ELIGIBILITY OF S.T.P UNITS AND COMPUTATION OF THEIR PROFITS FOR DEDUCTION U/S 10A OF THE INCOME-TAX ACT.

(Various issues regarding eligibility of Software Technology Park (STP) units and computation of profits of such units for deduction U/S 10A of the Income-Tax. Act, 1961)

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- By S.K. Tyagi

Ten year tax holiday is available under section 10A to certain undertakings in free trade zones, electronic hardware technology parks, software technology parks or in special economic zones. The exemption is however subject to fulfilment of certain conditions. What are these conditions and how to meet them to avail the maximum benefit is explained by the learned author. Some doubts which normally arise or which the Assessing Officer may raise are also dealt with properly which may help in arranging the affairs.

SYNOPSIS

I. Introduction

The Finance Act, 2000 has inserted provisions with a view to gradually phasing out the concession given to software exporters U/S 80-HHE of the Income-Tax Act, 1961. However, at the same time, it has promised a 10-year tax-holiday under the new section-10A subject to the fulfilment of certain conditions. The exemption to the profits of Software Technology Park (STP) units has been granted for a period of 10 consecutive assessment years (AYs.), beginning with AY 2000-01 and ending with AY 2009-10. It would mean that an STP unit set up in the Financial Year (FY) 1999-2000 would enjoy the exemption U/S 10A for the total period of 10 AYs. However, if an STP unit is set up after the FY 1999-2000 upto the FY 2008-09, then the exemption U/S 10A to such a unit would be available for the un-expired period of the aforesaid ten consecutive AYs. This is so because as per fourth Proviso to S.10A(1), no deduction under this section shall be allowed to any undertaking for the AY 2010-11 and subsequent years.

Recently, I had an occasion to handle the assessment proceedings in respect of a Company where the profits from an STP unit were to be computed for the first time for the AY 1998-99. As the Company was already availing of 100% deduction on the profits from software exports U/S 80-HHC, the Assessing Officer (AO) was, all along during the assessment proceedings, obsessed with a view that the Company had only shifted its earlier software export business to the newly established STP unit and therefore, such an STP unit could not be treated as a new unit. Another fact, which was troubling the mind of the AO again and again, was that the Company was allowed to establish its STP unit within its own factory premises, by the Software Technology Parks of India. A plethora of queries was raised by the AO with a view to somehow denying the deduction U/S 10A in respect of the profits of the STP unit or minimizing the quantum of such profits and thereby increasing the taxable profits.. All the aforesaid queries and objections raised by the AO were satisfactorily answered and effectively countered, with the result that the AO allowed the deduction U/S 10A in respect of the profits and gains of the STP unit in to-to; viz. as claimed by the Company. However, in order to convince the AO for granting the aforesaid full deduction U/S 10A, I had to do a lot of study of the relevant Circulars etc. and case law. It is with a view to sharing the benefit of the aforesaid study with the tax-paying public and the I.T Advisors, etc., that this article is prepared for publication.

II. Salient features of section 10A

The various aspects regarding the provisions of S.10A and the connected Circulars / Notifications and case-law, are discussed, hereinafter. For this purpose, the salient features of S.10A may be summarized, as follows:

(i) A deduction of profits and gains derived by an undertaking from the export of articles or things or computer software for a period of ten consecutive Assessment Years (A.Y.) beginning with the A.Y. relevant to the previous year (P.Y.) in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case maybe; shall be allowed from the total income of the assessee.

(ii) In other words, all the profits and gains derived from the aforesaid undertaking will be exempt for a period of ten consecutive A.Ys. from the A.Y. relevant to the P.Y. in which the business of the undertaking is set up.

(iii)If the undertaking initially located in any free trade zone or export processing zone is subsequently located in a special economic zone by reason of conversion of such free trade zone or export processing zone into a special economic zone, the period of ten consecutive A.Ys. shall be reckoned from the A.Y. relevant to the P.Y. in which the undertaking was first set up in such free trade zone or export processing zone.

