

## SETTING UP OF BUSINESS VIS A VIS INCOME TAX ACT, 1961(ACT)

### 1. Introduction

In Indian economy as more and more business players, both foreign and domestic are making entrance into new business avenues, it has been seen that there are huge costs which are incurred to float the new business venture. That is, before first business client is obtained, enormous costs are incurred in terms of salaries of staff, rentals of office etc. and the same may be further trebled by the longevity of period between “set up” of operations and “commencement” of operations.

In aforesaid connection, on income tax front, there have been interalia two issues which have captured attention of revenue authorities:

- a) Date of Setting up of Operations under section 3 of the Act dealing with definition of Previous year (which is triggered on “setting up” of business)
- b) Allowability of expenses after set up and before commencement of operations

An attempt has been made in this article to deliberate upon aforesaid issues.

### 2. Relevant Provisions in the Act

Section 3 of the Act, which defines “previous year” (which in turn is treated as a unit of assessment under the Act), in context of first year of business operation, states that same (previous year) shall start from date of “setting up” of business. Accordingly, date of setting up assumes importance because expenses prior to setting up of business will not be considered for allowability under section 37 of the Act (general provision for allowing business expenses). This is however subject to section 35D of the Act wherein specifically provision has been made by legislature for allowance of preliminary (preoperative) expenses. Succinctly speaking, salient features of section 35D are:

- a) It is applicable to an Indian company or other person “resident” in India. *That is, it is not applicable to foreign companies, which have opened branches in India and incurred specified expenses in setting up Indian operations.*
- b) It gives benefit for specified expenses which are incurred prior to business commencement and after commencement of business, for *extension* of same (setting up new units). In this connection, a welcome amendment *giving boost to service sector* had been recently introduced by Finance Act, 2008 w.e.f. AY 2009-2010, where hitherto allowed restricted benefit

extension of “industrial” undertaking has been extended to include service sector.

- c) The specified expenses are allowed in five installments beginning from the year in which business commences or the extension is completed as the case may be.

### **Interesting issues on Section 35D**

In aforesaid connection, Hyd Bench of ITAT in ITW Singnode 110 TTJ 170, has interestingly distinguished the expression “extension” from “expansion” in following words:

*“The expression used is "extension" and not "expansion". The former connotes that the assessee has extended its operations from the present activity to another activity. On the other hand, the latter indicates that the assessee has merely expanded its present operations. The expansion is generally meant to be the expansion of its present installed capacities. The capacity may be expanded either at the same location or at a different location. But the legislature has not used the word "expansion" and that is with a purpose. If there is merely an expansion, then it may not be necessary for the assessee to incur the type of expenditure envisaged in s. 35D. On the other hand, if there is extension or where altogether a new industrial unit is set up, such extension or setting up of a new unit may be preceded with the preparation of a feasibility report or a project report or conducting market survey and so on..”*

On aforesaid reasoning, it has been concluded that expenses incurred by assessee in innovating its products and improving them to cope with market conditions, are not subject to restriction of 1/5 as stipulated in section 35D and are allowable in toto, in year of incurrence u/s 37 of the Act. Similar sort of conclusion is available in DHC ruling in case of Gillete 173 Taxman 52.

Further, in context of section 35D, an interesting issue cropped up for consideration before DHC in Thirani 290 ITR 196, in context of debenture issue expenses, where after taking note of CBDT Circular No. 56 dated 19 March 1971 (explaining legislative intent behind section 35D), it was held that debenture issue expenses irrespective of being otherwise covered in plain language of section 35D, as intended by legislature, will continue to be allowed in full u/s 37 of the Act vide SC ruling in India Cements 60 ITR 52.

In view of above, since section 35D gives *proportionate benefit* over a period of 5 years and covers *limited expenses as specified there* under, therefore to have 100% allowance for every expense, it becomes wiser to deliberate upon date of setting up of business.

