A COMMISSIONER OF INCOME TAX

v.

WILLAMSON FINANCIAL SERVICES AND ORS.

DECEMBER 12, 2007

B **[S.H. KAPADIA AND B. SUDERSHAN REDDY, JJ.]**

Income Tax Act, 1961:

C *s.80HHC—Composite income from sale of tea, grown and manufactured—Export of tea—Deduction under s.80HHC—Held: Allowable after 60: 40 apportionment of income under Rule 8(1)—The said rule segregates agricultural income which is exempted income, from business income which is chargeable to tax—For that purpose,*

D *the ratio of 60 : 40 is applied—Therefore chargeability and computability is confined to only 40% of the income from tea which is taxable under Income Tax Act, 1961—In view of this, assessee cannot claim s.80HHC(3)(a) deduction against the entire tea composite income—Moreover Deductions under Chapter VIA are deductions not*

E *from a particular head of income but from gross total income—Therefore, s.80HHC is not part of provisions for computation of business income—Income Tax Rules, 1962—r.8(1).*

s.10(1)—"agricultural income"—Power to make laws with respect to taxes on agricultural income—Held: Is on State Legislature

F *under Article 246(1) of Constitution r.w. Entry 82 of List I in Seventh Schedule and Article 246(3) r.w. Entry 46 of List II in Seventh Schedule—Expression "agricultural income", means agricultural income as defined in Article 366(1) of Constitution for purpose of enactments relating to Indian Income-tax—Constitution of India,*

G *1950—Articles 246(1), (3), 366(1), Seventh Schedule List I Entry 82 and List II Entry 46.*

The question which arose for consideration in these appeals is

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whether Assessing Officer was right in holding that deduction under s.80HHC can be allowed only against part of the income from tea which was taxable under the Income Tax Act, 1961, namely, 40% of the income. A

Disposing of the appeals, the Court B

HELD: 1.1. The tea income consists of two parts : (i) "agricultural income' upto the stage of growing the tea; and (ii) "business income" from the manufacture and sale of tea grown by the assessee. Under the Constitution, "agricultural income" can be taxed only by the State Governments. Rule 8(1) of Income Tax Rules, 1962, provides that only 40% of the composite income can be taxed under the Income Tax Act, 1961. Power of the State Governments to levy tax extends to the balance, namely, 60% of the composite income. Rule 8(1) provides for the method in which composite income is to be computed. It says that income shall be computed as if it were income derived from business. Rule 8(1) uses the word "income" and not "total income". The 1961 Act contains provisions for computation of income under the head "Business". The computation in Rule 8(1) in respect of composite income, by reason of legal fiction in-built in Rule 8, cannot be read in entirety into computation of income under the head "Business". [Para 41] [400-E-G] C D E

Cambay Electric Supply Industrial Company Ltd. (1978) 113 ITR 84 SC; *The Karim Tharuvi Tea Estates Ltd., Kottayam and Anr.* v. *State of Kerala and Ors.*, (1963) 48 ITR 83 SC and *Distributors (Baroda) Pvt. Ltd.* v. *Union of India and Ors.*, (1985) 155 ITR 120 SC, held inapplicable. F

Tea Ltd. v. *State of West Bengal,* (1988) 173 ITR 18 SC, Distinguished.

1.2. Deductions under Chapter VIA are deductions not from a particular head of income but from gross total income. Therefore, s.80HHC is not part of the computation of income under the head "Business". S.80HHC Deduction is required to be allowed after apportionment of income under Rule 8(1) of the 1962 Rule. G

[Paras 44 and 45] [402-D-E] H

A **2. S.10(1) exempts "agricultural income" not only from taxable income but also from the "total income" of the assessee. These incomes are different from tax-free incomes under Chapter VIA. The exemption of agricultural income from central taxation is based on the provisions in the Constitution according to which Parliament has exclusive power**
B **to make laws with respect to taxes on income other than agricultural income, whereas State Legislature has exclusive power to make laws with respect to taxes on agricultural income, under Article 246(1) of the Constitution read with Entry 82 of List I in the Seventh Schedule and Article 246(3) read with Entry 46 of List II in the Seventh Schedule.**
C **The expression "agricultural income", for the purpose of these entries, means agricultural income as defined for the purpose of the enactments relating to Indian Income-tax vide Article 366(1) of the Constitution. From the definition of "agricultural income" in Article 366(1) it becomes clear that Rule 8 of 1962 Rule (corresponding to Rule 24 framed under**
D **I.T. Act, 1922) pertains to and is integrated with the definition of the expression "agricultural income" for the purposes of laws pertaining to Indian Income-tax and, therefore, the said rule has to be taken into account in considering the meaning of the expression "agricultural income" in Article 366(1) of the Constitution. The words used in Article**
E **366(1) of the Constitution are not "as defined by the enactments relating to Indian Income-tax" but "as defined for the purposes of the enactments relating to Indian Income-tax".**

[Paras 21 and 23] [390-G-H; 391-A-E]

Tata Tea Ltd. **v.** *State of West Bengal,* **(1988) 173 ITR 18 SC, relied**
F **on.**

3.1. Rule 8 refers to cases of integrated income. Where the income of the assessee is partly from agriculture and partly from manufacture – the profits on the sales have to be apportioned, and the elements in the profits referable to agricultural activities may be exempted as being
G **agricultural income. In such cases, the task of apportionment is simplified by Rules 7 and 8 framed in exercise of powers conferred by s.295(2)(b). Under Rule 8, which applies only in cases where the assessee himself grows tea-leaves and manufactures tea in India, 40% of the profits on sales is taxable as business income. Only the balance 60%**
H **of such income would be deemed to be agricultural income on which the**