(iv) The profits and gains derived from such **domestic sales** of articles or things or computer software as do not exceed 25% of total sales, shall be deemed to be the profits and gains derived from the export of articles or things or computer software.

In other words, the profits and gains derived from the undertaking including those derived from domestic sales will be fully exempt, provided the domestic sales do not exceed 25% of total sales.

As per the Finance Bill 2001, the benefit U/S 10A available in respect of domestic sales not exceeding 25% of the total sales, is proposed to be withdrawn, with effect from 1.4.2002 viz. AY 2002-03.

(v) No deduction U/S 10A shall be allowed to any undertaking for the A.Y. beginning on 1st day of April, 2010 and subsequent years.

In other words, any undertaking established after the end of Financial Year (F.Y.) 2009-10, shall not be entitled to exemption U/S 10A.

The provisions of S.10A apply to any Undertaking, which fulfils the following conditions, viz:

(i) it has begun or begins to manufacture or produce articles or things or computer software during the previous year relevant to the assessment year -
   (a) commencing on or after the 1st day of April, 1981, in any free trade zone; or
   (b) commencing on or after the 1st day of April, 1994, in any electronic hardware technology park, or, as the case maybe, software technology park;
   (c) commencing on or after the 1st day of April, 2001 in any special economic zone;

(ii) it is not formed by the splitting-up, or the reconstruction, of a business already in existence:
   Provided that this condition shall not apply in respect of any undertaking which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such undertaking as is referred to in section 33B, in the circumstances and within the period specified in that section;

(iii) it is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

Further, there are certain other conditions also which are required to be fulfilled for the deduction U/S 10A. The same are as follows:

(i) One of the requirements is that the sale proceeds of articles or things or computer software exported out of India, are received in or brought into India by the assessee in convertible foreign exchange within a period of six months from the end of P.Y. or within such further period as the competent authority may allow in this behalf.

The expression "competent authority" means the Reserve Bank of India, or such other authority as is authorized under any law for the time being in force for regulating payments and dealings in foreign exchange.

(ii) The second requirement for the purpose of exemption U/S 10A is that, the profits derived from export of articles or things or computer software shall be the amount which bears to the profits of the business, the same proportion as the export turnover in respect of such articles or things or computer software, bears to the total turnover of the business carried on by the assessee.

In other words, in case of a mixed business, the deduction in respect of profits derived from export sales, shall be computed on proportionate basis.

Vide Finance Bill 2001, computation of eligible profits shall be based on the "profits", 'export turnover" and "total turnover" in respect of the business of the Undertaking with effect from 1.4.2001 viz. AY 2001-02. In other words, deduction U/S 10A shall be worked out as follows:

$$\frac{\text{Profits of the Undertaking X Export turnover}}{\text{Total turnover of the Undertaking}}$$

(iii) The third requirement is that with effect from A.Y. 2001-02, the assessee shall be required to furnish in the prescribed form, alongwith the return of income, the report of a Chartered Accountant certifying that the deduction has been correctly claimed in accordance with the provisions of S.10A.

(iv) The fourth requirement is that where during any P.Y., the ownership or the beneficial interest in the undertaking is transferred by any means, the deduction U/S 10A shall not be allowed to the assessee for the A.Y. relevant to such P.Y. and subsequent years.

Vide Finance Bill 2001, it is proposed that this condition shall not be applicable to "companies in which public are substantially interested". This amendment is proposed with retrospective effect from AY 2001-02.

It may also be stated here that the same conditions apply in respect of industrial undertakings set-up in any Free Trade Zone (FTZ) or Electronic Hardware Technology Park (EHTP).

III. Some important issues

The other important issues regarding the deduction U/S 10A of the Act in respect of the profits of an STP unit set-up by the assessee are dealt with as follows:

1. **The new STP unit is required to be approved by the Software Technology Parks of India**

   The first requirement for a new STP unit is that it is to be approved by Software Technology Parks of India, an autonomous society under the Department of Electronics, Government of India.

