WIRC of ICAI
Seminar on Direct Taxes

Recent Landmark Judgements

CA Ravikant Kamath

February 13, 2010

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CIT vs. Sri Mangayarkarasi Mills (P) Ltd. (315 ITR 114)(SC)

- **Issue :** Whether expenditure incurred on replacement of machinery in a textile mill is deductible as revenue expenditure?
- Expenditure capitalized in books but claimed fully deductible in tax.
- **Tax Department's contentions**
  - Each item of machinery in textile mill is independent. Every replacement results in new asset.
  - Replacement results in enduring benefit: Not in the nature of current repairs u/s 31. Reliance placed on Ballimal Navalkishore (224 ITR 414) (SC)
  - Concept of 'assets', 'block of asset', 'depreciation' will become redundant if every replacement is allowed as deduction.
  - Not comparable to replacement of tube lights (CBDT Cir No. 69 dated 27.11.1957).

CIT vs. Sri Mangayarkarasi Mills (P) Ltd. (315 ITR 114)(SC)

Cont….

- **Assessee's contentions**
  - Replaced machinery cannot function independently.
  - Expenditure is of revenue nature.
  - Enduring benefit is not in capital field.
- **SC upheld disallowance and held** :
  - Each machinery in a textile mill though functioning in an integrated manner nevertheless has independent identity and function
  - Each machinery should be treated separately.
  - Repairs would be current only if part of a machinery is replaced and not the entire machinery.
  - Replacement of machinery brings in enduring benefit.
  - Though accounting practices are not best guide, they are indicative of assessee's own perception.

Rotork Controls India (P) Ltd. vs. CIT (314 ITR 62) (SC)

- **Issue :** Whether provision for warranty liability is deductible expenditure?
- Provision made at percentage of sales turnover.
- **Tax Department's contentions**
  - Contingent and notional liability.
  - Deduction permissible for actual expenditure only.
  - Accounting treatment is not relevant.
- **Assessee's contentions**
  - Supported by commercial accounting principles
  - Based on empirical statistical data.
  - Regularity of incurrence.
  - Method of accounting cannot be rejected without adequate justification.

Rotork Controls India (P) Ltd. vs. CIT (314 ITR 62) (SC)

Cont….

- **SC ruling**
  - AS – 29 principles upheld for deductibility of warranty provision.
    - Existence of present obligation
    - Probability of outflow of resources to settle obligation
    - Reliable estimate possible
  - Nature of business, sales, product, past experience, etc need to be considered
  - Warranty covenant is integral to sale of product.
  - Emphasis placed on matching concept and accrual method.
  - Estimate needs to be supported by robust working and historical trend.
  - Deduction allowable on fulfillment of above conditions.

CIT vs. Kelvinator of India Ltd [2010-TIOL-06-SC-IT-LB]

- **Issue** : Whether reassessment can be initiated on ‘change of opinion’ of Assessing Officer?
- **Tax Department’s contentions**
  - Post amendment w.e.f 1.4.1989, s.147 permits reassessment on change of opinion of A.O. on the basis of information available on record
- **SC Ruling**
  - A.O. does not have power to ‘review’ his own order.
  - S.147 permits reassessment where there is ‘reason to believe’.
  - Permitting reassessment based on change of opinion would amount to permitting review of order conferring arbitrary powers on assessing authorities. Hence, reassessment cannot be based on change of opinion.
  - Proposal to introduce reassessment based on ‘opinion’ of A.O. on income escaping assessment dropped in response to representations [CBDT Circular No. 549 dated 31.10.1989]
  - Reassessment should be based on ‘tangible material’ about escapement of income and reasons must have ‘live link’ with formation of belief.

CIT vs. Oracle Software India Ltd [2010-TIOL-04-SC-IT] and CIT vs. Emptee Poly-Yarn Pvt. Ltd [2010-TIOL-07-SC-IT]

- **Issue :** Whether following processes amount to ‘manufacture’ in context of eligibility for deductions u/s. 80I/80IA?
  - Copying of Master Disc on blank CD (Oracle’s case)
  - Twisting and texturising of POY (Emptee’s case)
- **Tax Department’s contentions**
  - **Oracle’s case** : No difference between Master Disc and recorded CD. Mere copying contents of Master Disc into a blank disc is not ‘manufacture’.
  - **Emptee’s case** : No change in character and use. Reliance placed on earlier SC decision in case of CCE vs. Swastik Rayon Processors (209 ELT 163) [twisting of cellulosic filament yarn with blended yarn comprising of polyster and viscose does not amount to manufacture]
- **SC Ruling**
  - Test applied in both cases : “If an operation/process renders a commodity or article fit for use for which it is otherwise not fit, the operation/process falls within the meaning of the word ‘manufacture’”