State Legislature would have the power to levy agricultural income-tax. However, the State Legislature would have no power to make any law which would have the effect of levying tax on the aforestated 40% of such income on which tax is payable under the I.T. Act by virtue of the provisions of the I.T. Act. The computation of income from tea has to be in accordance with the relevant provisions of the enactments relating to the Indian Income-tax and the deductions towards various expenses incurred for earning the income shall be liable under the said enactments relating to Indian Income-tax. Thus, where computation of income from cultivation, manufacture and sale of tea is made in accordance with the provisions of the I.T. Act, the Agricultural Income-tax Officer would have no option but to accept the computation by the A.O. under 1961 Act and treat 40% of such income, as business income and the balance 60%, as agricultural income. [Para 24] [391-H; 392-A-C, E-H; 393-A]

3.2. The term "agricultural income" has been defined under s.2(1A) of the 1961 Act. It is exempted from tax under 1961 Act because Parliament has no power under the Constitution to levy tax on agricultural income. The word "income" has been defined in s. 2(24) of the said Act to include profits and gains. The term "total income" is defined in s.2(45) of the said Act. The definition of the term "total Income" involves two ingredients – firstly, that the income must consist of the total amount of income referred to in s.5 and secondly, it must be computed in the manner laid down in the Income-tax Act. Therefore, the manner of computation laid down by the I.T. Act forms an integral part of the definition "total income". The correct method of approach is to treat nothing as being charged to tax until by the process of computation laid down by the said Act, the status of income, profits and gains, emerges. [Para 26] [393-C-E]

3.3. S.80HHC states that in computing the "total income" a deduction, to the extent of profits derived by the assessee from exports has to be taken into account. The important words are "profits derived from the export". The word "derived" would mean "derived from the source". That source has to be in s.14. Income covered by s.10(1) i.e. agricultural income, which is not chargeable to tax, does not fall in s.14 and, therefore, it will not fall under various computation sections

A commencing from s.15 to s.59. S.14 classifies "all income" into five enumerated heads for the purpose of charge of income-tax and computation of total income. "Exempted income" is different from "tax-free income". "Agricultural income" falls in the category of exempted income. It is neither chargeable nor includible in the total income. On
B the other hand, deduction under Chapter VIA is for "income" which forms part of total income but which is tax-free. Both these types of income are to be balanced, namely, exempted income vis-a-vis tax-free income. Thus, it is clear that "income", covered under s.10 and s.11 which is not chargeable to tax, does not fall under s.14 and under various
C computation sections from s.15 to s.59. However, on account of legal fiction built into Rule 8(1), which applies to composite income, a part of the composite income/integrated income is agricultural income and the balance is the business income. The object of Rule 8(1) is to disintegrate the two. [Para 37] [397-E-H; 398-A-B]

D 3.4. Rule 8(1) uses the word "income". In the entire rule the word 'total income' is not mentioned. Further, Rule 8(1) refers to income derived from the sale of tea cultivated and manufactured. In the case of an assessee deriving income, not from composite activity, one has to calculate agricultural income in the commercial sense. However, in
E composite income under Rule 8(1) a part of the composite income is business profit, which is one of the source/head of income under s.14, and therefore to that extent alone chargeability and computation would arise and that too only to the extent of computation of income under the head "profits and gains from business". Rule 8(1), therefore, states
F that composite/integrated income shall be computed as if it was income derived from business. The words "as if" stand for legal fiction. Rule 8(1) segregates agricultural income which is exempted income from business income which is chargeable to tax. For that purpose the ratio of 60 : 40 is applied. Therefore, to the extent of 40% only there is
G chargeability and computability to the extent of 40% only. If this distinction is kept in mind, the assessee cannot claim s.80HHC(3)(a) Deduction against the entire tea composite income. It can be claimed only against proportionate income.

[Paras 38 and 40] [398-D-F, G; 400-A-B]

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CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 3803-3808 of 2005. A

From the Judgment and final Order dated 24.8.2004 of the Gauhati High Court at Gauhati in L.T.A. Nos. 59, 60, 62, 63, 64 and 65/2003.

WITH B

C.A. Nos. 1021/2006, 6719-6720/2004, 1825, 1827 and 5827/2007.

Vikas Singh, A.S.G., Dr. R.G. Padia, H.N. Salve, Shyam Diwan, Dr. D.P. Pal, S. Ganesh, Arijit Prasad, A. Deb Kumar, Alka Sharma, C Lalit Srivastava, B.V. Balram Das, Prateek Jalan, Meenakshi Grover, Ruby Singh Ahuja, Manu Aggarwal, Christic Jain, Kamaldeep Dayal, Abhratosh Majumdar, S. Sukumaran, Alok Rai, Rajesh, K. Rajeev, Suruchi Aggarwal, V.K. Sidharthan and A. Bhattacharjee for the Appearing parties. D

The Judgment of the Court was delivered by

KAPADIA, J. 1. Leave granted in S.L.P. (C) No.2275 of 2007.

2. The intricate question which arises for determination in this batch E of civil appeals is at what stage Section 80HHC Deduction is to be allowed i.e. before the 60 : 40 apportionment under Rule 8(1) or from 40% profits on sales taxable as Business Income.

3. Rule 8(1) of the said Rule provides that 40% of the composite income from sale of tea, grown and manufactured, arrived at on making F of the apportionment "shall be deemed to be income liable to tax".

4. Assessees exported tea in the accounting year. They were entitled to deduction under Section 80HHC of Income-tax Act, 1961 (for short, '1961 Act") in respect of the export. They were in the business of growing G and manufacturing tea. Since they earned Composite Income, their case stood covered by Rule 8(1) of Income-tax Rules, 1962 ("1962 Rule" for short).

5. For the sake of convenience we state the facts occurring in *Civil* H

A *Appeal No.3803-3808 of 2005- Commissioner of Income Tax* v. *Willamson Financial Services & Ors.* In the returns, the assessee claimed Section 80HHC Deduction against the entire Composite Income *before* application of Rule 8(1).

B 6. This working was rejected by the A.O. who took the view that deduction under Section 80HHC can be allowed after 60 : 40 apportionment as 40% income was gross total income. However, in appeal, CIT (A) reversed the decision of the A.O. by holding that the A.O. should have first granted Section 80HHC Deduction against the C entire tea income before applying Rule 8(1).