2. **The STP unit may be set up within the factory or business premises of an assessee as a separate and independent unit of production.**

   A Software Technology Park (STP) may be set up by the Central Government, State Governments, Public or Private Sector Undertakings or any combination thereof. An STP may be an individual unit
   by itself or it may be one of such units located in an area designated as STP Complex by the Department of Electronics. These conditions have been laid down under the Software Technology Parks Scheme, vide clause 2.2 of Notification No. S.O. 388(E) dated 30th April, 1995.

3. **The STP unit may be set up in a separately earmarked part of the business premises of the assessee.**

   A separate part of the building or the factory premises of the assessee may be earmarked for the STP unit and cost of such part of the building or factory premises may be worked out on proportionate basis for the purpose of claiming depreciation and maintenance / repairs etc. expenses.

4. **<u>The old employees of the assessee may be employed in the new STP unit</u>.**

Whenever a new STP unit is to be set up, naturally a group of old employees will be entrusted with the job and after the STP unit is set up such employees may continue with the unit for effective management.

There is no condition U/S 10A(2) in regard to the issue whether no old employee should work with the newly set up STP unit. Therefore, the old employees of an assessee may be employed in the new STP unit and on this account, there would be no violation of the conditions laid down U/S 10A of the Act.

5. **<u>Similarly, the STP unit may continue its exports to the old customers of the assessee</u>.**

Regarding the issue whether the new STP unit could export the software to the old customers of the assessee, there is no prohibition in the Act. Therefore, the new STP unit may export its software, inter-alia, to the old customers of the assessee.

6. **<u>The STP unit should not be formed by the splitting-up of a business already in existence</u>.**

The expression "splitting-up of business already in existence" indicates that the integrity of earlier business is broken up and different sections of activities are carried on independently – **CIT Vs. Hindustan General Industries Ltd., 137 ITR p.851 (Delhi)**

7. **<u>The STP unit should not be formed by the reconstruction of a business already in existence.</u>**

The concept of ":reconstruction" was elucidated in **CIT Vs. Gaekwar Foam & Rubber Co. Ltd., 35 ITR p.662 (Bom.),** where it was observed that the reconstruction of a business or an industrial undertaking must necessarily involve a concept that the original business or undertaking is not to cease functioning and its identify is not to be lost or abandoned. In other words, if the new business is, in
substance, the old business in some altered form, then it may amount to reconstruction of a business already in existence..

In this connection, it is relevant to point out that once the industrial undertaking or unit is separate and independent unit in the sense that the commodities produced or the results achieved, are commercially tangible products and the undertaking could be carried on separately, the same would not be treated as formed by reconstruction of the old business. Besides, the fact that there was common management or that there was a common source of power, would not mean that it was not a new undertaking. In addition, the mere fact that a part of the premises used by the old undertaking was used for the new industrial undertaking or that some members of the staff were common, does not make any material difference in the situation.

The aforesaid position in law is supported by a number of High Court and Supreme Court judgements, which are as follows:

(i) **Municipal Commissioner, Chinchwad New Township Municipal Council Vs. Century Enka Ltd., 129 CTR p.265 (SC)**

It was held in this case that if the new undertaking or unit be separate and independent production units were to come in existence in the sense of producing a distinct commercial product and the undertaking could be carried on separately, the same would not be treated as formed by the reconstruction of the old business. Further that the new unit has been set up for substantial expansion of the existing business is not decisive.

(ii) **Textile Machinery Corporation Ltd. Vs. CIT, 107 ITR p.195 (SC)**

The relevant part of the judgement on pp.204 & 205 of the Report is reproduced as follows:

"The new activity may produce the **same commodities of the old business** or it may produce some other distinct marketable products, even commodities which may feed the old business. These products may be consumed by the assessee in his old business or may be sold in the open market. One thing is certain that the new undertaking must be an integrated unit by itself wherein articles are produced and at least a minimum of ten persons with the aid of power and a minimum of twenty persons without the aid of power have been employed. Such a new industrially recognisable unit of an assessee cannot be said to be reconstruction of his old business since there is no transfer of any assets of the old business to the new undertaking, which takes place when there is reconstruction of the old business. For the purpose of section 15C the industrial units set up must be new in the sense that new plants and machinery are erected for producing **either the same commodities** or some distinct commodities. In order to deny the benefit of section 15C the new undertaking must be formed by reconstruction of the old business."

