

### Taxation of Receipts – Extinction of Profit Earning Apparatus

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The taxation of a receipt under the **Income Tax Act** becomes challenging when the said receipt is in the nature of capital as pleaded by tax payer as against revenue by tax authorities. Needless to state, that under the **Income Tax Act, 1961** (for brevity 'ITA'), all revenue receipts are taxable unless specifically stated not taxable and all capital receipts are not taxable unless specifically stated to be taxable. This is one of the cardinal principals embodied in ITA. However, whether a receipt is in the nature of capital or revenue is always hard to find and the courts had always framed various tests to determine the nature of the receipt and consequently the taxability.

In this article, we are dealing with determination of nature of one such receipt, which is received on extinction of profit apparatus or sterilisation of profits. Let us understand the nature of receipt by taking an example.

#### **Case Study:**

Say, ABC Limited has entered an agreement with PQR Limited. Vide such contract, ABC Limited is allowed to occupy the land owned by PQR Limited and construct a hotel and manage the same and the revenues earned from such hotel are agreed to be shared among ABC Limited and PQR Limited in a proportion.

After ABC Limited spending certain resources and mobilising the work force for development of land into proposed hotel, differences arose between ABC Limited and PQR Limited which stalled the hotel project. Since no land was made available by PQR Limited despite repeated reminders, ABC Limited is constrained to invoke the arbitration clause in the contract. Accordingly, the matter has reached the arbitral tribunal.

Before the Arbitral Tribunal, both ABC Limited and PQR Limited has submitted various claims along with evidences in their support. ABC Limited has made claims based on loss of profits because the project could not take place. The Arbitral Tribunal after perusing the entire documents and claims has held that PQR Limited is liable to pay certain amounts to ABC Limited and ordered the same.

Accordingly PQR Limited has paid amounts as stated in arbitral award and the same were received by ABC Limited. Now, the question which arose is, what would be the nature of receipt in the hands of ABC Limited? If the response is Capital, then the same would not be coming into the purview of definition of 'income' as per ITA. If the response is Revenue, the same would be falling under the ambit of definition of 'income' and be subjected to tax. Keeping the above question in mind, let us proceed to examine the taxability of such a receipt in the hands of ABC Limited.

As stated earlier, the characterisation of receipt as 'revenue' or 'capital' is not codified in the law and there is no straight jacketed formula. Hence, we have to place reliance on the existing jurisprudence

on the said subject to decide the nature of such receipt. The Honourable Income Tax Appellate Tribunal (for brevity 'ITAT') of Pune had an occasion to deal with the taxation of similar receipts in the matter of Aquapharm Chemical Company Limited<sup>1</sup> (for brevity 'Aquapharm').

### **Aquapharm matter – ITAT Pune:**

The facts in Aquapharm were that they have entered an agreement with AIK-Germany, for supply of technical knowhow for manufacture of fire-retardant chemicals. Aquapharm was incorporated in 1974 and has two plants located in India. In order to diversify its business, Aquapharm has contemplated to start a new division which manufactures the fire-retardant chemicals. Since Aquapharm does not have enough experience and competence, they have entered agreement with AIK-Germany for supply of knowhow. Aquapharm obtained requisite approvals for project expansion for start of new manufacturing facility and also paid the first instalment of knowhow fee to AIK-Germany for the knowhow. Consequent to such payment, Aquapharm has received certain technical information and drawings from AIK-Germany. The information received was not good enough to start the manufacturing activities of fire-retardant chemicals. Despite repeated requests from Aquapharm, AIK-Germany has not shared any further information stating that all the information required to start the said manufacturing activities was already shared by the later. However, Aquapharm was of the belief that there was still certain information, which was required and in absence of such information, the manufacturing facility could not kick in. In light of the above deadlock, Aquapharm was forced to invoke the arbitration clause in the contract. The arbitral tribunal after hearing the said matter, has ordered AIK-Germany to pay an amount of INR 4.53 Crores as compensation for the settlement of dispute.

