



Tax Insights

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Examining the nature of business is prerequisite to determine set up of business, and consequential disallowance of expenditure – Delhi bench of the Tribunal

In brief

The Delhi bench of the Income-tax Appellate Tribunal (Tribunal)¹ was of the view that to determine whether the business has been set up, the pre-requisite is to examine the nature of business, and a mere conclusion cannot be drawn based on the nature of expenditure. In the given set of facts, the taxpayer was incorporated to procure and manufacture, and assemble automobiles accessories and auto parts. The Tribunal observed that it did not require immediate installation of any plant and machinery (P&M) to meet the set up of business threshold. Accordingly, the Tribunal deleted the disallowance of expenditure and denial of carry forward of losses made by the lower tax authorities.

In detail

Facts

- The taxpayer, a company incorporated in India, is a subsidiary of non-resident entity, engaged in the business of procurement, manufacture and assembling within India and selling worldwide automobile accessories developed by it for installation of products by virtue of the license agreement.
- During the relevant assessment year (AY), the taxpayer earned only interest income and did not have any business income. However, the taxpayer claimed certain expenditure, viz. group commission, business promotion, vehicle running expenses and research and development (R&D) expenses and returned a loss to be carried forward.
- Moreover, the taxpayer made certain additions to fixed assets, namely, purchase of vehicle, computer software, furniture and other office equipment but did not make any investment in the purchase of P&M in the said AY.
- During assessment and first appellate proceedings, the lower tax authorities disallowed the expenditure claim on the basis that in the absence of any purchase of P&M, the taxpayer could not have commenced business operation and consequently, denied the claim of carry-forward of loss. Interest income was taxed after allowing the proportionate expenditure incurred for earning such income.

¹ ITA No. 3368/Del/2018

Tribunal's observations and ruling

- At the outset, the Tribunal observed that to determine whether the taxpayer has set up its business, it is necessary to examine the nature of business activity undertaken. Accordingly, the Tribunal noted the following facts, which were disregarded by the lower tax authorities, and observed as below.
 - On perusal of the license agreement, it is clear that the taxpayer was formed to procure and manufacture, and assemble automobile accessories and auto parts. Hence, considering the nature of business activity, it did not require immediate installation of any P&M.
 - Moreover, the documents placed on record clearly evidence that the taxpayer entered into the process of negotiations for the procurement of parts from various vendors, placed purchase orders and also disclosed work-in-progress, as a part of the closing stock.
 - The Tribunal further noted the nature and purpose of various expenditures incurred by the taxpayer and opined that such expenditures were intricate to the nature of business activity carried on by the taxpayer.
- The Tribunal also relied upon various court decisions which have held that –
 - Installation of P&M is not a precondition for set-up of business.
 - In the context of trading, business is said to commence once the inventory is purchased.
 - With regard to manufacturing, business is said to commence when the first activity, out of several activities required to manufacture the product, is undertaken.
- In view of the above, the Tribunal concluded that the business of the taxpayer was set up during the said AY and accordingly allowed the claim of carry-forward of loss computed after claiming the expenses so incurred.

The takeaways

Set up of business must be determined in the context of the nature of the business of the taxpayer. There is no one test which can be applied in all situations. This ruling is consistent with other court decisions wherein set up has been interpreted based on the nature of the business of the taxpayer.

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