7. In short, the controversy is : whether Section 80HHC Deduction is admissible against the entire or part of the income from tea (i.e. 40%).

8. Against the said decision of CIT(A) the matter was carried in D appeal to the Tribunal who took the view that A.O. was right in allowing Section 80HHC Deduction only against part of the income from tea which was taxable under the 1961 Act, namely, 40% of the income. This view of the Tribunal stood reversed by the impugned judgment of the High Court. Hence this civil appeal is filed by the Department against the E judgment of the Division Bench of the Guahati High Court.

SUBMISSIONS

9. On behalf of the assessees learned senior counsel submitted that Rule 8 of 1962 Rule which provides for computation of composite income F is made under the power conferred by section 295 of the 1961 Act and as such the said Rule has the effect as if enacted in that Act. Further, the definition of "agricultural income" is bound up with the Rules. Therefore, according to the learned counsel, such composite income has to be computed in the first instance as if it is income derived from business. The G income has to be computed in accordance with the provisions of the Act which deals with computation of business income and, therefore, any deduction permissible under the 1961 Act is to be allowed while computing the composite income which is treated as business income and, therefore, deduction admissible under section 80HHC is to be computed H on the basis of the proportion which the export turnover bears to the total

turnover, which proportion is to be applied to the business profits to find out the export profits derived from export business. According to the learned counsel, when income is derived from profit computed under the head "profits and gains of business", all deductions and allowances are to be allowed and, therefore, it is not possible to compute the profit of the business by allowing only deduction and allowances, which fall under Chapter IV but all other deductions although they do not appear in Chapter IV but in Chapter VIA, like deductions under section 80HHC, have also to be allowed to compute business profits in accordance with the provisions of the Act under the head "profits of the business". According to the learned counsel, if total profits from the sale of tea cultivated and manufactured by the seller are to be included in the computation of business profits, then, necessarily, any deduction allowed in respect of the profits from tea export has also to be allowed in computing the business income. In this connection, learned counsel placed reliance on the definition of "total income" in section 2(45) and section 5 of the 1961 Act which defines the scope of total income. According to learned counsel, "business income" is one of the Heads of Income under Section 14 and such income is included in the total income of an assessee. According to assessees, Section 80A, which is in Chapter VI-A, provides that in computing the total income, there shall be allowed from gross total income, deductions specified in sections 80C to 80U of the Act and, therefore, there is no difference between deductions under Chapter IV and the deductions under Chapter VI-A. Therefore, according to the learned counsel, in computing the total income, it is not permissible to restrict the deduction under Chapter IV and not to allow deduction under Chapter VI-A. In this connection reliance was placed by the learned counsel on the judgment of this Court in the case of *Cambay Electric Supply Industrial Company Ltd.* v. *Commissioner of Income Tax,* (1978) 113 ITR 84 (SC) which had been approved by the Constitution Bench later on in the case of *Distributors (Baroda) Pvt. Ltd.* v. *Union of India and Ors.* (1985) 155 ITR 120 (SC) in which it has been held that though a deduction does not appear in Chapter IV, it has a direct impact upon the computation of income under the head "business profit" and, therefore, even if the deduction does not fall within the ambit of Sections 29 to 43A, still if the deduction directly affects the computation

A B C D E F G H

A of income under the head business profits then such deduction has got to be taken into account. Placing reliance on the said judgments, learned counsel submitted that the deduction admissible under section 80HHC is one of the items of deduction appearing in Chapter VI-A which has to be taken into account in computing the business income and, therefore, B section 80HHC is a part of the provisions relating to the computation of business income under the 1961 Act. Before us, it was further submitted that the legal fiction under Rule 8 became necessary because it was not possible for the ITO to assess an assessee, who not only carries on business in selling tea but also grows green tea leaves by agricultural C process and manufactures black tea from the same. Because of the said legal fiction, the entire sale proceeds is treated as business income and is computed as such after giving all allowances and deductions admissible in computation of business income and, therefore, according to the learned counsel, while computing business income, the legal fiction under Rule 8 D must be given effect by computing the business income after taking into account the deduction under section 80HHC. Learned counsel for the assessee further submitted that Chapter VI-A has several headings. Under heading 'C' we have "deductions in respect of certain incomes". That heading would cover "incomes" which are includible in the gross total E income of the assessee and, therefore, section 80AB which also falls in Chapter VI-A will apply only to incomes which fall under heading 'C'. In other words, according to the learned counsel, section 80AB will not have any application to incomes not falling under heading 'C'. Learned counsel for the assessee has relied upon the above analyses of various F deductions allowed under heading 'C' to show that under certain provisions, deductions are allowed where the gross total income includes profits or gains in respect of which such deductions are admissible. For example, section 80HH provides that where gross total income includes any profits derived from an industrial undertaking, there shall be allowed, G in computing the total income, a deduction equal to twenty per cent from such profits. Similar expression finds place in section 80HHB and section 80-IA. These illustrations have been given by the learned counsel in support of his contention that where the gross total income includes any business profits referred to under the specific section, section 80AB would H apply and the amount of income specified in the given section as computed