(iii) **CIT Vs. Indian Aluminium Co. Ltd., 108 ITR p.367 (SC)**

In this case, a new industrial undertaking was installed in the **existing factory premises**. The new undertaking was established for production of the **same commodity** as was being manufactured by the existing factory.

According to the I.T.A.T. and the High Court, there was no reconstruction of the old business. The Apex Court upheld the judgements of the ITAT and the High Court, following its judgement in the case of **Textile Machinery Corporation Ltd. Vs. CIT, 107 ITR p.195**.

(iv) **CIT Vs. Hindustan Malleables & Forgings Ltd., 191 ITR p.70 (Pat.)**

It was held in this case that the fact that there was **common management** or the fact that separate accounts had not been maintained or **that there was common source of power** would not mean that it was not a new undertaking.

(v) **CIT Vs. Metropolitan Springs (P) Ltd., 191 ITR p.288 (Bom)**

It was held in this case that the mere fact that **a part of the premises used by the old undertaking** was used for the new industrial undertaking or **that some member of the staff were common**, does not make any material difference in the situation.

8. <u>Setting up of a new unit under the same umbrella organization.</u>

In the aforesaid judgement, in the case of **Textile Machinery Corpn. Ltd.**, the Apex Court, overruling the judgement of the Calcutta High Court, held that re-construction of business involves the idea of substantially the same persons carrying on substantially the same business preserving the physical identity with the the old unit. But the new undertaking cannot be said to be formed out of the already existing business, if there is emergence of a new physically separate industrial unit, which may exist on its own as a viable unit. The unit set up must be new in the sense that new plants and machinery are erected for producing either the same commodities or some distinct commodities.

9. <u>The items of export, which are treated as software exports U/S 10A</u>.

The term "Computer software" is defined in Explanation 2(i) to S.10A. As per the aforesaid Explanation - "Computer Software" means –

(a) any computer programme recorded on any disc, tape, perforated media or other information storage device; or

(b) any customized electronic data or any product or service of similar nature, as may be notified by the Board, which is transmitted or exported from India to anyplace outside India by any means.

Under the aforesaid Explanation 2 (i)(b), the CBDT has issued a Notification No. S.O. 890(E) dated 26.9.2000. The aforesaid Notification has been published in **163 CTR (St.) p.25**. The aforesaid Notification is reproduced as follows:

"**S.O. 890(E):** In exercise of the powers conferred by clause (b) of item (i) of Explanation 2 of section 10A, clause (b) of item (i) of Explanation 2 of section 10B and clause (b) of Explanation to section 80-HHE of the Income-tax Act, 1961 (43 of 1961) the Central Board of Direct Taxes hereby specifies the following Information Technology enabled products or services as the case may be for the purpose of said clauses namely:-

1. Back-Office Operations
2. Call Centres
3. Content Development or animation
4. Data Processing
5. Engineering and Design
6. Geographic Information System Services
7. Human Resources Services
8. Insurance Claim Processing
9. Legal Databases
10. Medical Trnascription
11. Payroll
12. Remote Maintenance
13. Revenue Accounting
14. Support Centres, and
15. Web-site Services."

Vide Finance Bill 2001, it has been clarified that profits & gains derived from on-site development of computer software, are deemed to be profits and gains derived from export of computer software. This amendment is proposed with retrospective effect from AY 2001-02.

10. No allocation of expenditure on proportionate basis, in respect of part of business income enjoying an exemption is permissible.

There are certain services which are common with the other business of the assessee, e.g. Corporate, Administration and Finance Division, etc. Then, there may be expenditure like interest on loan payable by the assessee. Such expenses cannot be disallowed in respect of the other business profits of the assessee and thereafter deducted from the profits and gains of the STP unit in order to reduce the same. The reasons for the same are as follows:

If the expenses are allowable as business expenses, they will be allowed to be deducted from the income of the business, which is liable to tax. In the circumstance that the business activity has produced income, a part of which is liable to tax and part of which is free from tax, will not permit the allocation of expenses between these two parts of income and allowance only of that part which is attributable to the earning of the taxable income, but allowance of entire expenditure is permissible from the taxable portion of income.