CIT vs. Oracle Software India Ltd [2010-TIOL-04-SC-IT] and CIT vs. Emptee Poly-Yarn Pvt. Ltd [2010-TIOL-07-SC-IT] *Cont….*

- **Oracle's case**
  - Duplication of CD done at home cannot be compared to commercial duplication. Actual process undertaken should be seen. Technological advancement in computer science should also be considered.
  - Reliance placed on earlier SC decisions in TCS vs. State of AP (137 STC 620) and Gramophone Co. of India vs. CCE (114 ELT 770)
- **Emptee's case**
  - POY simplicitor is not fit for use in manufacture of fabric.
  - Thermomechanical process used for conversion of POY into texturised yarn. [Mumbai University's opinion relied upon by assessee]
  - SC however expressed caveat that decision restricted to facts of present case. Twisting and texturising *per se* in every case is not manufacture.

CIT vs. Hero Cycles Ltd (2009-TIOL-604-HC-P&H-IT)

- **Issue :** Whether s. 14A can be applied where non-user of interest bearing funds is factually established?
- Investment made in shares and mutual funds from interest free funds (viz. Sale of investment).
- **Tax Department's contentions:**
  - Since assessee had borrowing. s 14A disallowance is imminent.
  - Reliance placed on CIT vs. Abhishek Industries Ltd (286 ITR 1) (P&H)
- ITAT recorded factual finding of non-user of borrowed funds and deleted disallowance.
- HC upheld ITAT decision
- Key observation of HC:-

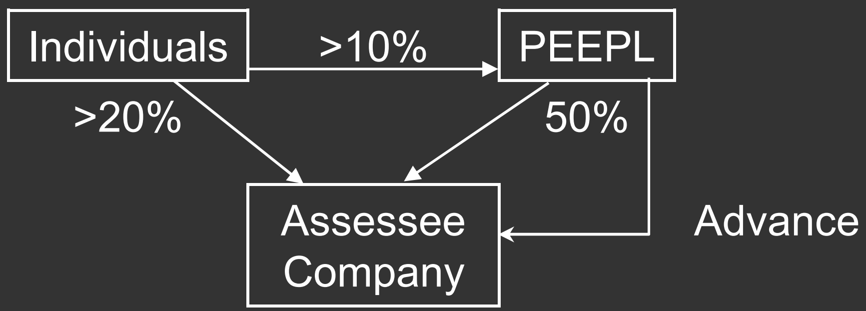
  "The contention of the revenue that directly or indirectly some expenditure is always incurred which must be disallowed under Section 14A and the impact of expenditure so incurred cannot be allowed to be set off against the business income which may nullify the mandate of Section 14A, cannot be accepted. Disallowance under Section 14A requires finding of incurring of expenditure where it is found that for earning exempted income no expenditure has been incurred, disallowance under Section 14A cannot stand."

CIT vs Bonanza Portfolio (320 ITR 178)(Del)

- **Issue** : Whether share brokers are eligible to claim bad debts u/s 36(i)(vii) on write off of irrecoverable amounts from clients for purchase of shares?
- **Tax Department's contentions**
  - Shares purchased are investments of assessee
  - Amount written off have not been considered as income of assessee in the past
- **Assessee's contentions**
  - Purchase of shares on behalf of client is not investment.
  - Brokerage was credited to P&L. Section 36(2) requires 'debt or part of debt' to be taken into account. Brokerage is part of debt.
- **HC Ruling**
  - Purchase of shares on behalf of client is not investment of assessee
  - Brokerage receivable was part of debt due from client, hence condition stipulated under section 36 (2) fulfilled.
  - Assessee entitled to claim bad debts with respect to full amount receivable from clients.

CIT vs. Creative Dyeing and Printing Pvt. Ltd (318 ITR 476) (Del)

- **Issue** : Whether business or commercial transactions are covered within scope of deemed dividend u/s 2 (22) (e)?
- **Facts**



  - Assessee Company was ancillary unit of PEEPL
  - PEEPL with intent to increase its own export business recommended modernization and expansion of assessee's plant.
  - PEEPL offered to part finance 50% of expansion cost and advanced INR 36.01 M to assessee to be adjusted against future supplies.
- **Tax Department's contentions**
  - Sum advanced to assessee is in the nature of 'advance' or 'loan'.
  - Covered within scope of S. 2 (22)(e) on strict literal interpretation.
  - Commercial purpose of advance is not a relevant factor.

