DIRECT TAXES CASE STUDY

FOR

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- **S.32 : BSE Membership Card is an Intangible Asset & Eligible for Depreciation : Techno Shares & Stocks Ltd (SC)**

BSE Card is an "intangible asset" and eligible for depreciation u/s 32(1) (ii). Techno Shares & Stocks Ltd (2010) 323 ITR 69 (Bom) reversed. (August 2010)

- S. 10A deduction allowable without set off of losses of non-eligible units. { Scientific Atlanta vs. ACIT (ITAT Chennai Special Bench) }

In respect of AY 2003-04, the assessee had an unit in Chennai which was engaged in software development and whose profits were eligible for deduction u/s 10A. The assessee had another unit in Delhi which was engaged in trading and had suffered a loss. The assessee claimed that it was eligible for **a deduction u/s 10A on the whole of the profits of the Chennai unit without it being reduced by the losses of the Delhi unit**. The AO and CIT (A) rejected the claim on the ground that after the amendment of s. 10A w.e.f. 1.4.2001, a deduction is allowed from the "total income" and consequently the losses have to be taken into account. On a reference to the Special Bench, HELD deciding in favour of the assessee.

S. 10A allows a deduction of the "profits and gains derived by the undertaking from the export of computer software" "from the total income of the assessee". **The effect is that the deduction has to be made at the stage of computing the income under head "Profits & gains" and not at the stage of computing the gross total income**. S. 10A grants a deduction to the "profits of the undertaking" and not to the "profits of the assessee". There is a well known distinction between the "undertaking" and the "assessee" as also noted by the CBDT in Circular F. No. 15/563 dated 13.12.1963. **The deduction u/s 10A attaches to the undertaking and not to the assessee**. Consequently, **the losses of a non-eligible unit cannot be set off against the profits of an eligible unit and are eligible to be set-off against other income or to be carried forward**. The position of a losses of an eligible unit may be on a different footing.

- S. 10(23C)(v) benefit cannot be denied merely because there are profits. In computing the profits, capital expenditure has to be deducted.{ Pinegrove International Charitable Trust vs. UOI (P & H High Court) }

S. 10(23C)(vi) provides that the income of any university or other educational institution existing solely for educational purposes and **not for purposes of profit** shall be exempt. The assessee was running a school solely for educational purposes and claimed exemption u/s 10 (23C) (vi). The exemption was denied /withdrawn on the ground that as the assessee had earned **substantial profits** year after year and **had not made efforts to lower its fees**, the profits were not incidental and the assessee existed for profits. On a writ petition filed by the assessee, HELD allowing the appeal of the assessee:

To decide whether an institution exists solely for education and not to earn profit **the predominant object of the activity** has to be seen. The mere fact that an educational institution generates surplus after meeting the expenditure over a period of time does not mean that it ceases to exist 'solely' for educational. The test to be applied is whether the predominant object of the activity is to sub-serve the educational purpose or to earn profit. It should be seen whether profit-making is the predominant object of the activity or whether profit is incidental to the carrying of the activity. **There is no requirement that the activity must be carried on in such a manner that it does not result in any profit. It would indeed be difficult for persons in charge of a trust or institution to so carry on the activity that the expenditure balances the income and there is no resulting profit. That would not only be difficult of practical realization but would also reflect unsound principle of management**.

In computing the total income, **capital expenditure incurred for the attainment of the objects of the society has to be deducted** under the third proviso to s. 10(23C). There is no bar to doing so unlike the provisions of ss. 37 and 36 (1)(xii). This is also supported by clause 11 of Form 56D which has to be filed as per Rule 2CA and the case law on s. 11 which provide that capital expenditure constitutes "application of income". On facts, as the society's application of income (after considering the capital expenditure) was more than 100%, it could by no stretch of imagination be held to be an educational institution existing for the purposes of making profit so as to be not entitled to exemption in view of the provisions of s. 10(23C) (vi).

- S. 14A disallowance can be made with regard to partner's share of profits. { Dharmasingh Popat vs. ACIT (ITAT Mumbai) }

The assessee, a partner in a firm, received 'share of profit' and 'salary' from the firm. While the 'share of profit' was exempt u/s 10(2A), the 'salary' was taxable as business income u/s 28 (v). The assessee claimed deduction for business expenditure incurred by him. The AO held that as the assessee had exempt income, s. 14A applied and a part of the expenditure had to be disallowed. This was confirmed by the CIT (A). Before the Tribunal, the assessee argued that as a partnership firm was merely a compendium of partners having no independent legal personality, **the share of profit was not an exempt income in the hands of partner** as the firm had paid tax thereon. HELD decided against the assessee.

Though in general law, a firm and its partners are not distinct, this is subject to statutory exceptions. Under the scheme of assessment of firms applicable from AY. 1993-94 a firm is treated as an independent entity and the expenditure by way of remuneration, interest, commission etc. paid to partners is allowable to it as a deduction subject to ceilings and such interest, salary etc is taxable in the hands of the partners. **A firm and its partners are consequently separate entities under the Act**. Accordingly, **the fact that the profits are charged to tax in the hands of the firm does not mean that the share of such profits is non – exempt in the hands of the partner. The profits being exempt in the hands of the partner, s. 14-A does apply in computing his total income**.