in accordance with the provisions of the Act (before making any deduction under Chapter VI-A) shall alone be deemed to be the amount of income of the said nature which is derived or received by the assessee and which is included in his gross total income. However, the said scheme of sections 80HHB, 80-I and 80-IA etc. is not applicable to the scheme of section 80HHC. According to the learned counsel, section 80HHC is the separate code by itself. That the said section cannot be confused or put on par with sections 80HHB, 80-I or 80-IA. According to the learned counsel, section 80HHC is different from other sections under Chapter VI-A because it provides that in computing the total income, the profits and gains from export would be allowed a deduction of the profits derived by the assessee from the export of such goods. According to the learned counsel, in section 80HHC, the following expression is not there, namely, "where gross total income of an assessee includes the profits derived from export business". According to the learned counsel, the said expression is omitted from section 80HHC because the deduction under section 80HHC is strictly not computed in accordance with the provisions of the 1961 Act, relating to the computation of business income. According to the learned counsel, the deduction under section 80HHC is only in respect of profit derived by the assessee from export, which has been defined under section 80HHC(3). That sub-section lays down that the profits derived from export shall be the amount which bears to the profits of the business, as computed under the head profits and gains of business, the same proportion as the export turnover bears to the total turnover of the business. Therefore, according to the learned counsel, the profits of the export business which are allowed deduction under section 80HHC are not computed in accordance with the provisions of the Act relating to the computation of business income *but is statutorily fixed under section 80HHC(3)* of the Act and that is the reason why section 80HHC does not use the expression "where gross total income includes any profits and gains derived from export business". Therefore, according to the learned counsel, section 80AB is not applicable to profits derived from export business. Therefore, according to the learned counsel, section 80AB will not govern section 80HHC. Consequently, according to the learned counsel, the ITO should have first granted Section 80HHC Deduction against the entire tea income, i.e., before applying Rule 8(1) and,

A thereafter, the ITO should have applied the said Rule and apportioned the income in the ratio of 60:40.

Analysis of relevant provisions of the Constitution, Income-tax Acts, 1922 and 1961.

B 10. For the sake of convenience we quote hereinbelow relevant sections, rules, articles and entries:

11. *Section 10 of I.T. Act, 1922 which reads as under:*

10. (1) The tax shall be payable by an assessee under the head C "Profits and gains of business, profession or vocation" in respect of the profits and gains of any business, profession or vocation carried by him.

(2) Such profits or gains shall be computed after making the D following allowances, namely:-

(i) Any rent paid for the premises in which such business, profession or vocation is carried on, provided that when any substantial part of the premises is used as a dwelling-house by the assessee, the allowance under this clause shall be such E sum as the Income-tax Officer may determine having regard to the proportional annual value of the part so used;

(ii) in respect of repairs, where the assessee is the tenant only of the premises, and has undertaken to bear the cost of such F repairs, the amount paid on account thereof, provided that, if any substantial part of the premises is used by the assessee as a dwelling-house, a proportional part only of such amount shall be allowed;

(iii) in respect of capital borrowed for the purposes of the business, G profession or vocation, the amount of the interest paid:

12. *Rule 24 of the 1961 Act reads as under:*

"24. Income derived from the sale of tea grown and manufactured by the seller in the taxable territories shall be computed as if it were H income derived from business, and 40 per cent. of such income

shall be deemed to be income, profits and gains liable to tax: A

Provided that in computing such income an allowance shall be made in respect of the cost of planting bushes in replacement of bushes that have died or become permanently useless in an area already planted, unless such area has previously been abandoned." B

13. *Section 2(1A) of the 1961 Act reads as under:*

"Definitions.

2. In this Act, unless the context otherwise requires, - C

(1A) *"agricultural income"* means

(a) any rent or revenue derived from land which is situated in India and is used for agricultural purposes;

(b) any income derived from such land by D

(i) agriculture; or

(ii) the performance by a cultivator or receiver of rent-in-kind of any process ordinarily employed by a cultivator or receiver of rent-in-kind to render the produce raised or E received by him fit to be taken to market; or

(iii) the sale by a cultivator or receiver of rent-in-kind of the produce raised or received by him, in respect of which no process has been performed other than a process of the nature described in paragraph (ii) of this sub-clause; F

(c) any income derived from any building owned and occupied by the receiver of the rent or revenue of any such land, or occupied by the cultivator or the receiver of rent-in-kind, of any land with respect to which, or the produce of which, any G process mentioned in paragraphs (ii) and (iii) of sub-clause (b) is carried on :

Provided that

(i) the building is on or in the immediate vicinity of the land, and H

A is a building which the receiver of the rent or revenue or the cultivator, or the receiver of rent-in-kind, by reason of his connection with the land, requires as a dwelling house, or as a store-house, or other out-building, and

B (ii) the land is either assessed to land revenue in India or is subject to a local rate assessed and collected by officers of the Government as such or where the land is not so assessed to land revenue or subject to a local rate, it is not situated -

C (A) in any area which is comprised within the jurisdiction of a municipality (whether known as a municipality, municipal corporation, notified area committee, town area committee, town committee or by any other name) or a cantonment board and which has a population of not less than ten thousand according to the last preceding census D of which the relevant figures have been published before the first day of the previous year ; or

(B) in any area within such distance, not being more than eight kilometres, from the local limits of any municipality or cantonment board referred to in item (A), as the Central E Government may, having regard to the extent of, and scope for, urbanisation of that area and other relevant considerations, specify in this behalf by notification in the Official Gazette:

F *Explanation.* – For the removal of doubts, it is hereby declared that revenue derived from land shall not include and shall be deemed never to have included any income arising from the transfer of any land referred to in item (a) or item (b) of sub-clause (iii) of clause (14) of this section;"

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14. *Section 10(1) of the 1961 Act reads as under:*

"CHAPTER III

INCOMES WHICH DO NOT FORM PART OF TOTAL H *INCOME*

Incomes not included in total income.

10. 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

(1) agricultural income;"

15. *Sections 80HHC(1) and 80HHC(3)(a) of the 1961 Act read as under:*

"Deduction in respect of profits retained for export business

80HHC. (1) Where an assessee, being an Indian company or a person (other than a company) resident in India, is engaged in the business of export out of India of any goods or merchandise to which this section applies, there shall, in accordance with and subject to the provisions of this section, be allowed, in computing the total income of the assessee, a deduction of the profits derived by the assessee from the export of such goods or merchandise :

(1A) to (2A) xxx xxx xxx

(3) For the purposes of sub-section (1),--

(a) where the export out of India is of goods or merchandise manufactured or processed by the assessee, the profits derived from such export shall be the amount which bears to the profits of the business, the same proportion as the export turnover in respect of such goods bears to the total turnover of the business carried on by the assessee;"

16. Rule 8(1) of the 1962 Rule reads as under:

Income from the manufacture of tea.