For this proposition, we may look at the relevant provisions of S.10A of the Act. As per S.10A(1), subject to the provisions of this section, any **profits and gains** derived by an assessee from **an industrial undertaking** to which this section applies shall not be included in the total income of the assessee. Besides, as per S.10A(3), the **profits and gains** referred to in sub-section (1) shall not be included in the total income of the assessee in respect of any ten consecutive assessment years, etc. For a comparison, we may refer to the provisions of S.10 of the Act. The heading of Chapter–III is **"Income which do not form part of total income"**. Further, the heading of S.10 is, "**Incomes not included in total income** ". The operative part of S.10 states that in computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included.

From the aforesaid comparison, the case-law applicable to S.10 would also be applicable to S.10A, as regards the computation of income or profits and gains, exempt from income-tax. Therefore, for the aforesaid proposition reliance is placed on the following judgements:

(i) CIT Vs. Indian Bank Ltd., 56 ITR p.77 (SC)

In this case, the assessee, in the course of its banking business, invested a large sum in securities, including securities the interest on which was exempt from tax. The bank claimed a deduction of Rs.25.92 lakhs as interest paid to various depositors. The I.T.O., the A.A.C. and the I.T.A.T. disallowed interest amounting to Rs. 2.80 lakhs. This amount was arrived at by calculating the proportionate interest which would be payable on the money borrowed for the purchase of Mysore Government securities for Rs. 250 lakhs, the interest relating to the income, which was exempt from tax.

It was held by the Apex Court that the interest paid by the assessee on moneys borrowed from its various depositors had to be allowed in its entirety and there was no warrant for the disallowance of a proportionate part of the interest referable to moneys borrowed for the purchase of securities whose interest was tax-free.

(ii) CIT Vs. Maharashtra Sugar Mills Ltd., 82 ITR p.452 (SC)

In this case, the assessee company owned extensive lands on which it grew sugar-cane and used the sugar-cane for manufacture of sugar in the factory. The I.T.A.T. found that the cultivation of sugar-cane and manufacture of sugar by the assessee constituted one single and indivisible business. The assessee company was managed by the managing agents. The managing agents were paid remuneration in accordance with the Agreement entered into between the assessee company and the managing agents. The managing agents' commission roughly worked out at 10% of the profits of the company. In the assessment year in question, the managing agents were entitled to a commission of Rs. 4,86,228/-. Out of that sum, the ITO disallowed a sum of Rs.1,26,359/- on the ground that the same relates to the commission of the managing agents for managing the sugar-cane cultivation part of the business, income from which was exempt from tax as agricultural income.

It was held by the Apex Court that the entire managing agency commission was laid out or expended for the purpose of the business carried on by the assessee and was allowable U/S 10(2)(xv) of the Income-Tax Act, 1922. The fact that the income from a part of the business was not exigible to income-tax under the Act was not a relevant circumstance. It was further held that if the allowance claimed is permissible under the Act then the same has to be deducted from the **gross profit.**

(iii) CIT Vs. Tractors and Farm Equipment Ltd., 238 ITR p.1042 (Mad.)

In this case, the assessee company was engaged in the manufacture of farm equipment and for that dpurpose it maintained 200 acre demonstration farm to train salesmen and dealers. The ITO rejected the assessee's claim for deducting the expenditure incurred by it on the farm to the extent of Rs. 71,088/- solely on the ground that it was expenditure on agricultural land.

It was held by the Hon. High Court that once it was found that the expenditure incurred was one which was laid out wholly and exclusively for the purpose of assessee's business, the deduction had to be allowed. The expenditure, though incurred in relation to agricultural land, was for the purpose of the assessee's business and was entitled to deduction U/S 37 of the Income-Tax Act, 1961.