- Even under Rule 8D of S. 14A, disallowance can be made only if there is actual nexus between tax-free income and expenditure.{ CIT vs. Hero Cycles (P & H High Court) } **(Important)**

The assessee earned dividend income on shares which was exempt from tax. The AO took the view that the investment in shares was made out of borrowed funds on which interest expenditure was incurred and consequently made a disallowance u/s 14A. This was partly upheld by the CIT (A). On further appeal by the assessee, the Tribunal deleted the disallowance by noting that **the assessee had proved that the investment in shares was made out of non-interest bearing funds. It held that unless there was evidence to show that the interest – bearing funds had been invested in the tax – free investments and the nexus was established by the Revenue, s. 14A could not be applied on mere presumption**. The Revenue appealed to the High Court and claimed that in view of **s. 14A (2) and Rule 8D (1) (b), a disallowance could be made even if the assessee claimed that no expenditure had been incurred in respect of the tax – free income**. HELD, dismissing the appeal of the department by stating that

" If the investment in the shares is out of the non-interest bearing funds, disallowance u/s 14A is not sustainable. The contention of the revenue that directly or indirectly some expenditure is always incurred which must be disallowed u/s 14A cannot be accepted. ***Disallowance u/s 14A requires a finding of incurring of expenditure. If it is found that for earning exempted income no expenditure has been incurred, disallowance u/s 14A cannot stand****. The contention of the revenue even if the assessee has made investments in shares out of its own funds, the said own funds are merged with the borrowed funds in a common kitty and, therefore, disallowance u/s 14A can be made is also not justified "*

❖ Non-owner can be "owner" under the Act. {Pallonji Mistry vs. CIT (Bombay High Court)}

Though it is the settled position under the common law that the term "owner" means a person who has valid title legally conveyed to him after complying with the requirements of law such as Transfer of Property Act, Registration Act, etc, a different view has to be taken in the context of S. 22 of the Act having regard to the ground realities and the object of the Act, namely, "to tax the income". **Accordingly, the term "owner" means a person who is entitled to receive income from the property in his own right.**" There is no requirement that there has to be a registered Deed of conveyance for a person to be treated as an owner for purposes of S. 22.

❖ Under "block of assets" even a closed unit is eligible for depreciation.{ Swati Synthetics vs. ITO (ITAT Mumbai) }

The assessee had two divisions, one at Dombivili and the other at Surat. **The division at Surat was closed since two/three years**. The assessee claimed depreciation on the assets of the said Surat division which was rejected by the AO and the CIT (A) on the ground that the assets were not "used" and depreciation could not be allowed. On appeal by the assessee, HELD allowing the appeal of the assessee.

The concept of allowing depreciation on block of assets was introduced w.e.f. 01.04.1988 with the object of avoiding separate book keeping. **A harmonious reading of the expression 'used for the purposes of the business', would show that it only means that the assessee has used the machinery for the purposes of the business in earlier years**. The doubt as to how deprecation can be allowed on assets which are not used for the purpose of business is answered by the legislative scheme that though the profit of that year is reduced, the WDV is reduced and the gain is taxed u/s 50 when the asset is sold and block ceases to exist;

The "use" of an individual asset can be examined only in the first year when the asset is purchased. In subsequent years the use of block of assets is to be examined. The existence of an individual asset in block of asset itself amounts to use for the purpose of business. This is supported by the proviso to s. 32 which provides half depreciation for assets acquired in the year and held for less than 180 days. Once an asset is included in the block of assets it remains there and can only be removed when it is sold, discarded etc u/s 43(6)(c)(i)(B) or used for non-business purposes u/s 38 (2) or where the entire block ceases to exist.

- Under "block of assets", use of individual assets is not required.{ CIT vs. Bharat Aluminium (Delhi High Court) }

The assessee purchased machinery which was **not** put to use during the year though it formed a part of the "block of assets". On the question whether depreciation on the said machinery was allowable, the Tribunal held that once a particular asset falls within the block, it is added to the WDV and depreciation is to be allowed on the block. The individual asset loses its identity and the question whether an individual asset is put to use in a particular year or not is irrelevant inasmuch as the requirement of law is to establish the use of the block of assets and not the use of particular equipment. On appeal by the Revenue, HELD affirming the Tribunal's order and dismissed the departmental appeal.

The rationale and purpose for which the concept of block asset was introduced, as reflected in the CBDT's Circular dated 23.09.1988 is that **once the various assets are clubbed together and become 'block asset' within the meaning of s. 2(11), it becomes one asset**. Every time, a new asset is acquired, it is to be thrown into the common hotchpotch, i.e., block asset on meeting the requirement of depreciation being allowable at the same rate. **Individual assets lose their identity and become an inseparable part of block asset insofar as calculation of depreciation is concerned**;

- Depreciation allowable even if asset not used at all for entire year. { CIT vs. G. R. Shipping (Bombay High Court) }

The assessee, engaged in shipping business, owned a barge which was included in the block of assets. The barge met with an accident and sank on 6.3.2000 (AY 2000-01). As efforts to retrieve the barge were uneconomical, the barge was sold on as-is-where-is in May 2001 (AY 2002-03). **As the barge was non-operational and not used for business at all in AY 2001-02, the AO denied depreciation**. The CIT (A) upheld the stand of the AO. On appeal by the assessee, the Tribunal took the view that after the insertion of the concept of "block of assets" by the T. L. (A) Act, 1988 w.e.f 1.4.1988 **individual assets had lost their identity and only the "block of assets" had to be considered**. It was held that **the test of "user" had to be applied upon the block of assets as a whole and not on individual assets**. On appeal by the Revenue, the High Court **dismissed the appeal** holding that the issue was squarely covered in favour of the assessee by its earlier judgements in **Whittle Anderson** 79 ITR 613 and **G. N. Agrawal** 217 ITR 250.