### **3. Meaning of “setting up” under section 3 of the Act**

### 3.1 BHC in Western Vegetable 26 ITR 151

In captioned case, BHC speaking through CJ Chagla (as his lordship then was) interalia held as under:

*“...It seems to us, that the expression "setting up" means, as is defined in the Oxford English Dictionary, "to place on foot" of "to established", and in contradistinction to "commence". The distinction is 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)(present section 37(1)) .....”*

In aforesaid case, Assessee Company's object was to run *oil mill* and in this line of business operation, it was the case of Assessing Officer (AO) that assessee's business was set up only when it made *first purchase of groundnut oil*. Finally, BHC upheld ITAT's view wherein it was held that albeit first purchase of raw material is indicative of setting up of business, *but still some time would have been taken in making arrangements for purchase, therefore additional cushion of one month was allowed in computing "set up" date*. In this case, another interesting feature which came to light was three authorities viz. AO, Appellate Commissioner (AC), ITAT came to three different set up dates viz. AO took date of raw material purchase, AC took date of commencement of business certificate, and ITAT took one month date prior to raw material purchase.

*This is how the issue becomes more complex and therefore it is advisable to minutely analyze/consider date of every event in initial phase of business operation so as to correctly decide the "date of set up" u/s 3 of the Act.*

*Further, it becomes manifest from aforesaid BHC ruling, that date of set up of business operations has to be necessarily and particularly analyzed in context of "objects" for which business is started which may be evident in company's case from Memorandum of Association, as different parameters will apply to different sets of business. Further relevant in this context is Guj HC ruling in Saurashtra Cement 91 ITR 170 wherein it is held that:*

*...the term business connotes a continuous course of activities. All the activities, which go to make up the business, need not be started simultaneously in order that the business may commence. The business would commence, when the activity which is first in point of time and which must*

*necessarily precede all other activities, is started. It was further held that in order to determine the question whether, the business of an assessee has commenced or not, it is necessary to consider, what constitutes the business of the assessee. It was also laid down that in determining this question arising under fiscal legislation, one must consider what are the activities which constituted such business without being misguided by the loose expressions of vague and indefinite import...*

- 3.2 In continuation of aforesaid discussion, in next mentioned tabular presentation, an attempt is made by the author to analyze relevant precedents in light of corresponding *object of assessee and its nature of business*:

<i>Title of Precedent</i>	<i>Nature of assessee's business</i>	<i>Assessee's contention for date of set up</i>	<i>AO's view</i>	<i>Court's verdict</i>
E-Funds International DHC 162 Taxman 1	Development of Software and IT Enabled Services	Since necessary infrastructure was set and technical employees to render IT services were employed – hence business set up	Since no income earned in relevant year, business not set up	Assessee's view confirmed  (Also refer Mum ITAT in 120 Taxman 205 (Mag) – Neil Automation – business of <i>distribution of software</i> – ITAT held business set up <i>when assessee started approaching prospective customers and supplied quotations of software</i>  <i>Further refer contrary proposition by Del ITAT in Adasoft 9</i>

				<i>SOT 31.</i>
Whirlpool of India 114 TTJ 211 Delhi ITAT	Finance Company, Advancing Loans etc (Financial Services)	Business setup on 1 Nov 1995 immediately after key employees were appointed viz. loan managers etc	Business set up when bank a/c opened on 1 Feb 1996	Business set up when directors are appointed, regional and branch managers are appointed, their salaries are paid, computers for carrying business are installed – Assessee's contention upheld
Hughes Escorts DHC- 213 CTR 45 & DEL ITAT – 106 TTJ 1065	Telecommunication Business (where VSAT an equipment was necessarily required for effective communication)	When letter of intent from prospective customer Bank of America for VSAT purchase was obtained (July 1994)	When first VSAT hub was set up by assessee company 9 March 1995)	CIT-A held date of first supply order by assessee Oct 1994 is material  ITAT upheld assessee's contention and DHC affirmed the same
Sarabhai Sons Guj HC 90 ITR 318	Manufacturing concern – of Scientific Instruments			When machinery was installed and not when land was purchased and orders or raw material were placed
Prem Conductors Guj HC 108 ITR 654	Manufacturing Concern			Date of securing orders, even before actual production started