(iv) Rajasthan State Warehousing Corporation Vs. CIT, 242 ITR p.450 (SC)

In this case, the assessee claimed deduction of expenditure of Rs. 38.14 lakhs U/S 37 of the Act in computing its income under the head "Profits and gains of business or profession'. The ITO allowed only so much of the expenditure as could be allocated to the taxable income and disallowed the rest of it, which was referable to the non-taxable income, exempt U/S 10(29) of the Act.

It was held that in view of the fact that income from various **ventures** was earned in the course of one indivisible business, the impugned order upholding the apportionment of the expenditure and allowing deduction of only that proportion of it which was referable to the taxable income, was unsustainable. The Apex Court has laid down certain principles in this connection. The same are to be found on p.455 of the Report and they are reproduced as follows:

"In view of the above discussion, the following principles may be laid down:

(i) if income of an assessee is derived from various heads of income, he is entitled to claim deduction permissible under the respective head whether or not computation under each head results in taxable income;

(ii) if income of an assessee arises under any of the heads of income but from different items, e.g., different house properties or different securities, etc., and income from one or more items alone is taxable whereas income from the other item is exempt under the Act, the entire permissible expenditure in earning the income from that head is deductible; and

(iii) in computing "profits and gains of business or profession" when an assessee is carrying on business in various ventures and some among them yield taxable income and the

others do not, the question of allowability of the expenditure under section 37 of the Act will depend on:

(a) fulfilment of requirements of that provision noted above; and

(b) on the fact whether all the ventures carried on by him constituted one indivisible business or not; if they do, the entire expenditure will be a permissible deduction but if they do not, the principle of apportionment of the expenditure will apply because there will be no nexus between the expenditure attributable to the venture not forming an integral part of the business and the expenditure sought to be deducted as the business expenditure of the assessee."

From the aforesaid judgements, it is quite evident that where an assessee is carrying on one indivisible business and the part of the income is either excluded or is exempt under any provision of the Income-Tax Act, it is not permissible to disallow the proportionate part of the expenditure attributable to such excluded or exempt income. In other words, if the expenses are allowable as business expenses, they will be deductible from the income of the business, which is liable to tax. The circumstance that the business activity has produced income, a part of which is liable to tax and a part of which is free from tax, will not permit the allocation of expenses between these two parts of income and allowance only of that part which is attributable to the earning of the taxable income, but allowance of entire business expenditure is permissible from the taxable portion of income.

Now the question which needs to be addressed to, is what is the meaning of " any profits and gains derived by an assessee from an industrial undertaking ", as contemplated in S.10A of the Act. Under S.10A(1), any **profits and gains** from the undertaking fulfilling the conditions prescribed thereunder, shall not be included in the total income of the assessee. Thus, the issue which arises for consideration is what kind of expenses are to be deducted, while working out the profits and gains of such industrial undertaking. **A careful reading of the aforesaid judgements of the Apex Court and Madras High Court, indicates that only direct expenses incurred by such unit should be deducted from the total turnover in order to arrive at the profits and gains of the unit which are to be excluded from the total income of the assessee**. This view gets support from the aforesaid judgement of the Apex Court in the case of Maharashtra Sugar

Mills Ltd. It has been held in this case that if the allowance claimed is permissible under the Act, then the same has to be deducted from the **gross profit**. It means that the gross profit from the new unit is to be excluded from the total income of the assessee. This would lead to an inescapable conclusion that all indirect or common expenses of the business of the assessee would not be deductible while computing the profits and gains of the new unit, as contemplated U/S 10A of the Act.

In the light of the aforesaid reasons, all the common expenses of the business of the assessee will be allowable from the taxable income of the assessee and no part thereof will be deductible on proportionate basis for computing the profits and gains of the new unit as contemplated U/S 10A of the Act.