8. (1) Income derived from the sale of tea grown and manufactured by the seller in India shall be computed as if it were income derived from business, and forty per cent of such income shall be deemed to be income liable to tax.

17. *Entry 46, List II* (State List) of the Seventh Schedule to the Constitution which reads as under:

"46. Taxes on agricultural income."

18. Article 245 of the Constitution reads as under:

"245. Extent of laws made by Parliament and by the Legislatures of States.-

(1) Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State.

(2) No law made by Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation."

19. *Entry 82, List I* (Union List) of the Seventh Schedule to the Constitution reads as under:

"82. Taxes on income other than agricultural income."

20. *Article 366(1) of the Constitution reads as under:*

"366. Definitions.- In this Constitution, unless the context otherwise requires, the following expressions have the meanings hereby respectively assigned to them, that is to say-

(1) "agricultural income" means agricultural income as defined for the purposes of the enactments relating to Indian income-tax;"

21. On analysis of the above provisions the position which emerges is as follows. Section 10(1) of 1961 Act exempts "agricultural income" not only from taxable income but also from the "total income" of the assessee. These incomes are different from tax-free incomes under Chapter VIA. The exemption of agricultural income from central taxation is based on the provisions in the Constitution according to which Parliament has exclusive power to make laws with respect to taxes on income other than agricultural income, whereas State Legislature has exclusive power to make laws with respect to taxes on agricultural income, under Article

246(1) of the Constitution read with Entry 82 of List I in the Seventh Schedule and Article 246(3) read with Entry 46 of List II in the Seventh Schedule. A

22. The expression "agricultural income", for the purpose of above-mentioned entries, means agricultural income as defined for the purpose of the enactments relating to Indian Income-tax vide Article 366(1) of the Constitution. Therefore, the definition of "agricultural income" in Article 366(1) indicates that it is open to the income-tax enactments in force from time to time to define "agricultural income" in any particular manner and that would be the meaning not only for tax enactments but also for the Constitution. This mechanism has been devised to avoid a conflict with the legislative power of States in respect of agricultural income. From the said definition of "agricultural income" in Article 366(1) it becomes clear that Rule 8 of 1962 Rule (corresponding to Rule 24 framed under I.T. Act, 1922) pertains to and is integrated with the definition of the expression "agricultural income" for the purposes of laws pertaining to Indian Income-tax and, therefore, the said rule has to be taken into account in considering the meaning of the expression "agricultural income" in Article 366(1) of the Constitution. It is significant to note that the words used in Article 366(1) of the Constitution are not "as defined by the enactments relating to Indian Income-tax" but *"as defined for the purposes of the enactments relating to Indian Income-tax"*. Therefore, it is clear from the definition in Article 366(1), that Rule 8 of 1962 Rule (Rule 24 of I.T. Rules, 1922), defines the term "agricultural income" for the purposes of laws pertaining to Indian Income-tax and, therefore, the said rule has to be taken into account in considering the meaning of the term "agricultural income" under Article 366(1) of the Constitution. [See: *Tata Tea Ltd.* v. *State of West Bengal,* (1988) 173 ITR 18 SC]. B C D E F

23. In short, whatever definition is given in the I.T. Act shall be deemed to be adopted under the Constitution by virtue of Article 366(1) of the Constitution of India. G

24. It is in the above context that one has to examine the scope of Rule 8 of 1962 Rule. Rule 8 refers to cases of *integrated income*. Where the income of the assessee is partly from agriculture and partly from H

A manufacture – example, where the assessee grows tea and subjects it to a manufacturing process, and sells the manufactured product – the *profits* on the sales have to be apportioned, and the elements in the profits referable to agricultural activities may be exempted as being agricultural income. In such cases, the task of apportionment is simplified by Rules 7
B and 8 framed in exercise of powers conferred by Section 295(2)(b). Under Rule 7 the market value of the agricultural produce used as raw material in the business is deductible from the business profits, as representing agricultural income. Under Rule 8, which applies only in cases where the assessee himself grows tea-leaves and manufactures tea in India,
C 40% of the profits on sales is taxable as business income, while the balance is exempt as representing agricultural income. If an income receipt, comprises of both agricultural and non-agricultural elements, it has to be disintegrated – and that portion which represents agricultural income should be exempted from tax. Thus, composite revenue derived from land may
D be apportioned. In cases where a person subjects agricultural produce to a manufacturing process before selling it, the profits on the sale has to be disintegrated and the portion representing agricultural income would be exempt from tax but the portion *attributable* to the manufacturing process would be taxable as business *profits*. This is the basic scheme
E of Rule 8. Therefore, the position which emerges is that income derived from the sale of tea grown and manufactured by the seller in India shall be computed as income derived from business and 40% of such income shall be deemed to be liable to tax under the I.T. Act. Only the balance 60% of such income would be deemed to be agricultural income on which
F the State Legislature would have the power to levy agricultural income-tax under Article 246(3) r/w Entry 46, List II of the Seventh Schedule to the Constitution. However, the State Legislature would have no power to make any law which would have the effect of levying tax on the aforestated 40% of such income on which tax is payable under the I.T.
G Act by virtue of the provisions of the I.T. Act. The computation of income from tea has to be in accordance with the relevant provisions of the enactments relating to the Indian Income-tax and the deductions towards various expenses incurred for earning the income shall be liable under the said enactments relating to Indian Income-tax. Thus, where computation
H of income from cultivation, manufacture and sale of tea is made in

accordance with the provisions of the I.T. Act, the Agricultural Income-tax Officer would have no option but to accept the computation by the A.O. under 1961 Act and treat 40% of such income, as business income and the balance 60%, as agricultural income. A

25. To the above extent there is no dispute. *The question before us is whether computation of Section 80HHC Deduction could be said to be part of computation provision under the 1961 Act*, particularly, provisions dealing with computation of income under the head "Business Income" and particularly when the said Deduction has to be made from "gross total income" under Chapter VIA B C

