, that in the subsequent years the assessee had classified

the indenting commission under the TS and the TPO had accepted the same, that in case of comparables indenting commission was considered to arrive at their margins, that the figures reported in TPO's order about manufacturing services were incorrect, that the total income received was Rs. 70.33 crores and the profit disclosed was Rs. 22.07 lakhs, that separate books of accounts were maintained in SAP system by the assessee for the manufacturing services, that same had been separately disclosed in segmental and directly the profit amount was shown under manufacturing services, that SAP service being an international transaction was shown separately in the segmental as separate accounts were maintained for the same, that SAP services were not part of TS.

**2.5.** We have heard the rival submissions and perused the material before us. We find that toll manufacturing cost had been considered under the MS, that the cost pertaining to toll manufacturing transaction had been allocated to MS, that export incentives were part of MS, that in case of trading the assessee would import from AEs and would sell locally, that the argument of the TPO that AE segmented export incentive was factually incorrect, that with regard to following of the standard costing system it is found that the assessee had given a proper reconciliation to the TPO of the profit as per the segment of financial split and the profit as per audited financials, that the reconciliation clearly established that all the items of operating income and expenses had been considered and accounted while preparing segmented financial split, that AE and the non-AE segment of the assessee were manufacturing agrochemicals, that the AE and non-AE segment under the MS were functionally similar, that internal TNM and analysis conducted by the assessee was correct, that intending commission and export incentive formed only 0.2% of the total turnover, that those expenses were not at all material to vitiate the segmental profitability, that the correct figure of manufacturing services was 70.33 crores and not 700.33 crores as reported by the TPO, that the profit disclosed was Rs. 22.07 lakh and not 22.07

crores as held by the TPO, that separate books of a/c.s were maintained for the manufacturing services, that same had been separately disclosed in segmental results, that the TPO and the DRP had accepted the IT.s. of MS, that no addition has been made for SAP services, that the TPO had made upward adjustment with regard to TS only and the DRP had confirmed it, that the assessee had applied internal TNMM for determining the ALP of the transactions it had entered in to with its AE.s., that the operating margin in the TS was 0.17%, that the weighted averaged arrived at by the assessee, using multiple year data, was 3.67%, that initially eleven comparables were selected, that in the final list of comparables only seven companies were picked up.

We find that the assessee had specifically advanced the issue that if any adjustment was to be made it should have been restricted to the Transaction with the AE.s., not for the entire segment. In our opinion, the argument is very basis of TP adjustments. The TP provisions were introduced in the Act to prevent the practice of transferring the profit to the AE by adopting certain dubious methods. Naturally, the target should be the transactions with the AE.s and not the all the transactions. The assessee had challenged the exclusion and inclusion of certain comparables. The DRP has not considered any of these basic issues. As stated earlier, it passed a two line order and the order is not assigning any reason for arriving at the conclusion. It is a fact that in the subsequent years the TPO has accepted the internal TNMM for TS also. We are not aware as to what distinguishing factors were there in the later years as compared to the facts of the year under consideration that the TPO had taken a diagonally opposite view. The DRP has not considered this vital issue. We agree that res-judicata is not applicable to the taxation proceedings, but, rule of consistency is very much applicable. Therefore, the DRP should have considered all the above facts and should have passed a reasoned order. In our opinion, matter needs further verification. So, in the interest of justice we are restoring back the matter to the file of the DRP who would decide the issue after hearing the assessee. It may call for

comments from the TPO. First effective ground (GOA 1-11) are decided in assessee's favour, in part.

**3.** Next ground, i.e. GOA-12, is about disallowance of payment made to clubs, amounting to Rs. 8.58 lakhs. During the assessment proceedings, the AO found that the assessee had incurred the above expenses towards annual subscription charges and cost of club services and facilities utilised by the executives of the company. He held that the expenditure had no business exigency, that expenditure was of capital nature. In his draft order he proposed the addition. The assessee filed objections before the DRP. In its order the DRP directed the AO that to examine the details of expenditure and to allow expenditure on account of subscription and club membership. However, in the final order the AO held the expenditure of capital nature and disallowed it.

