

* **THE HIGH COURT OF DELHI AT NEW DELHI**

Judgment reserved on : 08.08.2008
% Judgment delivered on : 21.08.2008

+ ITA No. 111/2008

**COMMISSIONER OF
INCOME TAX,**

..... Appellant

-versus-

**MICROSOFT CORPORATION
OF INDIA PVT. LTD**

..... Respondent

Advocates who appeared in this case:

For the Appellant : Mr R D Jolly with Mr Paras Chaudhry
For the Respondent : None

CORAM :-

**HON'BLE MR JUSTICE BADAR DURREZ AHMED
HON'BLE MR JUSTICE RAJIV SHAKDHER**

1. Whether the Reporters of local papers may be allowed to see the judgment ? Yes
2. To be referred to Reporters or not ? Yes
3. Whether the judgment should be reported in the Digest ? Yes

RAJIV SHAKDHER, J

1. This is an appeal under Section 260A of the Income Tax Act, 1961 (hereinafter referred to as the Act) against the judgment dated 31.01.2007 passed by the Income Tax Appellate Tribunal

(hereinafter referred as ITAT). By this judgment the ITAT rejected the appeal filed by the revenue confirming thereby the order of the Commissioner of Income Tax (Appeals) allowing the expenses incurred by the assessee, to the tune of Rs 1,30,60,957/- towards settlement of a foreseeable liability in respect of premature termination of an agreement for use of premises entered into with an entity by the name of, Paharpur Business Centre (hereinafter referred as to PBC).

1.1 The only issue which arises for our consideration is that whether settlement expenses paid by the assessee fall within the provision of Section 37 (1) of the Act. The learned counsel for the Revenue, Mr R D Jolly contends to the contrary – the basis being, that since there was no obligation under the contract on the assessee to pay settlement expenses, it cannot be said that the expenses have been incurred wholly and exclusively for the purposes of business, which is a sine qua non for seeking a deduction under Section 37 (1) of the Act.

2. In order to appreciate the controversy at hand, the following facts require to be noted :-

2.1 The assessee in respect of the assessment year 2000-01 had claimed as business expenditure a sum of Rs1,30,60,957/- which it had paid to PBC as settlement expenses. The Assessing Officer while scrutinising the return of the assessee under Section 143 (3) of the Act, issued a questionnaire dated 14.12.2001 whereby, he sought to know from the assessee the nature and the details of settlement expenses debited to the profit and loss account shown in schedule K under the head "Administrative and Other Expenses".

2.2 The assessee vide a reply dated 15.01.2002 and followed by letters dated 27.11.2003 and 14.01.2003 sought to explain the transaction. The sum and substance of the explanation given by the assessee is as follows:-

- i) on 01.08.1997, the assessee had entered into an agreement for use of premises provided by PBC for the purpose of its office. The said agreement was to end on 30.06.1998;
- ii) in 1997, the assessee had also exchanged an Aide-memoir with PBC whereby, it was understood as between them, that the use of the premises in issue would continue for a period of three years, and;

iii) on 01.07.1998 the assessee entered into another agreement which was to expire on 31.07.1999. The point to be noted is that as per clause 2 (d) of the agreement (as noted by the Assessing Officer) the assessee was not a tenant but was entitled to use the premises only during office hours. Furthermore, as per clause 2(j), the assessee was required to give a notice in advance of 180 days in the event it did not require any further use of the premises.

3. The Assessing Officer also noted that prior to the assessee's exit from the premises, plethora of correspondence was exchanged by the assessee with the PBC which resulted in the assessee paying a sum of Rs 1,30,60,957/- to PBC.

4. The Assessing Officer however, by his order dated 31.01.2003 disallowed the claim of the assessee under Section 37 (1) of the Act for the following reasons :-

“.....i) It was a lump sum payments for non user of the premises rather than for the use of the business premises. Therefore, it is not for business use.

ii) As per terms of the agreement assessee was not contractually bound to make payment for settlement. In other words there was no liability to pay on the assessee. It has been held in India Garments Ltd **98 ITR 69** that even payment in excess of the amount that assessee is liable to pay is not allowable under Section 37 (1) of the Act. In this case assessee was not bound to pay at all. Moreover, the agreements are not even registered including aide-memoir.”