26. The term "agricultural income" has been defined under Section 2(1A) of the 1961 Act. It is exempted from tax under 1961 Act because Parliament has no power under the Constitution to levy tax on agricultural income. The word "income" has been defined in Section 2(24) of the said Act to include profits and gains. The term "total income" is defined in Section 2(45) of the said Act. The definition of the term "total income" involves two ingredients – firstly, that the income must consist of the total amount of income referred to in Section 5 and secondly, it must be *computed in the manner laid down in the Income-tax Act.* Therefore, the manner of computation laid down by the I.T. Act forms an integral part of the definition "total income". The correct method of approach is to treat nothing as being charged to tax until by the process of computation laid down by the said Act, the status of income, profits and gains, emerges. This principle is very important for deciding the present case. We repeat that computation laid down by the said Act forms an integral part of the definition of "total income". Section 4 charges the total income of an assessee to income-tax. Section 5 of the I.T. Act defines "total income". D E F

27. At this stage we have to analyse Chapter III which deals with Incomes which do not form part of total income. Section 10 groups in one place various incomes which are exempt from tax. The incomes enumerated in Section 10 are not only excluded from the taxable income of the assessee but also from his total income. The exemption embodied in Section 10 can be divided into two categories, namely, exemption to which certain classes of income from their very nature are entitled to G H

A exemption and the second category concerns exemption to which the character of the assessee entitles him to claim exemption. In the first category is agricultural income whereas in the second category of exempted income is the income of local authorities and diplomatic officers. We are concerned with the first category.

B

28. In addition to the above two categories there is a third kind of income. These incomes are wholly or partly tax-free incomes on account of special deductions under Chapter VIA. We are essentially concerned with these "tax-free incomes".

C 29. In the present matter we are required to adjudicate upon the fiction in Rule 8 *vis-à-vis* the computation contemplated by Chapter VIA in which Section 80B(5) finds place and which defines the expression *"gross total income" as total income computed in accordance with the provisions of the said Act before* making any deduction under D Chapter VIA. Section 10(1) *inter alia* provides that agricultural income is not includible in the total income of the assessee. The result is that agricultural income is not only exempt from tax but, under the scheme of the I.T. Act, is also to be excluded from computation of the total income. Exemptions granted under the I.T. Act covers "incomes" which are exempt E from Charge and also from total income of the assessee whereas there are "incomes" which are exempted from income-tax but they are to be included in the total income of the assessee. In the first case, we have agricultural income which is exempt from Charge as also from total income whereas in the second case we have incomes which are exempted from F the Charge but they are included in the total income of the assessee, for example, at one point of time certain incomes were exempted under Sections 86 and 86A but expressly declared by Section 66 to be included in the total income. Section 110 indicates incomes which are free from the Charge but which are required to be included in the total income of G the assessee. The effect of including exempted income in the total income of the assessee is of two-fold. Firstly, the rate of tax is determined with reference to the total income and, therefore, exempted income which is included in the total income would affect *the rate of tax applicable to the chargeable portion of total income.* Secondly, calculations in several H cases have to be made with reference to total income. For example, tax

relief under Section 80HH is restricted to the ceiling limit determined by reference to gross total income of the assessee which expression, as stated above, is defined in Section 80B(5) of the I.T. Act. It is also important to bear in mind that under Section 4 the levy is on "total income" of the assessee computed in accordance with and subject to the provisions of the I.T. Act. What is chargeable to tax under the I.T. Act is the profits and gains of a year. What is chargeable to tax under the I.T. Act is not gross receipts but income. Under the I.T. Act the tax is on income and not on gross receipts. Section 4 is the charging section. Section 5 defines gamut of "total income". Section 4 charges every person in respect of his total income, however, income cannot be taxed unless it falls within Section 5 subject to it being saved by any other section from taxation. The ambit of taxation, being subject to the provisions of the I.T. Act, involves two consequences. Firstly, provisions of the I.T. Act, example, Section 10 to Section 12 and various sections under Chapter VIA, may have the effect of exempting income which would otherwise be chargeable under Section 5. Secondly, the amount of income from whatever sources derived is to be ascertained subject to the provisions of particular sections dealing with the sources, namely, Section 15 to Section 59.

ASSUMPTION

30. Before coming to the reasons in support of our findings we would like to explain the claim of the assessees. For that purpose we need to give a mathematical illustration based on certain assumptions.

(a) *Calculation according to assessees:*

Composite Income as business profits	**: Rs.16.05 crores**
Total turnover	: Rs.52.20 crores
FOB Value of Export Sales	: Rs.64.08 lakhs

Thus, Deduction under Section 80HHC

$$= \frac{64.08 \text{ lakhs}}{52.20 \text{ crores}} \times 16.05 \text{ crores} = \text{Rs.19.70 lacs (Apprx.)}$$

(Rounded off to Rs. 20 Lacs)

A After deducting Rs.20 lacs from Rs.16.05 crores the total income will come to Rs.15,85,00,000/- (Approx.) to which apportionment of 60:40 under Rule 8(1) will be applied to arrive at income liable to tax.

B (b) *Calculation according to A.O.*

Composite Income as business profits	: Rs.16.05 crores
40% of composite income	**: Rs.6.42 crores** (Approx.)
Total turnover	: Rs.52.20 crores
FOB Value of Export Sales	: Rs.64.08 lakhs

C

Thus, Deduction = $\frac{64.08 \text{ lakhs}}{52.20 \text{ crores}}$ x 6.42 crores = Rs.7.88 lacs (approx.)

D

NB : The main difference is on the amount of deduction i.e. between Rs.19.70 lacs (approx.) in the former case and Rs.7.88 lacs (approx.) according to A.O.

E *ISSUE*

31. As stated, the case of the assessees is that 80HHC Deduction should be granted against the entire tea income before applying Rule 8(1).