**3.1.** Before us, the AR stated that the DRP had directed the AO to allow expenditure on account of subscription and club membership as a deduction after examining the details, that in the final assessment order the AO held that the assessee had taken a corporate membership of the clubs, that it would give enduring benefit to the assessee, that the expenses were towards payment of membership fees and annual subscription charges as well as towards the cost of services, that the expenditure was capital in nature, that he had not followed the directions of the DRP, the directions of the DRP were binding, that assessee had paid club membership exclusively and wholly for the purpose of business, that club membership only facilitated assessee to conduct its business more smoothly and efficiently. He relied upon the cases of Otis Elevators Company (India) Ltd. (195 ITR 682), Samtel Colour Ltd. (326 ITR 425), Infosys Technologies Ltd. (349 ITR 582). The DR left the issue to the discretion of the Bench.

**3.2.** We have heard the rival submissions and perused the material before us. We find that the assessee had claimed expenditure towards payments made to club on account of subscription and membership, that the AO decided to disallow the expenditure, that the DRP directed the AO to allow expenditure with regard to subscription and club membership after examining the details, that while finalising the assessment he admitted that payments were made towards membership fees and annual substation services, that he disregarded the directions of the DRP and made the disallowance. In our opinion, the action of the AO is highly objectionable and not as per the provisions of the law. The AOs have to follow the directions of the DRP—they had no choice as far as following the directions of the DRP is concerned. They are authorised to challenge the directions before the Tribunal but they cannot refuse to carry out the directions. Therefore, only on this count the appeal of the assessee has to be allowed. But, even on merits the issue is covered in favour of the assessee by several judgements relied upon by the assessee. We would like to refer to the case of United Glass Manufacturing Co Ltd. (Civil appeal number 6649 of 2012 of Hon'ble Supreme Court). In that matter, the Hon'ble court has held as under:

*“..... We find that a series of judgements have been passed by High Court's holding that club membership fees for employees incurred by the assessee is business expenses under section 37 of the income tax act, 1961. We also find that none of the decisions have been challenged in this court. Even otherwise, we are of the view that it is a pure business expense.”*

Respectfully following the above judgement, ground number 12 is decided in favour of the assessee.

**4.** Next ground deals with disallowance made u/s. 14A r.w.r. 8D of the Income Tax Rules, 1962 (Rules), amounting to Rs. 22.87 lakhs. In the draft assessment order, the AO had proposed to make disallowance as per the provisions of section 14A of the Act. The assessee filed objections before the DRP who gave partial relief to the extent of Rs. 6.65 lakhs. It deleted the addition proposed by

the AO as per rule 8D(iii) of the Rules. While computing the total income of the assessee the AO did not allow the relief granted by the DRP.

**4.1.** Before us, the AR stated that assessee had sufficient own funds to make investments, that during the year under consideration additional investment of Rs.1.90 lakhs only was made, that if interest-free and interest-bearing funds were available presumption would be that interest free funds were utilized, that out of the total investment and amount of Rs.2.58 crores was in a subsidiary, that an investment of Rs. 20.48 lakhs were made out of compulsion, that those investments were made as per the requirements of the local authorities, that the investments were made out of commercial expediency and not with intention of exempt income, that the assessee itself disallowed a sum of Rs. 2.80 lakhs as expenditure incurred towards earning of exempt income, that the AO had neither controverted nor recorded any objective satisfaction with regard to explanation offered by the assessee. He relied upon the cases of HDFC Bank Ltd. (ITA.330 of 2012 of the Hon'ble Bombay High Court), Reliance Utilities and Power Ltd. (313 ITR 340), JM financial Ltd (ITA/4521/Mum/2012) Piem Hotels Ltd. (ITA/240/Mum/2012 and Bayer Bioscience(P)Ltd. (51 SOT 16). The DR stated that matter could be decided on merits.

**4.2.** We have heard the rival submissions and perused the material before us. We find that during the year under consideration the assessee had received dividend income of Rs. 37.51 lakhs, that it explain to the AO that dividend warrants were deposited into bank accounts in a routine manner along with the other checks, that the assessee had sufficient own funds to make investment, that it had made investments in subsidy companies, that on its own it had disallowed and amount of rupees 2.33 lakhs, that the AO had not given any reason as to why the calculation given by the assessee was not acceptable. He had simply applied the formula as envisaged by Rule 8D of the Rules. We are of the opinion that

approach of the AO was contrary to the provisions of law. Considering the above facts, Ground 13 is decided in favour of the assessee.