Sarabhai Mgmt Guj HC 102 ITR 25 and SC – 192 ITR 151	Leasing of Property	When assessee came in position to offer services to licensees (Oct 1964)	When first lease was given (May 1965)	Assessee's contention upheld
Western India Sea Products Guj HC - 199 ITR 777	Marine Processing Industry			Acquiring a Godown in month of August in anticipation of arrival of fish in October – held to be date of setting up
DHC in ESPN Software 301 ITR 368	Distribution of ESPN Programming Services	When agreement with Parent Company was entered giving assessee co. license to distribute programmes (15 Aug 1995)	Since necessary infrastructure (decoders) were purchased later and since further distribution agreement by assessee with MEN was entered later in Oct 1995 and since no revenue earned in relevant year – business not set up	CIT-A, ITAT and HC accepted assessee's contention that business set up in Aug 1995
Pune ITAT (Third Member) in Styler India 116 TTJ 333	Service & Consultancy Sector – To supply knowledge and technology to its customers	When infrastructure was set up (technical staff appointment etc) and initial contacts made with prospective	Business not set up since activities mentioned by assessee are not sufficient to bring the business in “ready to	Third Member concurring with Accountant Member decided the issue in favor of assessee

		customers (When services of <i>assessee's employees</i> were made ready to be available to prospective customers)	commence” position	
Mad HC in Adyar Gate Hotels 241 ITR 268	Non Resident Co. engaged in project execution opened a Project office (PO) in India	When letter of intent from Neyveli Lingite Corpn. in April 1981 obtained (even though RBI approval under FEMA and office set up were all later)	When RBI approval subsequent to letter of intent, in Oct 1981 obtained	ITAT and HC upheld assessee's contention
Mad HC in Club Resorts 287 ITR 552	Selling time share units at tourist places	When canvassing staff for promoting assessee's business was appointed and assessee opened a operating office, even though construction of project was at nascent stage	When business earning starts and When construction of Project is completed	CIT-A, ITAT and HC upheld assessee's contention
Guj HC in Hotel Alankar 133 ITR 866	Boarding and Lodging House	When hotel building was acquired	The day on which hotel was finally inaugurated	HC reversing ITAT's order upheld assessee's contention
Latest Del ITAT in Akzo Nobel ITA No. 164/2004 Aug 8, 2008	Trading of Paints etc.	Incorporation of Company and Appointment of Directors	When business is in position to deliver goods	ITAT upheld revenue's contention
Del ITAT in Superlight Mktg 4 SOT 348	Acquiring and Selling Lands after dividing them in plots	When assessee started purchasing lands for	When sale activity of land is conducted	ITAT upheld assessee's contention

	(Promoters and Developers of Land at Gurgaon)	development	<i>CIT- A held that mere getting of land for development and getting license from HUDA for development are not material &amp; hence upheld AO's views</i>	
Bang Swire Holdings 6 SOT 621	Real Estate Business	When money was advanced for purchase of property		ITAT upheld assessee's contention
DHC in Herbalife 297 ITR 303	Trading of Healthcare Products	When agreement was entered into with Supplier on 9 Feb 1999	Surmistically on 15 Sep 1999	HC & ITAT upheld assessee's contention
DHC in Marvel Polymers 165 Taxman 618	Manf. and Trading of Footwear	When solitary transaction of sale and purchase of footwear was made, admittedly for sales tax registration (coupled with available electricity connection and raw material purchase)	When labor (skilled or unskilled) is appointed for carrying business, which became available post Previous year ending 31 March 1998	Albeit, CIT-A held in assessee's favor, but ITAT and HC decided against the assessee.
Del ITAT in Bharti Cellular Limited ITA No. 1737/2002	Provision of telecom/cellular services in Delhi	Being last of the following activity viz.- license from government (obtained on 29/11/1994) &	Being the earliest of all the activities (as stated in preceding column) viz date of	Albeit, CIT-A accepted AO's version, ITAT accepted assessee's



		clearance from Ministry of Communication (given on 26/9/1995) and commercial services were launched on <b>15/11/1995</b>	obtaining of license 29/11/1994	version
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#### 4. Conclusion

*In view of aforesaid discussion, it is quite clear that “due diligence” is must before deciding the “set up” date in context of Income Tax Act which in turn has repercussion on allowability of administrative and other expenses incurred in initial phase of business and needs to be done with specific reference to nature of assessee’s business and chronological happening of various events.*