- Depreciation is mandatory for Chapter VI-A deduction. { Plastiblends vs. ACIT (Bombay High Court Full Bench) }

The Assessee had disclaimed the depreciation for the purposes of regular assessment. High Court stated that though the assessee may have an option to disclaim current depreciation in computing total income under Ch. IV does not mean that the quantum of deduction allowable u/s 80 – IA is dependent upon the assessee claiming or not claiming current depreciation**.** Ch. VI-A is a Code by itself and the special deduction granted therein has to be computed on the gross total income determined after deducting all deductions allowable under ss. 30 to 43D and any device adopted to reduce or inflate the profits of eligible business has got to be rejected. **By not claiming current depreciation, the assessee seeks to inflate the profit linked incentives provided u/s 80-IA which is not permissible**.

❖ Stock Exchange card is NOT an intangible asset eligible for depreciation . { CIT vs. Techno Shares & Stocks (Bombay High Court) }

S. 32 (1), allows depreciation on "intangible assets" being, inter alia, "licenses … or any other business or commercial rights of similar nature". The Tribunal took the view that a BSE card was an "intangible asset" eligible for depreciation. On appeal by the Revenue, High court reversing the decision of Tribunal.

Though the term 'licences' is a very wide term and includes permission to carry on any trade, business, profession, etc, it is used in s. 32(1)(ii) in a **restricted sense**. S. 32 restricts depreciation to a class of tangible & intangible assets specifically enumerated therein. All intangible assets enumerated in s. 32(1)(ii) (except the term 'licences') belong to the class of intellectual properties. As the expression 'licences' in s. 32(1)(ii) is preceded by the expressions know-how, patents, copyrights, trade marks and succeeded by the expression 'franchises' which are all relatable to intellectual property rights, **the term 'licences' in s. 32(1)(ii) is, applying the principle of Noscitur a sociis, intended to be used restrictively and as applying only to licences relating to acquisition / user of intellectual property rights**;

A BSE card is also not a "business or commercial right" because what s. 32(1)(ii) contemplates is "business or commercial rights" **relating to intellectual properties** and not all categories of business or commercial rights. Since a BSE card is not a business or commercial right relating to intellectual property rights depreciation cannot be allowed on it;

❖ For s. 36(1)(vii) Bad Debt, write off of individual debtor's a/c is not necessary { Vijaya Bank vs. CIT (Supreme Court) } (Very Important)

The assessee made a provision for bad debts by debiting the P & L A/c and crediting the Provision for Bad debts A/c. Thereafter, the provision account was debited and the loans and advances a/c was credited. The AO denied the claim for bad debts u/s 36(1)(vii) on the ground that **the individual account of the debtor had not been written off**. The CIT (A) and Tribunal allowed the assessee's claim though the High Court reversed it. On appeal by the assessee, HELD reversing the High Court. Pursuant to the Explanation inserted w.r.e.f. 1.4.1989 **a mere provision for bad debt is not entitled to deduction u/s 36(1)(vii)**. However, in the present case, besides debiting the P&L A/c and creating a provision for bad debts, **the assessee had also obliterated the said provision by reducing the corresponding amount from the debtors account** in the Balance Sheet. Consequently, the figure in the loans and advances in the Balance Sheet was shown net of the provision for bad debts.

Apex Court held that the AO's insistence that the individual account of the debtor should be written off was not acceptable because (a) it was based on a mere apprehension that the assessee might claim deduction twice over and it was open to the AO to check whether the assessee was claiming double deduction, (b) if the individual accounts were closed, the Debtor could in the recovery suits rely on the Bank statement and contend that no amount is due and payable to the assessee and (c) the AO was empowered by s. 41(4) to tax the recovery.

- Share broker is eligible to claim "bad debts" u/s 36 (1) (vii) / 36 (2).{ CIT vs. Bonanza Portfolio (Delhi High Court) }

The assessee, a share broker, purchased shares on behalf of its client and paid for them. The brokerage on the said transaction was offered to tax. As the client did not pay for the shares, the assessee wrote off the amount due and claimed the same as a bad debt u/s 36 (1) (vii). The AO rejected the claim on the ground that **as the said "debt" had not "been taken into account in computing the income", the conditions of s. 36 (2) (i) were not satisfied**. This was confirmed by the CIT (A). On appeal, the Tribunal upheld the claim on the ground that **s. 36 (2) (i) required "such debt or part thereof" to be taken into account in computing the income and as the brokerage had been offered to tax, s. 36 (2) (i) was satisfied**. On appeal by the Revenue, HELD dismissing the appeal:

The assessee being a broker, the fact that it paid for the shares did not make it an "investment" for the assessee. The transaction was one of brokerage on purchase / sale on behalf of the client. The money receivable from the client for the said shares was a "debt" and since it became bad, it was rightly treated as a "bad debt". **Since the brokerage payable by the client was a part of the debt and that debt had been taken into account in computing the income, the conditions of s. 36 (2) (i) read with s. 36 (1) (viii) were satisfied and the entire bad debt was allowable as a deduction**.