**5.**Next Ground pertains to disallowance of Rs. 2.40 crores, being product trial expenses. During the assessment proceedings the AO found that assessee had claimed production trial expenses of Rs. 2.40 crores. He directed the assessee to justify allowability of the expenditure. After considering the submission of the assessee, the AO held that the expenses pertained to new product development/trial expenses, that same were in the nature of capital expenditure which would give enduring benefit to the assessee. He proposed to treat it a capital expenditure and to disallow the same.

**5.1.**Aggrieved by the draft order of the AO, the assessee filed objections with the DRP. Before it, the assessee made elaborate submissions. After considering the available material, the DRP held that as per the assessee's own admission the expenses were in respect of research that was conducted in government approved institutions, that research and development activities were not carried out by the assessee, that the expenditure was capital nature. In pursuance of the directions of the DRP, the AO held that expenses pertaining to new product development/trial expenses were capital in nature, that same gave enduring benefit to the assessee, that the expenses could not be allowed under section 37 (1) of the Act.

**5.2.**Before us, the AR contended that the assessee had incurred expenses to test as to whether any of its existing products could be used for certain other crops, that the exercise was taken before selling the goods in the market, that the products were sold in the past for a specific crop, that if those products were to be used for other crops same were to be tested for/on product quality, bio-efficacy and toxicology, that expenditure related to testing charges were paid for

testing product, that assessee's product line was such that required concurrence of such expenditure, that by expanding the amount the assessee did not become owner of any capital asset, that fixed capital did not get enhanced by incurring of such expenditure, that same ought not to be treated a capital expenditure, that the expenditure resulted in smooth conduct of assessee's business. Alternatively, it was argued that the expenditure should be allowed as per the provisions of section 35 of the Act. The DR argued that assessee was not carrying out the research activities itself, that the government approved institutions were doing the job on behalf of the assessee, that expenditure could not be allowed as revenue expenditure.

**5.3.** We have heard the rival submissions and perused the material before us we find that while dealing with the objections filed by the assessee for the a why 2007-08 the DRP had allowed the direction under section 35 of the Act. In our opinion, the test to decide the nature of the expenditure i.e. capital or revenue expenditure the basic thing to be seen is as to whether the expenditure is for running the business of the assessee smoothly. If the expenditure is incurred for day-to-day business activities of the assessee and not for acquiring some asset it has to be allowed as revenue expenditure. In the case before us, it is a fact that no new asset came into existence. Secondly, the expenditure incurred was basically for carrying out the business. Payment to government agencies would not make any expenditure capital/revenue. Therefore, reversing the order of the AO, GOA -14 is decided in favour of the assessee.

**6.** Next ground is about disallowance of Rs.2.25 lakhs, being computer software expenses. During the assessment proceedings, the AO found that assessee had claimed the said expenditure as revenue expenditure. He proposed to disallow the same treating as capital expenditure. It filed objections before the DRP, who held that the computer software was a copyright, that it had to be capitalised and

that depreciation was to be allowed as per the rules following the directions of the DRP, the AO treated the software expenditure as capital in nature.

**6.1.** Before us, the AR stated that software facilitated the trading operations of the assessee, that it enabled the management to conduct business more efficiently and profitably, that it was not in the nature of profit-making apparatus. He relied upon the cases of Asahi India Safety Glasses Ltd. (ITA 1110/2006 and 1111/2006 of Hon'ble Delhi High Court), Raychem RPG Ltd. (ITA 476 of 2009 of Hon'ble Bombay High Court) GE Capital Services Ltd (300 ITR 420). The DR stated that matter could be decided on merits.