The said amount was claimed by Aquapharm as capital receipt and accordingly the same was not offered to tax. While processing the return under Section 143(1)(a) of ITA, prima-facie adjustment of INR 4.53 Crores as revenue receipt. Aquapharm has filed a rectification application under Section 154 but could not succeed. Aquapharm could not succeed even in the appeal proceedings as the appellate authority was of the belief that the receipt was revenue in nature. The said matter has reached the Honourable ITAT.

Before the Honourable ITAT, Aquapharm has argued that the compensation received was for lost profit due to non-supply of knowhow and not on loss of profit. Since the information was not received and the manufacturing activity could not take place, the entire works which were required to start the said facility has gone waste and accordingly Aquapharm pleaded that the compensation received was for the lost of profit due to disturbance to the profit-making apparatus (the manufacturing facility) and just for not loss of profit. Since the compensation was for the purposes of disturbance of profit-making apparatus, Aquapharm pleaded that the said receipt was in the nature of capital and hence not taxable and placed reliance on number of judgments including the Apex Court in the matter of Bombay Burmah Trading Corporation<sup>2</sup>.

Revenue agreed that the amounts received as compensation for giving up rights in profit making apparatus would be in the nature of capital receipt, however, the venture is only for the purposes of carrying on existing business by taking the help of another, then the compensation is in the nature of revenue. Since in the facts of Aquapharm, it was an existing business, the compensation received

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<sup>1</sup> 2012 (2) TMI 594 – ITAT Pune

<sup>2</sup> 161 ITR 386 (SC)

from AIK would be in the nature of revenue and accordingly subjected to tax. The Revenue has relied on the decision of Delhi High Court in the matter of CIT vs Manoranjan Picture Corporation<sup>3</sup>. The other arguments which were put forth by the Revenue are as under:

- The compensation is not for suffering injury to the profit-making apparatus. The apparatus of the assessee was the existing set up and the proposed making of fire-retardant chemical was merely an expansion of the existing business.
- The compensation received was in normal course of business carried on by the assessee.
- The injury if any was not inflicted on any capital asset of the assessee. The agreement was to use the knowhow as a license for a limited period.
- The failure to supply full details of knowhow did not affect the basic intention of the business of the assessee.
- The compensation for the loss suffered by assessee was incidental to business and it did not amount to be received for loss of an enduring asset.
- The assessee had mainly acquired the right to use the technology and the expenditure incurred has also been claimed as a revenue expenditure, therefore any receipt in view of such expenditure cannot be termed as capital receipt.
- The arbitration award there categorically states that the amount of compensation received by the assessee is in lieu of profits and not because the assessee's profits earning apparatus was affected, hence the expenses on arbitration has been claimed as revenue expenditure and
- The loss of extinction of source of income which the assessee contends never came into the effect. The arbitration award is only in lieu of profits.

The Honourable ITAT after pursuing all the above objections have examined each objection in detail. Let us proceed to understand the rationale delivered by the Honourable ITAT for each of the above objection.

**The compensation is not for suffering injury to the profit-making apparatus. The apparatus of the assessee was the existing set up and the proposed making of fire-retardant chemical was merely an expansion of the existing business:**

The Honourable ITAT has held that the new division of Aquapharm cannot be called as an extension to an existing set-up. The new manufacturing facility as contemplated by Aquapharm was not in any way connected with the existing facility and accordingly the ITAT held that the manufacturing facility is profit earning source and non-facilitation of technical knowhow made Aquapharm deprived from such profit earning source. The ITAT placing reliance on the decision of Honourable Bombay High Court in the matter of J. Vajantizies & Others<sup>4</sup> held that where the Vajantizies was prevented from commencement of business and the damages for compensation received were worked out on the basis of loss of profit which the J. Vajantizies would have earned if he had carried on business would be only a capital receipt and held that the amount received by Aquapharm was capital in nature.