- Bad debts need not be proven to be irrecoverable u/s 36(1)(vii). It is sufficient if they are written off { TRF Limited vs. CIT (Supreme Court) } (**Very Important**)

The Supreme Court held that the position in law is well-settled that after 1.4.1989, **it is not necessary for the assessee to establish that the debt, in fact, has become irrecoverable. It is enough if the bad debt is written off as irrecoverable in the accounts of the assessee**. When a bad debt occurs, the bad debt account is debited and the customer's account is credited, thus, closing the account of the customer. In the case of companies, the provision is deducted from Sundry Debtors.

- Foreign Exchange fluctuation losses are allowable on accrual basis. { CIT vs. Woodward Governor India p. Limited.(Supreme Court) **Very Important** }.

Assessee had debited to its Profit & Loss Account a sum of Rs. 41 lakh, out of which a sum of Rs.29 lakh was the unrealized loss due to foreign exchange fluctuation on the last date of the accounting year. The Assessing Officer held that the liability as on the last date of the previous year under consideration was a contingent liability, it was not an ascertained liability and consequently it had to be added back to the total income of the assessee. Accordingly, he added back Rs. 29 lakh being the unrealized loss due to foreign exchange fluctuation. In other words, the debit to the P&L account was disallowed.

Supreme Court in his order stated that where the assessee carrying on the mercantile system of accounting then the additional liability arising on account of fluctuation in the rate of exchange in respect of loans taken for revenue purposes was allowable as deduction u/s 37(1) in the year of fluctuation in the rate of exchange and not in the year of repayment of such loans. The actual cost of imported assets acquired in foreign currency is entitled to be adjusted u/s 43A (prior to the amendment by the FA 2002) on account of fluctuation in the rate of exchange at each balance sheet date, pending actual payment of the varied liability.

The term "expenditure" in s. 37 covers an amount which is a "loss" even though the said amount has not gone out from the pocket of the assessee. The "loss" suffered by the assessee on account of the exchange difference as on the date of the balance sheet is an item of expenditure u/s 37(1).Profits and gains are required to be computed in accordance with **commercial principles** and accounting standards (AS-11). Accounts and the accounting method followed by an assessee continuously for a given period of time **needs to be presumed to be correct** till the AO comes to the conclusion for reasons to be given that the system does not reflect true and correct profits. The fact that the department taxed the gains on fluctuation on the basis of accrual while disallowing the loss is important and indicates the **double standards adopted by the Department**;

- Estimated expenditure towards warranty is allowable u/s 37 (1). { Rotork Controls vs. CIT (Supreme Court) **Important**}

The assessee sold valve actuators. At the time of sale, the assessee provided standard warranty that if the product was defective within the stated period, the product would be rectified or replaced free of charge. For relevant assessment year the assessee made a provision for warranty at Rs.10,18,800 at the rate of 1.5% of the turnover. As the actual expenditure was only Rs. 5,18,554, the excess provision of Rs.5,00,246 was reversed and only the net provision was claimed. The Tribunal allowed the claim on the basis that the provision had been consistently made and on a realistic manner. The High Court reversed the Tribunal on the basis that the liability was contingent and not allowable u/s 37 (1). Supreme Court, **reversing** the High Court and stated that :

" A provision is a liability which can be measured only by using a substantial degree of estimation. A provision is recognized when: (a) an enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision can be recognized."

- Advances to sister concerns must be presumed to have come out of own funds and not borrowed funds.{ CIT vs. Reliance Utilities (Bombay High Court) }

Where the assessee had its own funds as well as borrowed funds and it advanced funds to its sister concerns for allegedly non-business purposes and the question arose whether the AO was justified in disallowing the interest on the borrowed funds on the ground that they had been used for non-business purposes.

Hon'ble High Court stated that where an assessee has his own funds as well as borrowed funds, a presumption can be made that the advances for non-business purposes have been made out of the own funds and that the borrowed funds have not been used for this purpose. Accordingly, the disallowance of the interest on the borrowed funds is not justified.

- Expenditure on convertible debentures is deductible. { CIT vs. Secure Meters (Rajashthan High Court)}

The assessee incurred expenditure on issue of **convertible debentures**. The department claimed that convertible debentures were akin to shares and the expenditure was capital in nature. High Court rejecting the claim of the department by stating that **A debenture, when issued, is a loan. The fact that it is convertible does not militate against it being a loan**. In accordance with India Cement 60 ITR 52 (SC), expenditure on a loan is always revenue in nature even if the loan is taken for capital purposes. Consequently, **the expenditure on convertible debentures is admissible as revenue expenditure**.