32. To put it simply, if the business profit is Rs.50 lacs, the total F turnover is Rs.200 lacs and export turnover is Rs.100 lacs then Section 80HHC Deduction will be: $\frac{50 \times 100}{200}$ = Rs. 25 lacs and accordingly assessee would claim deduction of Rs.25 lacs from business profits of Rs.50 lacs to arrive at the total income of Rs.25 lacs which would be liable to be apportioned in the ratio of 60 : 40 and consequently Rs.10 G lacs would be liable to income-tax.

33. On the other hand, according to Department, applying the apportionment of 60 : 40 in Rule 8(1) to Rs.50 lacs the business profit would come to Rs.20 lacs which would be allocated between export H turnover : total turnover to arrive at Section 80HHC Deduction which

will be : $\frac{50 \times 100}{200}$ = Rs.10 lacs. A

34. In short, assessee claims 80HHC Deduction at Rs.25 lacs whereas Department calculates 80HHC Deduction at Rs.10 lacs to arrive at the "total income".

FINDINGS B

35. The word "income" is defined in Section 2(24) of the 1961 Act. That word finds place in Rule 8(1). The word "income" in Section 2(24) includes "profits and gains". The term "total income" is defined in Section 2(45) to mean the total amount of income referred to in Section 5, computed in the manner laid down in the I.T. Act. The word "total income" is not there in Rule 8. C

36. The word "income" is an expression of elastic ambit. It is not exhaustive. That is why Section 2(24) defines "income" as including a particular category of receipts. Mere gross receipt cannot be taxed as income. D

37. Section 80HHC *inter alia* states that in computing the "total income" a deduction, to the extent of profits derived by the assessee from exports has to be taken into account. The important words are "profits derived from the export". The word "derived" would mean "derived from the source". That source has to be in Section 14. Income covered by Section 10(1) i.e. agricultural income, which is not chargeable to tax, does not fall in Section 14 and, therefore, it will not fall under various computation sections commencing from Section 15 to Section 59. Section 14 classifies "all income" into five enumerated heads for the purpose of charge of income-tax and computation of total income. As stated hereinabove, "exempted income" is different from "tax-free income". In the present case, we are concerned with both these types of income. "Agricultural income" falls in the category of exempted income. It is neither chargeable nor includible in the total income. On the other hand, deduction under Chapter VIA is for "income" which forms part of total income but which is tax-free. In the present case, we have to balance both these types of income, namely, exempted income vis-à-vis tax-free income. Thus, it is clear that "income", covered under Section 10 and Section 11 which E F G H

A is not chargeable to tax, does not fall under Section 14 and under various computation sections from Section 15 to Section 59. However, on account of legal fiction built into Rule 8(1), which applies to composite income, a part of the composite income/integrated income is agricultural income and the balance is the business income. The object of Rule 8(1) is to B disintegrate the two. If the income from agriculture cannot be computed under 1961 Act then the income from agriculture has to be arrived at in a normal commercial manner. There is no scope for computing such income by complying with the computation section under the I.T. Act. In other words, the real income has to be taken into account for the purpose C of considering the exemption under Section 10(1). This position emerges in a case where we have to deal solely with agricultural income. However, as stated above, in this case we are concerned with the composite income. Therefore, we have to interpret Rule 8(1) of the 1962 Rule.

D 38. At the outset, it may be noticed that Rule 8(1) uses the word "income". In the entire rule the word "total income" is not mentioned. Further, Rule 8(1) refers to income *derived* from the sale of tea cultivated and manufactured. In the case of an assessee deriving income, not from composite activity, one has to calculate agricultural income in the E commercial sense. However, when we come to composite income under Rule 8(1) a part of the composite income is business profit, which is one of the source/head of income under Section 14, and therefore to that extent alone chargeability and computation would arise and that too only to the extent of computation of income under the head "profits and gains from F business". Therefore, the charging provision and computation provision will apply only to that limited extent. That is why in Rule 8 a legal fiction is incorporated.

39. It is well-settled that chargeability and computation under 1961 Act, constitutes one integral Code. Rule 8(1), therefore, states that G composite/integrated income shall be computed *as if* it was income derived from business. The words "as if" stand for legal fiction. Therefore, the composite income had an element of agricultural and business incomes which needed to be separated by applying the rule of apportionment under Rule 8. That is because, agricultural income has no linkage with any of

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the enumerated heads in Section 14 though the non-agricultural element has such linkage. Rule 8(1) says that when income is derived from composite activity such income shall be chargeable to income-tax as "business income". In other words, in the case of composite income, by legal fiction, chargeability is assigned only to non-agricultural part of the composite income which has linkage with one of the enumerated heads in Section 14, namely, "business income". Therefore only to that extent, the computation provisions, mentioned in Section 15 to Section 59 of the I.T. Act, stand attracted. Therefore, Rule 8(1) makes it clear that chargeability and computability shall be confined to 40% of such income which shall be *deemed to be income liable to tax*. We have to confine the legal fiction in Rule 8(1) to that rule alone. We cannot extend the legal fiction in Rule 8(1) to Section 80HHC(3)(a). As stated above, there is a vital difference between income not chargeable to tax and not includible in the total income (for example, agricultural income) and income which forms part of total income but which is made tax-free. Deductions under Chapter VIA fall in the category of tax-free incomes. In fact, history shows that some of the incomes in Chapter VIA have been transferred from Chapter VII to Chapter VIA. Chapter VII has been deleted. However, at the relevant time Chapter VII referred to incomes forming part of total income on which no tax was payable. That is why, we have stated that there is a difference between "exempted incomes" and "tax-free incomes". This distinction is of some importance. As stated above, Section 5 provides what the "total income" *shall include.* Chapter III refers to "incomes which do not form part of total income". Chapter IV deals with "computation of total income". It classifies the "income" under different heads and the deductions to be made in respect of each of the different heads of income. In the Income-tax Act, the expression "income includible in the total income" has a definite connotation. Similarly, the expression "deduction and allowances" have particular connotation. Therefore, on one hand we have "agricultural income" which is neither chargeable nor includible in the total income and on the other hand we have "incomes" under Chapter VIA which are part of total income but which are tax-free.