CIT vs. Creative Dyeing and Printing Pvt. Ltd (318 ITR 476) (Del)

Cont….

- **Assessee’s contentions**
  - Deemed dividend provisions are intended to prevent tax avoidance.
  - Genuine commercial transactions not intended to be covered.
- **HC Ruling**
  - Given intent of preventing tax-avoidance, s. 2(22)(e) applies to ‘loan’ or ‘advance’ simplicitor without any commercial purpose.
  - Exception for banking and money lending businesses are merely illustrative.
  - Reliance placed on CIT v. Nagindas Kapadia (177 ITR 393) (Bom) : business transactions are outside purview of deemed dividend.
  - PEEPL advanced money for its own business interest not for assessee’s benefit.
  - On principle of ***‘noscitur a sociis***’ advance in the nature of ‘loan’ alone covered by 2(22) (e).
  - Deemed dividend not attracted in present case.

CIT vs. Techno Shares & Stocks Ltd. (184 Taxman 103)(Bom)

- **Issue:** Whether BSE membership card entitled for depreciation as an 'intangible asset' post amendment w.e.f. 1.4.1998?
- **Assessee's contentions**
  - Post amendment to s. 2(11) defining 'block of assets' w.e.f. A.Y. 1999-2000. BSE membership card qualifies for depreciation as 'intangible asset' being a 'licence'.
  - 'License' is very wide in scope- Includes all licenses except those which are personal in nature (e.g driving license).
  - Common parlance meaning should be adopted in absence of statutory definition of 'license'.
  - Alternatively, it is business or commercial right
  - BSE Card is a capital asset transfer whereof is chargeable to capital gains.
- **Tax Department's contentions**
  - BSE card is not subject to wear and tear.
  - It is a personal privilege – not in the nature of license or business or commercial right.

CIT vs. Techno Shares & Stocks Ltd. (184 Taxman 103)(Bom)

Cont….

- **HC Ruling**
  - Though ‘license’ is very wide in scope, it has restricted meaning u/s 2(11) being enumerated amidst other items which are in nature of IPR. (i.e. know-how, patents, copyrights, etc.)
  - Hence license should be relatable to IPR to qualify as ‘intangible asset’ u/s 2 (11)
  - On parity, even business or commercial right should also relate to IPR.
  - SC ruling in Scientific Engineering’s case (157 ITR 86) not applicable in view of specific statutory amendment to cover Intangible assets.
  - BSE card is not eligible for depreciation.

CIT vs. Industrial Finance Corporation of India [2010-TIOL-42-HC-DEL]

- **Issue :** Whether difference between forward rate and exchange rate prevailing on date of entering into forward contracts is fully allowable as deduction though amortised in books over life of the forward contracts?
- **Facts**
  - Assessee engaged in business of making loans and advances to various industrial concerns.
  - Foreign currency borrowings raised for meeting lending requirements
  - Forward contracts entered to safeguard against foreign exchange fluctuation.
  - Loss of INR 817 M on difference between forward rate and exchange rate prevailing on date of entering into contracts amortized in books over life of forward contracts in terms of relevant Accounting Standard (AS-11).
  - But for tax purposes, deduction claimed for full amount of INR 817 M.

CIT vs. Industrial Finance Corporation of India [2010-TIOL-42-HC-DEL]

Cont….

- **Tax Department's contentions**
  - Assessee follows mercantile system of accounting.
  - Upfront payment of INR 817 M needs to be spread over period of benefit.
  - Reliance placed on Madras Industrial Invt Corpn Ltd vs. CIT (225 ITR 802)(SC) and Taparia Tools Ltd vs. JCIT(260 ITR 102)(Bom) in context of upfront discount on issue of debentures.
- **Assessee's contentions**
  - Loss of INR 817 M crystallized in entirety during year under reference though forward contracts settled in future.
  - Reliance placed on Calcutta Co. Ltd vs. CIT (37 ITR 1)(SC) and Bharat Earth Movers vs. CIT (245 ITR 428)(SC) – deduction for business liability definitely arisen in the accounting year allowable in entirety though actual quantification and discharge may be at future date.

CIT vs. Industrial Finance Corporation of India [2010-TIOL-42-HC-DEL]

Cont….