- Explanation to s. 37 (1) does not apply to "penalty" which is not of the nature of illegal / unlawful expenditure. { Western Coalfields vs. ACIT (ITAT Nagpur) }

The assessee became liable to pay "**penalty**" for overloading wagons under the rules of the Railways. The question arose whether the said "penalty" was disallowable under the **Explanation to s. 37 (1)** which provides that "expenditure incurred for any purpose which is an offence or which is prohibited by law" shall not be allowable. Tribunal while deciding the matter stated that the substance of the matter had to be looked into and given preference over the form. **Though the amount was termed "penalty", it was essentially of a commercial nature and incurred in the normal course of business and was consequently allowable**.

- Expenditure incurred prior to set up of project office is allowable. { DDIT vs. Stork Engineers (ITAT Mumbai) }

The assessee was a foreign company. It was awarded a contract in India on 24.2.1998. The actual work of basic engineering etc started in March 1998 though the RBI's approval for setting up the project office was given in June 1998. The assessee incurred expenditure for the period 1.4.1998 to 16.6.1998

Tribunal held that When computing the income of the project as a whole including that part which relates to the period anterior to the setting up of the project office, there can be no question of not allowing such expenditure which is relatable to the period prior to the setting up of the project. If the expenditure is identifiable with the project, it has to be allowed as a deduction under the matching concept.

❖ Roll-over charges for foreign currency contracts have to be capitalized u/s 43A { ACIT vs. Elecon Engineering (Supreme Court) (**Important**) }

The assessee procured a foreign currency loan for expansion of its existing business. To ensure availability of foreign currency, the assessee booked forward contracts with a bank. The contract was for the entire amount and delivery of foreign currency was obtained from the bank for the installment due from time to time. The balance value of the contract was rolled over for a further period up to the date of the next installment. The assessee paid "roll over premium charges" for the same. The AO disallowed the said charges on the ground that as it were incurred for purchase of plant & machinery, it was capital expenditure. The matter ultimately went to Supreme Court.

Apex Court reversing the High Court by stating that **Exchange differences are required to be capitalized if the liabilities are incurred for acquiring fixed assets like plant and machinery. It is the purpose for which the loan is raised that is of prime significance. Whether the purpose of the loan is to finance the fixed asset or working capital is the question which one needs to answer**. It cannot be said that roll over charge has nothing to do with the fluctuation in the rate of exchange. Roll over charges represent the difference arising on account of change in foreign exchange rates. **Roll over charges paid/ received in respect of liabilities relating to the acquisition of fixed assets should be debited/ credited to the asset in respect of which liability was incurred**. However, roll over charges not relating to fixed assets should be charged to the Profit & Loss Account.

❖ Even employees' contribution to PF paid before due date of filing ROI is allowable u/s 43B.{ CIT vs. AIMIL Limited (Delhi High Court) }

S. 2 (24) (x) provides that amounts received by an assessee from employees towards PF contributions etc shall be "income". S. 36 (1) (va) provides that if such sums are contributed to the employees account in the relevant fund on or before the due date specified in the PF etc legislation, the assessee shall be entitled to a deduction. The second Proviso to s. 43B (b) provided that any sum paid by the assessee as an employer by way of contribution to any provident etc fund shall be allowed as a deduction only if paid on or before the due date specified in 36(1)(va). After the omission of the second Proviso w.e.f 1.4.2004, the deduction is allowable under the first Proviso if the payment is made on or before the due date for furnishing the return of income. The High Court had to consider whether the benefit of s. 43B can be extended to **employees' contribution as well** which are paid after the due date under the PF law but before the due date for filing the return. HELD deciding in favour of the assessee:

If the employees' contribution is not deposited by the due date prescribed under the relevant Acts and is deposited late, the employer not only pays interest on delayed payment but can incur penalties also, for which specific provisions are made in the Provident Fund Act as well as the ESI Act. Therefore, the Act permits the employer to make the deposit with some delays, subject to the aforesaid consequences. **Insofar as the Income-tax Act is concerned, the assessee can get the benefit if the actual payment is made before the return is filed, as per the principle laid down in Vinay Cement**.

❖ Indexed cost of gifted assets has to be determined with reference to previous owner.{ DCIT vs. Manjula Shah (ITAT Mumbai Special Bench) }

The assessee transferred a capital asset which was received by her by way of gift on 1.2.2003. The previous owner had acquired the capital asset on 29.1.1993. In computing capital gains, the assessee claimed that the indexed cost of acquisition had to be worked out by taking the date of acquisition by the previous owner. The AO rejected the claim though the CIT (A) accepted it. On appeal by the Revenue, the issue was referred to the Special Bench. HELD by the Special Bench:

Explanation (iii) to s. 48 defines the term "indexed cost of acquisition" to mean the amount which bears to the cost of acquisition the same proportion as the …. Cost Inflation Index **for the first year in which the asset was held by the assessee** …" A literal reading of the provision suggests that one has to go by the year in which the asset was held by the assessee. However, this would be inconsistent with the scheme of the Act as reflected in the definition of "short-term capital asset" in Expl. 1(b) to s. 2 (42A) which provides that **the period for which the asset was held by the previous owner also has to be taken into account**. **It is not logical that the cost of acquisition and the period of holding is determined with reference to the previous owner and the indexation factor is determined with reference to the date of acquisition by the assessee**. Such an interpretation will lead to absurdity and unjust results and defeat the purpose of the concept of 'indexed cost of acquisition'. In accordance with the principles of purposive interpretation of statutes, Expl. (iii) to s. 48 has to be read to mean that **the indexed cost of acquisition has to be computed by taking into account the period for which the asset was held by the previous owner**.

