



Set-up of business vs. Commencement of business and deduction of expenses.

Issue:

X Ltd. is a company engaged in the business of development of industrial park. It has obtained certificate of incorporation, certificate of commencement of business, acquired land and applied for necessary permission from the Government Authorities. It has claimed that its business is set up and hence it is entitled to deduction of all expenses. The AO is of the view that since the industrial park is not developed, business is not set up and hence the expenses cannot be allowed as deduction.

Proposition:

It is proposed that when land is acquired, compound wall is constructed, project report is prepared, applications are made to appropriate authorities and competent directors are appointed. Business is set up and is ready to commence and hence expenses will be allowed as deduction. It is not necessary that actual business of development of industrial park should have commenced.

View Against the Proposition:

It is submitted that merely taking land on lease, obtaining certificate of commencement of business cannot be treated as setting up business/commencement of business. Let me now refer to very useful and important decisions with regard to setting up of business vs. commencement of business.

In the case of *joint commissioner of Income-tax vs. Sardar Sarovar Narmada Nigam Ltd, ITAT Ahmedabad Bench 'B' [2005] 96 Itd 321 (Ahd)*, the Hon'ble ITAT laid following principles for the determination of setting up of business:

(a) There is a clear distinction between commencement of a business and the setting

up of the business as there may be an interval between setting up of business and commencement of business.

- (b) The question as to when the business can be said to have been set up and commenced will depend of facts and circumstances of each case and not on the accounting treatment of books of accounts of the assessee.
- (c) It is only when the unit has been put into such a shape that it can start functioning as a business or a manufacturing organization that it can be said that the unit has been set up.
- (d) The assessee can be said to have set up its business from the date when one of the essential categories of its business activities is started and it is not necessary that all categories of its business activities must start either simultaneously or that the last stage must start before it can be said that the business was set up.
- (e) Expenses incurred during the preparatory stage prior to setting up of business would not qualify for deduction. However the expenses incurred during the intervening period between setting up of the business and the commencement of the business would be permissible deduction however, long the intervening period may be.

In the case of *Breeze Construction (P) Ltd Vs. ITO, Ward 3(1) – Delhi Bench 'A' [2012] 21 Taxmann.com 114 (Delhi)* it is held that Section 36(1)(iii) of the Income-tax Act, 1961 – Interest on borrowed capital – Assessment year 2001-08 – Assessee company took on lease a plot of land for running hotel business – For taking that plot of land, assessee took loan from its holding company and claimed deduction of interest paid – Whether since during relevant assessment year assessee company had merely taken land on lease, by no stretch of imagination it could be treated as commencement/

setting up of its hotel business – Held yes – whether, therefore, Assessing officer was justified in rejecting assessee’s claim in view of proviso to section 36(1)(iii) – Held, yes.

In the case of *Interlink Petroleum Ltd. V. DCIT – Ahmedabad Bench ‘c’* [2004] 4 SOT 802 (Ahd) the Hon’ble ITAT Ahmedabad laid down various principles as under:

- (a) There is a clear distinction between a person commencing and person setting up of the business. There may be an interval between setting up of business and the commencement of the business.
- (b) When a business is established and is ready to commence then it would be said that the business is set up.
- (c) The expenses incurred during the intervening period between setting up of business and commencement of business would be permissible as deduction. However, expenses incurred during the preparatory stage prior to setting up of business would not qualify for deduction
- (d) The assessee can be said to have set up its business from the date when one of the essential categorizes of its business activities is started and it is not necessary that all categories of its business activities must start either simultaneously or that the last stage must start before it can be said that the business was set up.
- (e) The question as to when business can be said to have been commenced will depend upon facts and circumstances of each case. The test to be applied is as to when a businessman would regard a businessman as being setup and/or commenced and the approach must be from a common sense point of view.