**6.2.** We have heard the rival submissions and perused the material before us. We find that in the case of Asahi India Safety Glasses Ltd. the Hon'ble Delhi High Court has held as under:

*“Software is nothing but another word for computer programs i.e. instructions that make the hardware work. Software is broadly of two types i.e. the system software, which is also known as operating system which controls the working of the computer; while the other being applications such as word processing programmes, spreadsheets and databases which perform the tasks for which people use computers. Besides these, there are two other categories of software, these being: network software and language software. The network software enables group of computers to communicate with each other, while language software provides the tools required to write programs.*

*The aforesaid facts show that what the assessee required through A was an application software which enabled it to execute tasks in the field of accounting, purchases and inventory maintenance. The fact that the application software would have to be updated from time to time based on the requirements of the assessee in the context of advancement of its amendments by law or by professional bodies like the Institute of chartered accountants of India, which are given the responsibility of conceiving and formulating the accounting standards from time to time, and perhaps also, by reason of the fact that expenses may have to be incurred on account of corruption of the software due to unintended or intended ingress into the system-what not give a colour to the expenditure incurred is one on capital account. Given the fact that there are myriads of factors which may call for expenses to be incurred in the field of software applications, it cannot be said that either the extent of the expense or the expense being incurred in close proximity, in the subsequent years, would be conclusively determinative of its nature. The Assessing Officer has erred precisely for these very reasons.*

*The contention of the revenue that in the books of accounts the assessee had not written off the expenses in issue while in succeeding assessment year only a part of*

*the expense had been written off and, therefore, the assessee's own understanding of the nature of the expense involved was that it was expended on capital account is to be rejected. The reason being: that the treatment of a particular expense or a provision in the books of accounts can never be conclusively determine native of the nature of the expense. And assessee cannot be denied a claim for deduction which is otherwise tenable in law on the ground that assessee had treated it differently in its books..... Therefore, the tribunal was correct in law in holding that the expenditure incurred by the assessee on account of software and professional expenses was revenue expenditure."*

Respectfully, following the above judgment we allow the ground is by the assessee.

**7.**Ground 16 is about disallowance of Rs.2.96 crores, being compensation paid by the assessee to Punjab Pesticides Industrial Corporation Society Limited (PPICSL). During the assessment proceedings, the AO found that the assessee had made the payment of Rs. 2.96 crores to PPICSL. He directed the assessee to furnish explanation as to why said expenditure should not be treated as capital expenditure after considering the submission of the assessee, the AO held the payment had been made in the settlement of claim with respect to plant and machinery installed at the premises of PPICSL and its basis on the valuation of machinery.

**7.1.**Deciding the objection, filed by the assessee, the DRP held that the payment, as per the assessee's own admission, had been made to ensure goodwill and continued relationship, that it was in the nature of generating the goodwill, that it could not be considered to be a revenue expenditure, that the goodwill not being a depreciable assets depreciation was also not allowable.

**7.2.**During the course of hearing before us, the AR submitted that PPICSL was closely associated with the assessee is a tolling unit for over 30 years, that it made a huge investment in plant in 2002 in order to meet desired quality and quantity expectations of the assessee, that the plant was commissioned in September 2002, that the assessee had committed to PPICSL assured production

of 15 lakh litres of raw materials, that due to market conditions assessee was unable to lift the committed quantities, that it was called upon to pay compensation by PPICSL, that it appointed a consultant to conduct a fair and independent valuation in order to take well-informed decision, that on the basis of television report and amount of Rs. 2.96 crores was determined as a compensation to terminate the agreement on mutual consent, that the compensation was paid for non-lifting of agreed quantity of raw material from PPICSL, that the payment was of revenue nature, that the expression wholly and exclusively did not mean necessarily, that the expenditure was incurred for furthering that rate/business interest of the assessee. He relied upon the cases of Jamna Auto Industries (167 Taxman 192), Indo Asian Switchgears Private Ltd. (222 ITR 757) and Microsoft Corporation of India Private Ltd. (ITA 111 of 2008 of Hon'ble Delhi High Court). The DR supported the order of the AO and the DRP.