❖ Consideration for permission to use TDR / FSI not chargeable to tax. { Om Shanti Co-op Society vs. ITO (ITAT Mumbai) }

The assessee co-op housing society gave permission to a developer to construct 2 floors and 8 flats on the building belonging to the society by using the TDR / FSI available to the developer. In consideration, the developer paid Rs. 26 lakhs to the assessee and Rs. 66 lakhs to its members aggregating Rs. 92 lakhs. The AO took the view that the assessee had relinquished its right "to load TDR and construct additional floors" and as there was no cost of acquisition, the entire consideration of Rs. 26 L was assessable as long-term capital gains. On appeal, the CIT (A) took the view that even the amounts received by the Members were assessable in the assessee's hands. He accordingly enhanced the assessment and directed that the consideration be taken at Rs. 92 L. On appeal by the assessee, HELD reversing the CIT (A):

The assessee – society and its members had no right to construct additional floors on the existing building as they had exhausted the right available while constructing the flats in the building. The TDR was not obtained by the assessee and sold to the developer. Accordingly, **the assessee had not transferred any existing right to the developer** nor any cost was incurred / suffered prior to permitting the developer to construct the additional floors. **In the absence of a cost of acquisition, the judgement in B. C. Srinivasa Setty 128 ITR 294 (SC) applied and the consideration was not assessable as capital gains**.

❖ Even introduction of stock-in-trade as capital contribution into firm attracts s. 45(3).{ DLF Universal vs. DCIT (ITAT Delhi Special Bench) }

The assessee was engaged in the business of real estate development. It held land as **stock in trade** with a book value of Rs. 4.4 crs. The said land was introduced at its market value of Rs. 11.50 crs as **capital contribution into a new firm**. The surplus of Rs. 6.01 crore was credited to the profit and loss account. Relying on **Hind Construction** 83 ITR 211 (SC), it was claimed that the surplus of Rs. 6.01 crs was not liable to tax as the introduction of an asset into a partnership was not a sale. It was also claimed that s. 45 (3) was applicable only to capital assets and not to stock-in-trade. The AO and the CIT (A) took a contrary view relying on **Sunil Siddharthbhai** 156 ITR 509 (SC) & **McDowell** 154 ITR 148 (SC). On appeal by the assessee, HELD **by the majority**, dismissing the appeal. In **Sunil Siddharthbhai** it was held that when a partner introduces his asset into a firm as capital contribution, there is a "transfer" though the gains are not chargeable to tax as the consideration is not determinable. It was clarified that this principle did not apply if the partnership was non-genuine or sham or where the transaction of transferring the personal asset to the partnership firm was a device or ruse to convert personal assets into money while evading tax on capital gains;

❖ Right to subscribe for shares arises only when offer is made by the company.{ Navin Jindal vs. ACIT (Supreme Court) }

The assessee held shares in Jindal Iron and Steel Co. Pursuant to a rights issue of partly convertible debentures announced by Jindal, the assessee received an offer to subscribe to 1875 PCDs on Rights Basis. The assessee renounced his right to subscribe to PCDs and received a consideration of Rs. 56,250/- for the renunciation. Against the said sale consideration, the assessee claimed that he had suffered a diminution in the value of the original 1500 equity shares being the difference between the cum-right price per share and the ex- rights price per share aggregating Rs. 3,00,000. The difference of Rs. 2,43,750 was claimed as a short-term capital loss. The lower authorities held that **as the shares were held long-term, the said loss was also long-term**. On appeal by the assessee, HELD allowing the appeal of the assessee.

The right to subscribe for additional offer of shares/debentures on Rights basis, on the strength of existing shareholding in the Company, **comes into existence when the Company decides to come out with the Rights Offer**. Prior to that, such right, though embedded in the original shareholding, remains inchoate. The same crystallizes only when the Rights Offer is announced by the Company. **Therefore, in order to determine the nature of the gains/loss on renunciation of right to subscribe for additional shares/debentures, the crucial date is the date on which such right to subscribe for additional shares/debentures comes into existence and the date of transfer [renunciation] of such right. The said right to subscribe for additional shares/debentures is a distinct, independent and separate right, capable of being transferred independently of the existing shareholding, on the strength of which such Rights are offered**.

For the purposes of s. 48 an important principle that must be borne in mind is that **chargeability and computation go hand in hand**. Computation is an integral part of chargeability under the Act. Accordingly, the right to subscribe for additional offer of shares/debentures comes into existence only when the Company decides to come out with the Rights

Offer and it is only when that event takes place, that diminution in the value of the original shares held by the assessee takes place. One has to give weightage to the diminution in the value of the original shares which takes place when the Company decides to come out with the Rights Offer.