**The compensation received was in normal course of business carried on by the assessee:**

The Honourable ITAT stated that as held earlier that the above compensation was not received in normal course of business since the business qua manufacturing facility has not kicked off to say that

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<sup>3</sup> 1977 228 ITR 202 (Del)

<sup>4</sup> 91 ITR 345 (Bom)

the compensation was received in normal course of business. The ITAT took support from Honourable Andhra Pradesh High Court in the matter of Barium Chemicals Limited<sup>5</sup>, wherein the High Court held that in order to decide whether a payment is in the nature of revenue or not, its true nature and substance has to be found out. If the payment is received in the normal course of business for loss of stock in trade, the same can be held as revenue receipt. On the other hand, the High Court continued to state that if a payment is towards compensation received for extinction or sterilisation partly or fully of a profit earning source, such receipt not being in the ordinary course of business would be a capital receipt. The ITAT held that since in the facts of Aquapharm, there was no loss of stock or any other loss after starting of its business (qua manufacturing of fire retardant chemical) and the compensation was received since the knowhow was not good enough to start the manufacturing activity, the compensation would be very well called for extinction of profit earning source and accordingly the nature of such receipt would be in the nature of capital.

The ITAT further stated that the reliance of the Revenue on the decisions in the matter of Ansal Properties & Industries Limited<sup>6</sup> would not help since the fact patterns in such case was different from facts of Aquapharm. The ITAT has held that the decision of Ansal Properties & Industries Limited can be distinguished from the facts of Aquapharm matter, since in the former case, the facts were that the company was carrying on business within the existing framework of business and as per the needs of business, contracts with existing agencies were terminated and the fresh agencies were entered. The compensation was granted for loss of future profits which were held as revenue receipts. Since the compensation was received during the normal course of business, the court therein held that such receipt was in the nature of revenue. However, the facts in Aquapharm are completely different and the reliance on Ansal Properties & Industries Limited would not help the Revenue.

**The injury if any was not inflicted of any capital asset of the assessee. The agreement was to use the knowhow as a license for a limited period:**

The Honourable ITAT then proceeded to take up the next objection. The Revenue contended that the compensation received by Aquapharm did not inflict any capital asset and accordingly the compensation received was revenue in nature. The Revenue further placed reliance on decision of Honourable High Court of Delhi in the matter of Manornajan Corporation<sup>7</sup> and pleaded that the compensation received should be held as revenue in nature. The ITAT stated that the decision of Manornajan Corporation would help the cause of Aquapharm and not of Revenue. The ITAT has stated that in the facts of Manornajan Corporation, the amounts were received as compensation for existing business and there was no damage to the profit earning apparatus. Hence, the Honourable Delhi High Court in such fact pattern, held that the receipts were revenue in nature. However, the Honourable Delhi High Court stated that if the compensation is received for giving up its right was itself the profit earning apparatus and such an action would disrespect the entire profit earning structure, the said compensation should be treated as capital in nature. The ITAT has held that the ratio delivered by Honourable High Court squarely applies to the facts of Aquapharm and accordingly the receipt should be treated in the nature of capital.

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<sup>5</sup> 168 ITR 164 (AP)

<sup>6</sup> (2008) 19 SOT 391 (Del)

<sup>7</sup> (1997) 223 ITR 32 (Gau)

**The failure to supply full details of knowhow did not affect the basic intention of the business of the assessee:**

The Honourable ITAT has held that there was no evidence to show that the Aquapharm could continue the business as usual in absence of knowhow. In absence of such evidence and treating the manufacturing plant of fire-retardant chemical as a distinct unit, the ITAT could not uphold the submission made by Revenue on this count.

**The compensation for the loss suffered by assessee was incidental to business and it did not amount to be received for loss of an enduring asset:**

The Honourable ITAT has brushed away this allegation of Revenue by referring to the observations made in the preceding paras. Accordingly, ITAT held that the compensation cannot be treated as receipt incidental to business.

**The assessee had mainly acquired the right to use the technology and the expenditure incurred has also been claimed as a revenue expenditure, therefore any receipt in view of such expenditure cannot be termed as capital receipt:**

The Revenue pleaded that since Aquapharm has claimed the payments made to AIK-Germany were charged off to profit and loss account, any receipt thereof should also be credited to profit and loss account and accordingly be subjected to tax. The Honourable ITAT has held that whether a receipt is revenue or capital has to be decided based on the complete facts available and circumstances in which such compensation was ordered. The ITAT held that the loss was compensated by the award by the arbitrator keeping in mind that the Aquapharm could not start the manufacturing and earn the profit therefrom due to non-supply of technical knowhow. Hence, the plea of authorities that expenditure incurred to acquire the right to use of technology was claimed as revenue expenditure, therefore any receipt in lieu of such expenditure cannot be claimed as capital receipt has no substance.