**7.3.** We find that the assessee had entered into an agreement with PPICSL to manufacture certain amount of raw material, that due to adverse market conditions it could not lift the goods from PPICSL, that it appointed a value of two to determine the compensation to be paid to PPICSL, that the AO and DRP dated the said expenditure as capital expenditure. In our opinion, for allowing/disallowing any expenditure u/s. 37 of the Act the basic thing to be seen as to whether the expenditure was incurred for furtherance of business interest of the assessee or not. It is a fact that in this case because of the expenditure incurred no new assets came into existence. The expenditure was incurred considering the old relation with the PPICSL and to avoid future business complications. If an assessee makes payment which is compensatory nature, it has to be allowed. In the case before us, the payment was made in pursuance of an agreement and that was of compensatory nature i.e. it was not penal. We would like to refer to the case of Peico Electronic and Electricals Ltd (107 CTR 240), delivered by the Hon'ble Calcutta High Court. In that case the assessee had entered into an

agreement with Vulcan industries, that Vulcan industries had to manufacture for the assessee certain goods, that it was lifting the goods regularly, that it stopped purchasing the goods from March 1975 though there was no breach of contract on part of the supplier, that the assessee paid compensation. The AO and the FAA held that amount of compensation paid by the assessee was an expenditure of capital nature. The Tribunal reverse the order of the FAA and held that the payment was made as a result of the business expediency and was a revenue expenditure. The Hon'ble Calcutta High Court upheld the order of the Tribunal. It referred to the case of G Scammell & Nephew Ltd.(8 ITR- supplement- 41 CA)wherein it was held that the expenditure incurred for termination of a trading relationship in order to avoid losses occurring in the future through the relationship, whether pecuniary losses or commercial inconveniences, was just as much for the purpose of the trade is the making or the carrying into effect of trading agreement.Considering the above discussion,we decide GOA-16 in favour of the assessee.

**8.**Next ground of appeal is about disallowance of gift expenses of Rs. 22.49 lakhs. We find that the assessee had filed objections before the DRP with regard to proposed addition by the AO. However, the DRP did not adjudicate the issue. Therefore,in the interest of Justice, we are restoring that the matter to the file of the DRP to decide the issue afresh after hearing the assessee. Ground number 17 is decided in favour of the assessee, in part.

**9.**Last effective ground of appeal pertains to adjustment of opening stock of Rs. 5.53 crores. Before us, the AR relied upon the case of Mahalakshmi glassworks (P)Ltd.(318 ITR 116) and stated that the AO erred in not allowing consequential adjustment/enhancement of Rs. 5.53 crores to the value of opening stock of the relevant assessment year 2006-07 on account of addition made to the closing

stock for the previous year under section 145A of the Act, that the double taxation had not been deleted till date. The DR stated that issue could be decided on merits.

In our opinion the basic principle of taxation jurisprudence stipulate that no item can be taxed twice. Considering the fact and circumstance of the case, the AO is directed to make further verification and to allow the adjustment as per the provisions of section 145A of the Act. He is to ensure that assessee does not suffer taxation for the same amount in two different assessment years. Ground raised by the assessee is partly allowed.

**10.** We hold that initiation of penalty proceedings(GOA-19)is a premature issue and the issue of the levy of interest under section 234D of the Act(GOA-20)is of consequential nature. Both the grounds are decided accordingly.

As a result, appeal filed by the assessee stands partly allowed.

Order pronounced in the open court on 25<sup>th</sup> May, 2016.  
आदेश की घोषणा खुले न्यायालय में दिनांक 25 मई, 2016 को की गई।

**Sd/-**

(सी. एन. प्रसाद / C.N. Prasad )

न्यायिक सदस्य / JUDICIAL MEMBER

मुंबई Mumbai; दिनांक Dated : 25.05.2016.

Jv. Sr. PS.

**आदेश की प्रतिलिपि □ प्रेषित/Copy of the Order forwarded to :**

1.Appellant /अपीलार्थी

2. Respondent /प्रत्यर्थी

3.The concerned CIT(A)/संबद्ध अपीलीय आयकर आयुक्त, 4.The concerned CIT /संबद्ध आयकर आयुक्त

5.DR "K " Bench, ITAT, Mumbai /विभागीय प्रतिनिधि, खंडपीठ, आ.अ.न्याया.मुंबई

6.Guard File/गार्ड फाईल

सत्यापित प्रति //True Copy//

**Sd/-**

(राजेन्द्र / Rajendra)

लेखा सदस्य / ACCOUNTANT MEMBER

आदेशानुसार/ **BY ORDER,**

उप/सहायक पंजीकार Dy./Asst. Registrar

आयकर अपीलीय अधिकरण, मुंबई /ITAT, Mumbai.