- S. 54 relief allowable even if new house purchased from borrowed funds. { CIT vs. Dr. P. S. Pasricha (Bombay High Court) }

S. 54 provides that if an assessee has LTCG on transfer of a residential house and he purchases or constructs a residential house within the specified period then the amount appropriated towards the new house shall be deducted from the LTCG. The assessee sold a house and **used the sale proceeds to buy commercial property**. Subsequently (but within the specified period) **he borrowed funds and purchased a new house**. The AO denied deduction u/s 54 on the ground that the new house had been purchased out of borrowed funds and not out of the consideration received for the old house. On appeal, the Tribunal and High Court upheld the claim on the ground that **s. 54 merely required the purchase of the new house to be within the specified period. The source of funds for the purchase was irrelevant**.

- Speculation loss can be set off against delivery based profits. { CIT vs. Lokmat Newspapers (Bombay High Court) }

The assessee earned a profit on sale of shares held as stock-in-trade. This profit was offered as profit from a 'speculation business' and was set off against a 'speculation loss' brought forward from an earlier assessment year. The AO took the view that the profit from sale of shares was not from a 'speculation business' on the ground that **the assessee had settled its transaction of sale and purchase of shares through physical delivery**. Consequently, the claim for set off against the speculation loss was denied. This was confirmed by the CIT (A) though reversed by the Tribunal on the ground that the profit earned from sale of shares fell within the purview of the Explanation to s. 73 and could be set off against speculation losses. On appeal by the Revenue, HELD affirming the Tribunal's order and dismissed the revenue's appeal.

The Explanation to s. 73 creates a deeming fiction that where the assessee is a company and any part of its business consists of the purchase and sale of shares of other companies, the assessee is deemed to be carrying on a speculation business, to the extent to which the business consists of the purchase and sale of shares. A business postulates a systematic course of activity or dealing. Unless the business of a Company consists of the sale and purchase of shares, the deeming fiction would not apply. However, once the requirements of the Explanation are satisfied the assessee is deemed to be carrying on a "speculation business". **There is no justification to exclude a business involving actual delivery of shares**. Once an assessee is deemed to be carrying on a speculation business for the purpose of s. 73, any loss computed in respect of that speculation business, can be set off only against the profits and gains of another speculation business.

- Copying software onto blank discs is "manufacture" for s. 80-IA. {CIT vs. Oracle Software India (Supreme Court) **Very Important** }

The assessee imported Master Media of software from Oracle Corporation which was duplicated on blank discs, packed and sold in the market. The question arose whether the activity of copying the discs amounted to manufacture or processing of goods for purposes of s. 80IA. HELD, deciding in favour of the assessee:

The term "manufacture" implies a change, but, every change is not a manufacture, despite the fact that every change in an article is the result of a treatment of labour and manipulation. However, this test of manufacture needs to be seen in the context of the process adopted by the assessee for duplication of software. **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"**. Applying this test, as the assessee has undertaken an operation which renders a blank CD fit for use for which it was otherwise not fit, the duplicating process constitutes 'manufacture' u/s 80IA(12)(b).

The argument of the revenue that **since the software on the Master Media and the software on the pre-recorded media is the same, there is no manufacture because the end product is not different from the original product is over-simplified and does not take into account the ground realities of business in modern times**.

❖ Cutting & polishing marble blocks is "production" for s. 80-IA { ITO vs. Arihant Tiles & Marbles (Supreme Court) } (**Important**)

The assessee was engaged in conversion of marble blocks into slabs and tiles by sawing and polishing. The question was whether this amounts to "manufacture or production of article or thing" for purposes of deduction u/s 80IA. HELD, deciding in favour of the assessee:

The word "production" is wider in its scope than the word "manufacture". It means manufacture plus something in addition thereto. This ground reality is now noted in s. 2(29BA) inserted by Finance Act, 2009 w.e.f 1.4.2009. While mere extraction of stones and its cutting into slabs may not constitute manufacture the activity of polishing and conversion of blocks into polished slabs and tiles amounts to "manufacture" or "production" because the conversion of blocks into polished slabs and tiles results in emergence of a new and distinct commodity. There is accordingly "manufacture or production" for s. 80-IA

❖ S. 80-IA (4) deduction is not available to contractors.{ B. T. Patil & Sons vs. ACIT (ITAT Mumbai Larger Bench) }

The assessee, a civil contractor, claimed deduction u/s 80-IA (4) in respect of the profits from infrastructure projects executed by it. The lower authorities rejected the claim on the ground that the assessee was a mere contractor and not a developer. On merits, s. 80-IA (4) (even pre-amendment) applies to a "developer". **The difference between a "developer" and "contractor" is that the former designs and conceives new projects while the latter executes the same**. As the assessee was merely executing the job of civil construction, it was not eligible u/s 80-IA (4). The assessee was also not the "owner" of the facility.

The intention of the Legislature is to provide deduction u/s 80-IA (4) only to the person directly engaged in developing, maintaining and operating the facility. There should be a complete development of the facility and not just a part of it. The Explanation below 80-IA (13) inserted by FA 2007 & 2009 w.r.e.f 1.4.2000 which provides that s. 80-IA(4) shall not apply to a person executing a works contract entered into with the enterprise is unambiguous and cannot be interpreted otherwise.