- **HC Ruling**
  - Loss of INR 817 M fully allowable in year of entering into forward contracts.
  - Forward contracts represent legally binding, enforceable contracts for purchase of foreign currency at future date at pre-determined rates.
  - Difference between forward rate and prevailing exchange rate represents definite and ascertained liability. Fully allowable in terms of ratio of Calcutta Co. Ltd (supra) and Bharat Earth Movers (supra).
  - Cases of Madras Industrial Invt. Corpn Ltd (supra) and Taparia Tools Ltd (supra) are distinguishable. Money secured by issue of debentures issued at discount is used over number of years and continuing benefit is secured over the entire period of debentures.
  - Ordinarily, revenue expenditure incurred in particular year should be allowed in entirety unless assessee himself claims spread over for tax purposes and claim is in consonance with matching principles.

CIT vs. Bharat Aluminium Co. Ltd [2009-TIOL-619-HC-DEL-IT]

- **Issue :** Whether user of each individual asset post inclusion in block of asset essential for depreciation allowance?
- **Facts**
  - Certain items of plant & machinery forming part of block of assets (on which depreciation was allowed in earlier years) not used during year under reference
- **Tax Department's contentions**
  - Ownership and user of assets are primary conditions for depreciation allowance in every year.
  - Proviso for restricting deprecation to 50% where user < 180 days supports necessity of user of asset in every year
- **Assessee's contentions**
  - Block of asset concept introduced to simplify depreciation computation and dispense with individual asset calculations.
  - Asset entering block loses its identity and merges with the pool of assets in the same block.
  - Reliance placed on several favourable ITAT decisions.

CIT vs. Bharat Aluminium Co. Ltd [2009-TIOL-619-HC-DEL-IT]

Cont….

- **HC Ruling**
  - Rationale and purpose of block concept to simplify depreciation computation as explained by CBDT needs to be given due cognizance.
  - Test of user to be applied to entire block and not to individual asset
  - Proviso restricting depreciation to 50% applicable only for first year in which asset is acquired
  - Depreciation admissible on entire block regardless of non-user of some of assets within the block.

CIT vs. Kohli Brothers Color Lab (P) Ltd [2009-TIOL-662-HC-ALL-IT]

- **Issue:** Whether amendment of s.36(1)(vii) w.e.f 1.4.1989 precludes A.O. from verifying the write off of bad debts?
- **Facts**
  - Debit to P&L A/c under the caption ‘Amounts written off’
- **Tax Department’s contentions**
  - No details furnished by assessee despite specific requisition by A.O.
  - Amendment permitting allowance of bad debt in year of write off does not preclude A.O. from questioning veracity/genuineness of write off.
- **Assessee’s contentions**
  - Post amendment, no onus on assessee to prove debts written off are bad.
- **HC Ruling**
  - Effect of amendment is that assessee need not establish debt had become bad; mere write off is sufficient
  - Though assessee need not provide demonstrative and infallible proof of debt having turned bad and commercial wisdom of write off cannot be questioned, A.O. fully empowered u/s. 143(2) to verify whether write off is genuine.
  - Amendment does not preclude inquiry by A.O. to find out whether there is ‘semblance of genuineness’ in the write off entry.

CIT vs. AIMIL Ltd [ITA No. 1063 /2008] (Delhi-HC)

- **Issue** : Whether employees contribution to PF paid beyond statutory due date but before due date of filing return is allowable as deduction ? (A.Y 2002-03)
- **Tax Department's contentions**
  - Second proviso to section 43B (omitted w.e.f 1.4.2004) r.w.s 36(1)(va) requires contribution to be paid before statutory due date.
  - Distinction between employees' contribution and employer's contribution. Former is received from employees and hence stricter test applies.
- **HC Ruling**
  - Reliance placed on dismissal of Department's SLP (213 CTR 268) against Gauhati HC decision in George Williamson's case (284 ITR 619)
  - Reliance also placed on earlier Delhi HC decisions where omission of second proviso to section 43B was held to be clarificatory and retrospective*.
  - PF and ESI statutes permit delayed payment with penalty. I.T Act permits deduction if paid by due date of filing return.

* *Now affirmed by SC in CIT vs. Alom Extrusions Ltd (32 DTR 49)*

DCIT vs Manjula Shah (ITA No. 7315/Mum/2007)

- **Issue :** Whether benefit of indexation in case of gifted asset is available from date of acquisition by assessee or previous owner?
- **Facts**
  - Sale of flat received as gift from daughter in 2002-03
  - Daughter had acquired in 1992-93
  - Which CII to be applied : 2002-03 or 1992-93?
- **Tax Department’s contentions**
  - Explanation (iii) to s. 48 refers to the first year in which the capital asset was held by the assessee.
  - Inclusion of holding period of previous owner u/s 2(42A) is only for determining whether asset is short term or long term.
  - CII of 2002-03 to be applied.