5. Aggrieved by the order of the Assessing Officer, the assessee preferred an appeal before the CIT (Appeals). The CIT (Appeals) by an order dated 17.09.2003 allowed the appeal of the assessee with respect to the ground in issue. The CIT (Appeals) noted that the assessee had brought on record sufficient evidence in the form of correspondence exchanged with the PBC including the understanding arrived at, as recorded in the aide-memoir, which suggested that there was a mutual understanding between the assessee and the PBC that it would continue to use the premises till July 2000. The CIT (Appeals) further noted that the assessee in

order to avoid protracted litigation, based on the legal advice received, that the understanding recorded in the aide-memoir, the assessee could be sued for the specific performance or, in the alternative for damages; it settled for a lumpsum payment in furtherance of its business interest. The CIT (Appeals) significantly, went into the aspect as to whether the settlement expenses was a camouflage for a payment for purposes other than commercial reasons. Towards this end, the CIT (Appeals) called for the list of directors, of the assessee and PBC, in order to ascertain whether there were any common directors. As a matter of fact the CIT (Appeals) recorded in his order that the assessee had certified that there was no other relationship with PBC. The CIT (Appeals) on the perusal of evidence on record and material in the form of agreements of August 1997, August 1998, the aide-memoir of 1997, correspondence and other relevant material came to the conclusion that in the absence of any suggestion of fraud, the settlement expenses satisfied the test of commercial expediency. The CIT (Appeals) also noted that the assessee's decision to pay settlement expenses was a bonafide commercial call made, after considering the financial implications relating to damages for breach of contract, and

the financial liability that would ensue in the event of litigation, as also, the monetary gains in securing immediate repayment of security deposits. Accordingly, the CIT (Appeals) allowed the assessee to take into account the settlement expenses in the computation of income chargeable under the head 'profit and gains of business' as they were incurred wholly and exclusively for the purpose of business.

6. The Revenue being aggrieved by the order of the CIT (Appeals) preferred an appeal to the ITAT. The ITAT after a detailed discussion and on upon a minute examination of the facts and the law on the subject dismissed the appeal of the Revenue. In paragraph no. 15 of the impugned judgment, these facts are noted in great detail.

7. As stated above, Revenue being aggrieved, has preferred the present appeal. Before us, at the stage of admission of appeal, the learned counsel for the Revenue, Mr. R D Jolly, has submitted that the settlement expenses incurred by the assessee in order to pre-empt litigation, do not fall within the purview of Section 37 (1) of the Act. It was the learned counsel's contention that the expenses

incurred towards anticipated litigation even before they get crystallised, cannot be termed as one which are, incurred wholly and exclusively for the purpose of business.

8. Having heard the learned counsel for the Revenue and considered the material on record, as also, the findings recorded by the authorities below, we are of the view that the appeal deserves to be dismissed in limini for the following reasons:-

8.1 The conditions for all allow-ability of expenses under Section 37 (1) of the Act are :-

- (i) the money expended by the assessee is wholly and exclusively for the purposes of business and;
- (ii) the expenditure incurred is not in the nature of a capital expenses.

8.2 In so far as the second condition is concerned, it has been fairly conceded, by Mr R D Jolly, the learned counsel for the Revenue, that, it is not in the nature of a capital expenditure. He has, as noted, above confined himself to the first condition i.e., the settlement expenses are not incurred wholly and exclusively for the purposes of business.

8.3 To determine whether an expense incurred is wholly and exclusively for the purposes of business – according to us, can be ascertained only, if it meets the test of commercial expediency, and that too, from the point of view of the assessee who is engaged in the business and, not from the point of view of an outsider who is unaware of the needs of the business.

8.4 There are several judgments of the Supreme Court laying down principles which, need to be applied in determining whether an expenditure ought to be allowed under Section 37 (1) of the Act. These principles have emerged over the years by virtue of judicial interpretation giving meaning to the words ‘wholly and exclusively for purpose of business’ appearing in Section 37 (1) of the Act. The principles deducible even though not exhaustive are as follows:-

- i) the expression ‘wholly and exclusively for the purpose of business’ is of a wide import – as a matter of fact, is wider than the expression for the purpose of earning profit;
- ii) the expense is allowable under Section 37 (1) of the Act if it is commercially expedient;

- iii) the expense should be commercially expedient from the perspective of a prudent businessman, and not from the point of view of the Revenue;
- iv) it is not a requisite condition that expense is incurred on account of compelling necessity, and;
- v) last but not the least, the allowability of the expense is not dependent on the fact that it is incurred to fulfill or discharge a legal obligation.