**The loss of extinction of source of income which the assessee contends never came into the effect. The arbitration award is only in lieu of profits:**

The Revenue further placed arguments stating that the arbitral award categorically records that amount of compensation received by Aquapharm was in lieu of profits and not because the Aquapharm 's profit earning apparatus was effected. The Revenue further placed reliance on the decision of Apex court in the matter of Raghuwansi Mills Limited<sup>8</sup> and Travancore Rubber & Tea Co. Limited<sup>9</sup> to argue that the receipts were in the nature of revenue. The Honourable ITAT has held that in light of the undisputed fact that the compensation was awarded for the loss suffered by Aquapharm which was attributed to extinction of profit earning apparatus, the receipt was capital in nature. Further, the ITAT has held that the decisions relied by Revenue cannot be applied to the present set of facts because, the facts involved in relied upon matters was receipts in case of tax payers who were already in business. The ITAT further placed reliance on the decision of Apex court in the matter of Senairam Doongarwell<sup>10</sup>, where in it was held that just because compensation was determined with

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<sup>8</sup> 22 ITR 484 (SC)

<sup>9</sup> 243 ITR 158 (SC)

<sup>10</sup> 42 ITR 392 (SC)

reference to the lost profits, it would not amount to revenue receipt. The basic question would be whether the proposed business is sterilised or could not take off.

**Conclusion in Aquapharm 's matter:**

The Honourable ITAT accordingly held that the compensation which is received for extinction of profit-making apparatus or sterilisation of profits would be in the nature of capital and accordingly brushed away all the grounds put forth by Revenue.

**Aerens Developers matter – ITAT Delhi:**

The Honourable ITAT of Delhi had an occasion to decide upon the nature of receipt in the matter of Aerens Developers and Engineers Limited<sup>11</sup> (for brevity Aerens Developers). The facts in the matter of Aerens Developers were, that the assessee has entered a consortium agreement amongst its associates defining their roles, rights and responsibilities along with respective share in consortium. All the consortium companies through their lead company, entered an agreement with JMA Buildcom (P) Limited to purchase 10 acres of land for a consideration of INR 15 Crores. Since JMA Buildcom could not purchase the said lands despite many reminders, the consortium companies has settled the dispute invoking arbitration clause. Accordingly, one of the consortium company being Aerens Developers has received INR 1 Crores as compensation. Aerens Developers has claimed that the said amount as a capital receipt and has not offered tax on the reasons that there is a disturbance to the profit earning apparatus and accordingly the receipt is capital in nature. The Revenue has stated that no tangible asset has not been lost to treat the compensation as capital loss and accordingly pleaded that the compensation was to be treated as revenue.

The Honourable ITAT after referring to the decision of Honourable ITAT Pune in the matter of Aquapharm (supra), has held that the injury was caused to the profit-making apparatus as the land which was profit making apparatus for consortium was not supplied by JMA Buildcom (P) Limited and hold that the compensation received was for lost profit due to non-supply of land and not on loss of profit and accordingly the receipt of INR 1 Crore was held to be capital in nature.

**Conclusion to Case Study:**

In the facts of our case study, ABC Limited has received compensation since PQR Limited could not make available the land which is required to start the project. Since land being the most important aspect for the project and absence of which could disturb the entire profit-making apparatus of ABC Limited, the compensation seen from the perspective of the above judgments would be treated as capital. The Honourable Supreme Court's observation in the matter of Senairam Doongramall (supra), which states that just because the damages were worked on loss of profits, the receipt could not be coloured as revenue is quite an essential one and important too.

However, as everyone is aware there is no one size fits all answer to the question which deals with determination of nature of receipt. Every receipt has to be judged in the context which it arises and surrounding facts should be taken into consideration before concluding on the nature of receipt and consequently its taxability.

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<sup>11</sup> 2016 (9) TMI 948 – ITAT Delhi