DCIT vs Manjula Shah (ITA No. 7315/Mum/2007)

Cont….

- **Special Bench Ruling**
  - Transfer of capital asset by way of gift is exempt u/s 47 (iii).
  - Subsequent transfer of gifted asset attracts capital gains tax in successor's hands. Hence scheme is to shift capital gains incidence from predecessor to successor.
  - Indexation benefit intended to grant relief from inflationary effect (CBDT Circular No 636 dated 31 August 1992).
  - Literal interpretation will result in denial of benefit of indexation for holding period of previous owner.
  - Purposive construction should be adopted where literal interpretation leads to absurdity.
  - CII of 1992-93 should be applied.

Shree Capital Services Ltd vs. ACIT (124 TTJ 740)(Kol)(SB)

- **Issue :** Whether derivative transactions in shares prior to amendment w.e.f. A.Y. 2006-07 to S. 43(5) were speculative transactions?
- **Assessee’s contentions**
  - ‘Actual delivery’ of derivatives is not possible.
  - S. 43(5) contemplates possibility of delivery.
  - Derivatives are not ‘commodity’, ‘stock’ or ‘shares’.
  - Amendment excluding derivative from scope of speculative transactions is clarificatory in nature and was intended to supply an ‘obvious omission’.

Shree Capital Services Ltd vs. ACIT (124 TTJ 740)(Kol)(SB)

Cont….

- **Tax Department's contentions**
  - Derivatives derive value from underlying items which are 'commodity', 'stocks' or 'shares'.
  - 'Commodities' is wide in scope. Film telecast rights is also regarded as 'goods'. [CIT vs. B. Suresh [313 ITR 149(SC)]
  - Amendment is prospective in nature.
- **SB ruling**
  - Derivatives in present case derive value from 'shares'.
  - Ratio of B. Suresh's case is applicable to derivatives.
  - Inclusion of 'shares' and 'stocks' alongwith 'commodity' reflects legislative intent to give wider meaning.
  - Any other interpretation will render amendment redundant
  - Amendment made recognizing systemic and technological advances. Not clarificatory in nature. Exclusion is restricted to 'eligible' derivatives only.
  - By implication, derivatives were covered within scope of speculative transactions prior to amendment.

Scientific Atlanta India Technology Pvt. Ltd vs. ACIT [2010-TIOL-69-ITAT-MAD-SB)

- **Issue:** Whether losses of non-eligible unit needs to be set off against profits of eligible unit for determining allowable deduction u/s. 10A of the Act?
- **Comparative contentions**

	Assessee	Tax Department
Profits of eligible undertaking Less: Loss of non-eligible unit	100 -	100 40
 Less : Deduction u/s. 10A	100 100	60 60
Total Income	NIL	NIL
Loss of non-eligible unit available for set off / carry forward	40	-

Scientific Atlanta India Technology Pvt. Ltd vs. ACIT [2010-TIOL-69-ITAT-MAD-SB)

Cont….

- **Assessee's contentions**
  - Deduction u/s. 10A is attached to undertaking. Hence deduction needs to be computed on stand alone basis as if eligible undertaking is separate island unconnected to assessees business.
  - Even after amendment w.e.f A.Y 2001-02, section 10A continues to operate as 'exemption' section. Profits to be excluded at threshold and do not enter computation of total income.
  - Provisions comparable to section 80AB / 80B absent in Chapter III.
  - Return form also supports this view.
  - Specific provisions exist in other provisions for restricting deduction (e.g. 24(b), 80A(2), 57, etc).
  - Incentive provisions need to be interpreted liberally.
- **Tax Department's contentions**
  - Deduction is from 'total income'.
  - Computation of total income involves set off of losses.
  - Return form cannot override statutory provisions.

Scientific Atlanta India Technology Pvt. Ltd vs. ACIT [2010-TIOL-69-ITAT-MAD-SB)

Cont….

- **Ruling of the SB**
  - Scheme of section 10A is to provide ‘deduction’ and not exclusion from total income.
  - However, deduction is to be granted at the stage of business income computation and not while computing Gross Total income.
  - Section 80AB applies only to Chapter VI A and does not apply to section 10A.
  - Deduction u/s. 10A is qua the eligible undertaking.
  - Losses of non-eligible units cannot be set off against profits of eligible undertaking.
  - SB clarified that this decision does not apply to case of multiple eligible undertaking some of which may have losses.

Thank You !!!

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