In case of *Maharashtra Airport Development Co. Ltd. vs. Maharashtra Airport Development Co. Ltd.* [2013] 35 Taxmann.com 591 (Mumbai–Trib.) it was held that Section 37(1) of the Income-tax Act, 1961 – Business expenditure – Allowability of [Commencement of Business operations] – Assessment year 2005-06 – whether, where assessee

had only acquired land and appointed consultants for various business purposes, but had neither obtained environmental clearance nor favorable feasibility reports nor obtained approved plans of development, it could not held as ‘Set up’ and commencement of business operations with respect to business of development of airport infrastructure.

Section 56 of the Income-tax Act, 1961 – Income from other sources – Chargeable as [Interest] – Assessment year 2005-06 – whether Interest income, arising out of surplus funds not required immediately for business purpose and deposited in bank for short period is assessable as income from other sources and not business income.

In the case of *ALD Automotive (P.) Ltd V. DCIT Circle 15(1) Mumbai* (2014) 45 taxmann.com 530 (Mumbai – Trib, it was held that Section 37(1) of the Income-tax Act, 1961 – Business expenditure – Allowability of [Setting up of business] – Assessment year 2005-06 – whether, where state of preparedness of company was clearly in setting up stage – Held, yes – whether, where expenses were incurred by assessee prior to setting up of business, assessee’s claim of allowance of business, assessee’s claim of allowance of business loss during said period was not maintainable.

Thus, from the above referred case laws it is very clear that set up before the set up of business cannot be treated as business is ready to commence and hence the expenses will not be allowed as deduction.

View in Favour of the Proposition:

It is submitted that when certificate of commencement of business is obtained, land is acquired, resolution is passed by the BOD, applications/license has been applied from the Government Authorities and when MOU is also entered into by the company, the business is set up. It has been held by the Hon. Bombay High Court in the case of *Vegetable products of India ltd.* that when business is set up, it is ready to commence and actual commencement is not necessary for the purpose of deduction of expenses.

It is submitted that it is important to consider the decisions regarding the concept of ready to

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commence business vs. actual commencement of business. This distinction is clearly spelt out in the following decisions.

In case of *E-Funds International DHC 162 Taxman 1*, Assessee was engaged in the business of development of software and IT enabled services. It was claimed by the assessee that since necessary infrastructure was set and technical employees to render IT services were employed hence business is set up. The claim of the assessee was accepted. In this case also, land is acquired, compound wall is constructed and competent expert directors are appointed for the purpose of the project and hence business is set up.

In case of *Neil Automation 120 Taxman 205*, Assessee was engaged in the business of distribution of software. The Hon. ITAT held that business is set up when assessee started approaching prospective customers and supplied quotations of software. In our case assessee approached Government of Gujarat, obtained leasehold land and entered into MOU with Government of Gujarat and hence business is set up.

In case of *Hughes Escorts FHC-213 CTR 45 & DELITAT – 106 TTJ 1065*, Assessee was engaged in Telecommunication Business (where VSAT equipment was necessarily required for effective communication). The assessee claimed that business is set up when letter of intent from prospective customer Bank of America for VSAT purchase was obtained (July 1994). The claim of the assessee was accepted. In our case also the company entered into MOU with state authorities of Government and also the project development agreement which goes to conclusively show that the intent of the company is established and hence business is set up.

In case of *Western India Sea Products Guj HC – 199 ITR 777*, Assessee was engaged in the Business of marine processing industry. The Hon. Jurisdictional High Court of Gujarat held that acquiring a godown in the month of August in anticipation of arrival of fish in October held to be date of setting up.

In case of *Mad HC in club Resorts 287 ITR 552*, the assessee was engaged in project execution and

opened a project office in India. The assessee argued that business is set up when letter of intent was received though RBI approval was not received. The claim of the assessee was accepted by their lordships of Madras High Court. In this case it is submitted that business is set up when MOU is entered into with the Government of and lease agreement with GIDC for possession of land.

Let me refer the case of *Gujarat HC in Hotel Alankar 133 ITR 866*, the assessee was engaged in boarding and lodging house and assessee claimed that the business is set up when hotel building was acquired. The claim of the assessee was accepted by their lordships of High Court of Gujarat. In our case also the business is set up when land is acquired, compound wall is constructed, and project agreement is entered into.

