



Tax alert: Nature of business activity to be examined for deciding date of set-up of business

21 July 2023

The Delhi Bench of the Income-tax Appellate Tribunal (ITAT), based on facts of the case, has rendered its decision that the nature of business activity needs to be examined to determine the date of set-up, and without examining the same, on the nature of expenditure alone, the question cannot not be sufficiently answered.

In a nutshell



The nature of business activity of the taxpayer (in the case under consideration) did not require immediate installation of any plant and machinery.



A business will "commence" with the first purchase of stock-in-trade and the date on which the first sale is made is immaterial.



For manufacturing, several activities to bring or produce finished products, have to be undertaken, but business commences when the first of such activities is taken.



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Background:

- The taxpayer¹ was incorporated on 17 July 2012 in India as a subsidiary of a Japanese company (H Co) and is engaged in the business of manufacturing, trading etc., of automobile accessories, auto parts and fittings of all kinds. For the Financial Year (FY) 2012-13, corresponding to Assessment Year (AY) 2013-14, the taxpayer filed its return of income declaring business loss.
- During the course of the audit proceedings, the Assessing Officer (AO) observed that:
 - The taxpayer made additions in fixed assets for purchase of vehicle, computer software, furniture and other office equipment.
 - The taxpayer had not made any investment for purchase of plant and machinery.
 - The taxpayer had shown interest income in its profit and loss account.

Accordingly, the AO concluded that the taxpayer had not begun its business operation and it was still under incorporation process and made disallowances of the group commission, business promotion vehicle running expenses and research and development (R&D) expenses. Thus, the loss claimed by the taxpayer was reduced.

- Aggrieved, the taxpayer filed an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)] who upheld the observations and findings of the AO that the taxpayer had not commenced its business during the year under consideration. However, the CIT(A) enhanced the additions made by the AO by making, amongst others, the following observations:
 - A taxpayer can incur business losses only in the course of an existing business and not before the commencement of business. Once it was the finding of the Revenue that the taxpayer has not commenced business, such taxpayer could not have any business losses.
 - Since the taxpayer had made a claim that the findings of the AO, that the taxpayer had not commenced its business during the year under consideration, was incorrect, it was incumbent upon the taxpayer to prove correctness of its claim and the taxpayer had to do the same on its own and not through the instrumentalities of the CIT(A)'s office.
 - As the taxpayer could not lead any independent third-party evidence to corroborate its claim that it had commenced its business during the year under consideration and the books of accounts being relied upon were only self-same evidence, the claim of the taxpayer that its business had commenced, was incorrect.
- Aggrieved, the taxpayer filed an appeal before Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

Decision of the ITAT:

The ITAT noted / observed as follows:

- The AO primarily drew conclusion that taxpayer was in the state of incorporation only because the taxpayer had not made any investment in the purchase of plant and machinery.
- While dealing with the question as to whether taxpayer had set up its business, the nature of business activity needs to be examined by the Revenue and without examining the same, on the nature of expenditure alone, the question could not be sufficiently answered.

Nature of business activity of the taxpayer

- The license agreement between the taxpayer and H Co, showed that the very purpose of establishing the subsidiary in the form of taxpayer, was to procure and having manufactured/assembled within India and

¹ ITA No. 3368/Del/2018 (Delhi-Trib.)

neighbouring countries and selling worldwide, certain accessories developed by H Co for installation of H Co's products.

- Thus, the nature of business activity of the taxpayer did not require immediate installation of any plant and machinery.

Activities undertaken by taxpayer during the year under consideration

- The taxpayer had initiated the process of negotiations for the procurement of the parts from various vendors.
- The confirmation of business activity given by third party vendors established that the taxpayer had placed the purchase order for supply of certain car covers and car floor mats appearing under the head 'WIP' as part of closing stock in the books of accounts of the vendor for the year ending 31 March 2013 and which were supplied by invoice dated 2 April 2013.
- The brokerage and commission expenses were paid to property consultants for taking apartment on lease for the director or recruitment of employees.
- The business promotion expenses were towards vendor selection and development.
- The vehicle running expenses were in the nature of fuel and maintenance of the vehicles owned by the taxpayer and used for the business purpose.
- The R&D expenses were towards samples of products/ accessories for testing purpose before placing a purchase order and all these were intricate to the nature of business activity of the taxpayer.

- In an earlier ruling², the Delhi High Court had observed as follows:

"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. "

- In another ruling³, the Gujarat High Court, had taken into consideration the argument of the Revenue that in the absence of plant and machinery being installed, the business could not be said to be set up. The Gujarat High Court had observed as follows:

"The argument of the Revenue based on these observations was that extraction of limestone by quarrying leased area of land was merely in the nature of preparation for the establishment of the business of the assessee and the business of the assessee could be said to have been set up only in June, 1960, when the installation of the plant and machinery was completed and the unit was ready to discharge the function for which it was being set up, namely, manufacture of cement. This argument is, however, fallacious because it overlooks that these observations were made by the Supreme Court while considering the question as to when a unit of an industrial undertaking can be said to have been set up and they were not intended to refer to a totally different question as to when a business can be said to have been set up or when it can be said to have commenced. Here in the present case also if the question had been as to when the industrial undertaking or factory of the assessee could be said to have been set up the answer would have undoubtedly been that it was set up only when the plant and machinery were installed and it was ready to discharge the function for the which it was set up namely as to when the business of the assessee could be said to have commenced and on that question no light is thrown by this decision of the Supreme Court".

In view of the above the ITAT allowed the taxpayer's appeal and held that the AO and CIT(A) had erred in concluding that taxpayer's business was not 'set up' during the year under consideration, to deny the claim of loss

² CIT vs. Samsung India Electronics Ltd. [2013]356 ITR 354 (Delhi)

³ CIT vs. Saurashtra Cement & Chemical Industries Ltd.[1973] 91 ITR 170

or to categorise certain expenses as pre-operative expenses.

Comments:

The date on which a business has been set-up or commenced, is of relevance in order to decide whether the expenditure incurred for a newly set-up business is allowable or not. The terms 'set-up of business' or 'commencement of business' have not been defined under the Income-tax Act, 1961 and accordingly, the same has been a subject of litigation based on facts of each case.

This ruling reiterates the principle that the nature of business activity needs to be examined to determine the date of set-up and without examining the same, on the nature of expenditure alone, the question could not be sufficiently answered.

The ITAT in this ruling, based on examination of the facts of the case under consideration, has held as follows:

- The nature of business activity of the taxpayer (in the case under consideration) did not require immediate installation of any plant and machinery.
- A business will 'commence' with the first purchase of stock-in-trade and the date on which the first sale is made is immaterial.
- For manufacturing, several activities to bring or produce finished products have to be undertaken but business commences when the first of such activities is taken.

Taxpayers with similar facts may want to evaluate the impact of this ruling to the specific facts of their cases.



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