In this context, the provisions of new section 14-A proposed to be inserted in the I.T. Act, vide Finance Bill 2001, are very relevant. The proposed new S.14-A governs the deduction of expenditure incurred in respect of exempt income. This section reads as follows:

***"S.14A** : For the purposes of computing total income under this chapter, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act."*

In spite of the insertion of the aforesaid S.14-A in the Act, common expenditure relatable to the profits and gains of an STP unit, may not be required to be deducted therefrom on proportionate basis. The common expenditure in respect of services of the Corporate, Administration and Finance Division, etc. was, in any case, being incurred even before the setting up of the new STP Unit. Therefore, the same cannot be treated to have been incurred in relation to the profits and gains of the STP unit which are not included in the total income of the assessee. Hence, the aforesaid type of the common expenses will continue to be a part of allowable deduction from the taxable income of the assessee and the same will not be required to be deducted on proportionate basis from the profits and gains of the new STP unit and thus would not reduce the quantum of such profits and gains.

11. Expenditure incurred on setting-up of STP unit cannot be disallowed as Capital Expenditure

It may be stated here that the new STP unit is part of the business of the assessee company and therefore, all expenses incurred in connection with the setting-up of the STP unit till the commencement of the operations of the STP unit, are allowable as part of the expenses of the on-going business of the assessee.

In this connection, it may be stated that the test in respect of "same business" is unity of control and not the nature of lines of business. Regarding the test of the "same business" viz. unity of control, reliance may be placed on the judgements of the Apex Court in the cases of **(i) Produce Exchange Corporation Ltd. Vs. CIT, 277 ITR p.739 and (ii) B.R. Ltd. Vs. V.P. Gupta, CIT, 113 ITR p.647.**

For the proposition that expenses incurred by the existing business for starting a new unit are allowable as deduction; reliance is placed on the following judgements of various High Courts:

(i) Prem Spg. & Wvg. Mills Co. Ltd. Vs. CIT, 98 ITR p.20 (All.)

In this case, the assessee company was running a spg. & wvg. factory. The company borrowed money for starting a straw-board factory. It was held that the expenses incurred in borrowing the money were allowable as deduction. It was observed by the Hon. Court that the amount spent was not in the nature of capital expenditure and the act of borrowing money was incidental to the carrying on of the business of the assessee.

(ii) CIT Vs. Alembic Glass Industries Ltd., 103 ITR p.715 (Guj.)

In this case, the existing business started a new unit. During the accounting period relating to A.Ys. 1965-66 and 1966-67, the company incurred expenditure of Rs. 7.53 lakhs and Rs.77 lakhs respectively for establishing the new unit. The said unit did not go into production during the A.Ys. in question and therefore, during the course of assessment, the I.T.O disallowed payment of Rs.50,000/- and Rs. 2,00,000/- respectively in the two years, on such borrowings. The I.T.O. also disallowed for both the years, some miscellaneous expenditure and traveling expenditure referable to the establishment of the new unit.

The Hon. High Court allowed all the aforesaid expenses as revenue.

(iii) CIT Vs. Hindustan Machine Tools Ltd. (No.1), 175 ITR p.212 (Karn.)

In this case, expenditure was incurred in connection with new units. It was held by the High Court that it was allowable as revenue expenditure.

(iv) CIT Vs. Indian Telephone Industries Ltd., 175 ITR p.215 (Karn.)

In this case also, the assessee company established a new unit. It was held that expenditure incurred on new unit was allowable as revenue expenditure.

(v) CIT Vs. Hindustan Machine Tools Ltd. (No.2), 175 ITR p.216 (Karn.)

In this case, the assessee entered into Collaboration Agreement with parties in connection with the commissioning of its 6 new divisions. The new units were only a continuation of existing business of the assessee.

It was held that the technical assistance fees paid to parties, in connection with the setting-up of six new divisions, were allowable as business expenditure. Besides, the expenditure incurred by the assessee in connection with its new divisions, was also held as deductible as business expenditure.

IV. Conclusion

The tax-payers in consultation with their tax-advisors may arrange the affairs of their STP unit(s) in the light of the aforesaid discussion. Besides, the aforesaid discussion may also be very useful during the course of assessment proceedings of the STP unit, in case any of the aforesaid issues is raised by the AO.

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