In case of *Bang ITAT in Swire Holdings 6 SOT 621*, assessee was engaged into real estate business. Assessee claimed that business is set up when money was advanced for purchase of property. The Honorable ITAT upheld assessee's contention.

Summation:

It is submitted that, the company is awaiting various approvals from State Authorities for constructing various units/incubation centers etc. for Industrial Parks.

The company got incorporated and further, there are following evidences to prove that the business is set up.

1. Resolution of BOD regarding commencement of business.
2. A certificate of Commencement of business.
3. MOU with Government.

Hence the company has set up its business which can be seen from the facts that the company has constructed compound wall for the project and has applied for various approvals from the State Government Authorities.

Recently, the Delhi High Court in the case of *Dhoomketu Builders & Development Private Limited* (the taxpayer) upheld the decision of Delhi Bench of Income-tax Appellate Tribunal which has acknowledged the distinction between the commencement of a business and setting up of a

business and applied the test laid down by the Bombay High Court in the case of Western India Vegetable Products Ltd.

1. Issue before the High Court

Whether the act of depositing earnest money while participating in the tender and the act of borrowing monies be construed as acts constituting setting up of the business of real estate development?

2. Tax department’s contention

Until the taxpayer actually acquires any land for the purpose of carrying on its business as per the objects clause of memorandum of association, the business cannot be said to have been set up within the meaning of Section 3 of the Act.

3. Taxpayer’s contentions

The business was set up the moment the taxpayer took steps to participate in the tender on 29 November 2005 and deposited the earnest money and it is irrelevant that it was not successful in acquiring the land.

The setting up of the business could be either simultaneous with or anterior to the commencement of the business and in this case the moment the taxpayer borrowed money and deposited them with NGEF Ltd. and thus participated in the tender, it had taken the steps that constitute the setting up of the business.

4. High Court’s ruling

The decision of the Tribunal is based on the relevant tests that have been handed down judicially for the purpose of ascertaining as to when a business can be said to have been set-up.

The question as to when a business can be said to have been set-up is a question of fact to be ascertained on the facts and circumstances of each case and considering the nature and type of the particular business and no universal test or formula applicable to all types of business can be laid down.

The tax department’s contention that the tax auditors of the taxpayer have pointed out that the taxpayer is yet to commence its business is irrelevant because

of the distinction between the commencement of the business and setting-up of business as laid down by various judicial precedents, more so by Bombay High Court.

Since the Tribunal has taken the note of the distinction between the commencements of a business and setting up of a business and applied the test laid down by the Bombay High Court, there is no substantial question of law arises out of the order of the Tribunal.

Further I would like to submit that in the case of CIT vs. ESPN Software India (P) Ltd. ref no. ITA No. 516/2007, their lordships of Delhi High Court held as under:

A finding regarding the date when a business was set up is a finding of fact. Here in the present case, there is a finding of fact given by two statutory authorities below that Assessee was ready to commence its business on 15th August, 1995 when it acquired license to distribute in India through Cable Television Systems, Satellite Master Antenna System and DTH etc. The relevant findings of the Tribunal in this regard as under :- “The Assessee in the present case as one of its business activity distribution of T.V. programmes in the area of sports, entertainment etc. in furtherance of this objects referred to above it obtained the license from ESPN Inc. to distribute ESPN Channel Services. This was rightly held by the commissioner of Income Tax (A) to be the point of time when the business of the Assessee has been set up. By virtue of the license it could discharge one of its objects as set out in the Memorandum of Association of the Company. This was the activity, which was first in point of time and which must necessarily precede all other activities and on this activity being done, the business of the Assessee, would be deemed to have been set up.”

Thus, when there is reference to object clause of Memorandum of Association for starting industrial park, assessee acquired land, applied for various approvals from Government Authorities and entered into MOU with Govt. the business of the company is set up and hence ready to commence and I submit that all the expenses must be allowed as deduction.