See:

- (i) **Jugal Kishore Baldev Sahai v. CIT : AIR 1967 SC 495;**
- (ii) **Sri Venkata Satyanarayana Rice Mill Contractors Co v. CIT, AP-II: (1996) 6 SCC 611;**
- (iii) **CIT v. Walchand & Co. Pvt. Ltd : AIR 1967 SC 1435 = 65 ITR 381;**
- (iv) **M/s Sassoon J. David & Co. Pvt Ltd v. CIT Bombay : 1979 (3) SCC 524;**
- (v) **The CIT, West Bengal v. Birla Cotton Spinning & Weaving Mills & Another : (1971) 3 SCC 344**
- (vi) **SA Builders Ltd v. CIT ; 2007 (1) SCC 781.**

8.5 Keeping in mind the aforesaid test, let us examine the facts of the present case.

8.6 The assessee had entered into an agreement for use of the premises of PBC by an agreement dated 01.08.1997. In 1997, the assessee and the PBC had recorded that the assessee would use the premises of PBC for a period three years. The relevant extract of the aide-memoir is as follows :

“..... AIDE-MEMOIR”

The understanding is for a period of 3 years. The schedule of charges for Office Facilities are valid from August 1, 1997 to July 31, 1999, subject to the modifications provided hereunder:

1. The facilities charges will be increased by 10% for Unit 2A w.e.f. August 1 every year on the last Office Facilities charges paid as on July 31 of the current year. Unit 1A & 1B shall be billed using the prevailing area rate for Unit 2A w.e.f. August 5, 1998.
2. Fresh Documents containing the terms and conditions contained :-
 - a) Membership Application Form.
 - b) Agreement dated August 1, 1997.
 - c) Letter dated August 1, 1997.

Which will be signed before August 1 every year. The Security Deposit will be increased by 10% calculated on 24 times. The difference in Security Deposit would be payable on August 1, every year.”

8.7 The aide-memoir was signed on behalf of the assessee by one Shri Rajiv Nayar on 21.08.1997.

8.8 In August 1998, the assessee entered into another agreement by virtue of which it could continue the use of the premises till 31.07.1999.

8.9 In the interregnum, in March 1999, the assessee acquired a new premises, and evidently, entered into a contract with respect to the same with M/s Great Eastern Shipping Company Private Limited. The charges payable for the new premises were Rs 20,56,416/- as against Rs 30,87,827/- per month with respect to the use of the premises of PBC.

8.10 By a communication dated 22.03.1999, the assessee informed the PBC of its intention to dis-continue the use of the premises with effect from 31.08.1999, and consequently, demanded return of its interest free security amounting to Rs 7,46,07,848/-.

8.11 This communiqué triggered correspondence between the assessee and PBC on the specific issue of early termination of the understanding which required continued use of the premises till July, 2000.

8.12 In this background, the assessee sought legal advice. The assessee was advised that there was a possibility of litigation ensuing, in respect of, its early exit from the premises. It was advised that it could be sued for damages for breach of contract and / or for specific performance, keeping in mind the contents of the aide-memoir based on the doctrine of promissory estoppel. The legal advisers of the assessee referred to various judgments of Supreme Court and the High Court in this regard.

8.13 The assessee keeping in mind the legal advice rendered to it, as also, the following the factors which directly impinged upon its business, took a decision to pay the settlement expenses to the tune of Rs 1,30,60,957/- The factors which compelled the assessee to take a decision to pay the settlement expenses were as follows :-

- (i) the assessee could avoid payment of Rs 3,70,53,924/- as user charges for the unexpired period between August 1999 to July 2000;
- (ii) it would get immediate return of its interest free security

deposit lying with PBC in the sum of Rs 6,15,81,997/- after netting off the settlement expenses to the tune of Rs 1,60,30,957/- on which it could earn a return, in the form of interest, or otherwise;

(iii) it would avoid the payment of discount charges of Rs 1,26,35,881/- as demanded by the PBC for immediate payment of interest free security deposit;

(iv) it would save moneys towards payment of rent not only for two premises, but would, also save an amount of not less than Rs 10.00 lacs per month by shifting to the new premises offered by Great Eastern Shipping Company Private Limited and;

(v) last but not the least, it would avoid not only expenditure in the form of litigation costs, but would also, avoid the attendant expenses in the form of productive time spent by its officers/ executives looking after the litigation.

9. In our view, the aforementioned factors which the assessee took into account while taking its decision to pay PBC settlement expenses for an early exit from PBC's premises falls squarely within the meaning of expression "commercial expediency" when, seen from the perspective of the assessee's business.

10. In the aforesaid circumstances, we are of the view that the findings recorded by the authority below are the findings of fact based on appreciation of evidence placed before them. There is no demonstrable perversity in the order of the Tribunal. No substantial question of law, much less a question of law, arises in the instant case for our consideration.

11. In the result, the appeal is dismissed.

RAJIV SHAKDHER, J

BADAR DURREZ AHMED, J

August 21, 2008

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