40. In this case, however, we are concerned with composite income

A which is partly agricultural and partly business. Therefore, Rule 8(1) segregates agricultural income which is exempted income from business income which is chargeable to tax. For that purpose we need to apply the ratio of 60 : 40. Therefore, to the extent of 40% only we have chargeability and computability. If this distinction is kept in mind we are
B of the view that the assessee cannot claim 80HHC(3)(a) Deduction against the entire tea composite income. It can be claimed only against proportionate income. Therefore, in the above example, 80HHC Deduction can be claimed not against the entire composite income of Rs.50 lacs but it can be claimed only against a part thereof which is Rs.20
C lacs. Similarly, in the other example, 80HHC Deduction can be claimed not against composite income of Rs.16.05 crores, it can be claimed only against the composite income of Rs.6.42 crores. For the above reasons, we are of the view that Section 80HHC Deduction cannot be allowed against the entire tea income.

D *Is Section 80HHC a part of the provisions of the 1961 Act which deals with computation under the head "Profits and Gains from Business"?*

41. The contention of the assessees cannot be accepted for one more
E reason. The tea income consists of two parts : (i) "agricultural income" upto the stage of growing the tea; and (ii) "business income" from the manufacture and sale of tea grown by the assessee. Under the Constitution, "agricultural income" can be taxed only by the State Governments. Rule 8(1), therefore, provides that only 40% of the composite income can be
F taxed under the 1961 Act. Power of the State Governments to levy tax extends to the balance, namely, 60% of the composite income. This part of the composite income (60%) cannot be taxed under the 1961 Act (See: Section 10(1) of the 1961 Act). As stated above, Rule 8(1) provides for the method in which composite income is to be computed. Rule 8(1) says
G that income shall be computed *as if* it were income derived from business. Rule 8(1) uses the word "income" and not "total income". The 1961 Act contains provisions for computation of income under the head "Business". *The question is whether Section 80HHC is part of the provisions in the 1961 Act which deals with computation of income under the head*
H *"profits and gains from business"?* If it is, then apportionment prescribed

by Rule 8(1) can be applied only after deducting the allowance under Section 80HHC from the composite income as contended by the assessees. However, in our view computation in Rule 8(1) in respect of composite income, by reason of legal fiction in-built in Rule 8, *cannot be read in entirety into computation of income under the head "Business"*. If the contention of the assessees is accepted, namely, that the entire computation of composite income under Rule 8(1) is part of computation provisions under the head "Business" then it would amount to granting deduction under Section 80HHC even with reference to income which is exempt under Section 10(1) of the 1961 Act, namely, agricultural income. Such a result would be opposed to the basic scheme of the 1961 Act. In this connection, it is also important to note that under Section 80A which falls in Chapter VIA, deductions are allowed only from "gross total income". The object for making such provision is to limit the amount of 80HHC Deduction. It is true that Section 80HHC provides for deduction of a percentage of the export profits. The percentage is calculated with reference to the export profits, but the deduction is only from "gross total income" as defined under Section 80B(5) of the 1961 Act. Therefore, the very scheme of 1961 Act is to treat the deductions under Chapter VIA as deductions only from "gross total income" in order to arrive at the "total income". In other cases falling under Section 28 where computation of income falls under the head "Business", allowances are deductible from the income but not from "gross total income". *It is, therefore, not possible to accept the contention that Section 80HHC is part of the provisions for computation of business income.* Section 80HHC does not have any direct impact on the computation of business income in the manner in which, for example, Section 72 affects the computation of business income. On behalf of the assessees heavy reliance was placed on the judgment of this Court in the case of *Cambay Electric Supply Industrial Company Ltd.* (supra). That was a case where this Court held that Section 72 provides for the business loss, not set-off fully against the other heads of income under Section 71, to be carried forward and adjusted against the profits of the same business in the next year. Inter-head and intra-head adjustments and carry-forwards are part of the computation provisions. However, Section 72 cannot be compared with Section 80HHC because Section 80HHC provides for deduction only

A from "gross total income". Therefore, the judgment of this Court in *Cambay Electric Supply Industrial Company Ltd.* (supra) has no application.

42. Reliance was also placed by the assessees on the judgment of this Court in the case of *The Karim Tharuvi Tea Estates Ltd., Kottayam and Anr.* v. *State of Kerala and Ors.*, (1963) 48 ITR 83 SC. In that decision this Court referred to the provisions of Section 10 of I.T. Act, 1922 and to the deduction available thereunder as being deductible while computing the composite income. It was not concerned with Section 80HHC Deduction. Therefore, that judgment has no application to the present case.

43. Even in the case of *Tata Tea Ltd.* v. *State of West Bengal,* (1988) 173 ITR 18 SC, there is no reference to the deductions under Chapter VIA.

44. *In short, deductions under Chapter VIA are deductions not from a particular head of income but from gross total income.* Therefore, Section 80HHC is not part of the computation of income under the head "Business".

45. For the aforestated reasons, we hold that 80HHC Deduction of the 1961 Act is required to be allowed *after* apportionment of income under Rule 8(1) of the 1962 Rule.

46. For the aforestated reasons, we set aside the impugned judgments of the Guahati High Court in Civil Appeal Nos. 3803-3808 of 2005, Civil Appeal No.1021 of 2006, Civil Appeal No.1825 of 2007, Civil Appeal No. 1827 of 2007 and Civil Appeal No.....of 2007 arising out of S.L.P.(C) No.2275 of 2007 and affirm the impugned judgment of the Calcutta High Court in Civil Appeal Nos.6719-20 of 2004 *Warren Tea Ltd. & Anr. etc.* v. *Union of India & Ors. etc.,* Accordingly, the above issue is answered in favour of the Department and against the assessees. Civil appeals are, accordingly, disposed of with no order as to costs.

D.G. Appeals disposed of.