- Interest on surplus funds is "other income" and not eligible for dedn u/s 80P {The Totgars' Cooperative vs. ITO (Supreme Court) } (**Important**)

The assessee, a co-op credit society, was engaged in providing credit facilities to its members and also marketing the agricultural produce of its members. The assessee had surplus funds which it invested in short-term deposits with banks and govt securities. The question arose whether the said interest earned on the said deposits was "business profits" and eligible for deduction u/s 80P(2)(a)(i). The assessee argued that its activity of providing credit facilities to its members was an "eligible activity" u/s 80P(2)(a)(i) and that as the investments were made as per statutory requirement, the benefit was allowable from the gross total income. HELD deciding against the assessee:

S. 80P(2)(a)(i) allows a deduction in the case of a co-op society engaged in carrying on the business of providing credit facilities to its members of the whole of the amount of profits and gains of business attributable to such activity. **The words "profits and gains of business" means "business profits" and not "Income from other sources"**; **The interest on surplus invested in short-term deposits**, not being attributable to the business of providing credit facilities to the members or marketing of agricultural produce of the members, **is assessable as "other income" and not as "business profits"**. The words "the whole of the amount of profits and gains of business" attributable to one of the activities specified in s. 80P (2)(a) mean that **the source of income is relevant** and that the **income must be "operational income"**.

- Benefit of lower tax rate under Proviso to s. 112 available to bonus shares despite no indexation. { CIT vs. Anuj A. Sheth HUF (Bombay High Court) }

The proviso to s. 112(1) provides that "where the tax payable in respect of any income arising from the transfer of a long-term capital asset, being listed securities … exceeds ten per cent of the amount of capital gains **before giving effect to the provisions of the second proviso to section 48** (i.e. indexation), then, such excess shall be ignored for the purpose of computing the tax payable by the assessee". The assessee sold bonus shares of Infosys for Rs. 6.13 crores. As there was no cost of acquisition of bonus shares and no indexation, the long-term capital gains were computed at Rs. 6.13 crores. The assessee sold other shares and computed a long-term capital loss of Rs. 2.68 crores after indexation, which was claimed as a set off against the LTCG of Rs. 6.13 crores. On the balance of Rs. 3.45 crores (comprising of gains on the bonus shares), the assessee paid tax at 10% as per the Proviso to s. 112. The AO took the view that as the assessee was not eligible to claim indexation benefits in respect of the bonus shares, it was not entitled to the option given by the Proviso to s. 112 and tax was payable on the entire gains at the rate of 20%. The AO's stand was upheld by the CIT (A) though reversed by the Tribunal. On appeal by the revenue, HELD dismissing the appeal:

In the case of bonus shares, the question of indexation does not arise because the cost of acquisition is taken to be nil. What the proviso to s. 112 essentially requires is that where the tax payable in respect of a listed security (being LTCG) exceeds 10% of the capital gains before indexation, such excess beyond 10% is liable to be ignored. The proviso to s. 112 requires a comparison to be made between the tax payable at 20% after indexation with the tax payable at 10% before indexation. **If the shares were acquired at a cost, it becomes necessary for purposes of the proviso to s. 112(1) to compute capital gains before giving effect to indexation. However, that does not arise in respect of bonus shares**. There is nothing in the s. 112 to suggest that the assessee would be entitled to a set off of the loss u/s 70 but without the benefit of indexation;

❖ Even capital profits have to be added to "book profits" for s. 115JB.{ DCIT vs. Bombay Diamond Co (ITAT Mumbai) }

The assessee earned a capital profit of Rs. 10.38 crores on sale of rights to immovable property. **The said profit was directly credited to the capital reserves in the balance sheet instead of being routed through the Profit & loss account**. The accounts of the assessee company were duly certified by the auditors and were also adopted in the AGM. The audited accounts were filed with ROC. In the computation of "book profits" for s. 115JB, the said capital profits were not included. The AO took the view that **by not crediting the capital profit to the P&L A/c, the assessee had contravened sub-clause (xi)(a) of clause (3) of Part II of the Schedule VI** to the Companies Act and that he was, therefore, entitled to add the capital profit to the "book profit". On appeal, the CIT (A) reversed the AO on the ground that the AO had no jurisdiction to go beyond the net profit shown in the P&L A/c except to the extent provided in the Explanation to s. 115JB. On appeal by the Revenue, HELD reversing the CIT (A) and decided in favour of the revenue by sataing that **As the assessee had not routed the capital profits through the Profit and Loss A/c. and directly credited it to the Balance Sheet, its accounts were not prepared in the manner provided in Part II and Part III of Schedule VI to the Companies Act**. The fact that the auditors had certified the accounts is not relevant.

❖ S. 115JA assessment is not liable for advance tax interest u/s 234B and 234C.{ Snowcem vs. DCIT (Bombay High Court) }

Where an assessment is made u/s 115JA of the Act, an assessee is not liable to pay interest for non-payment/shortfall of advance tax u/s 234B and 234C of the Act.

❖ If the search warrant is in joint names, an assessment in individual capacity is void.{ CIT vs. Vandana Verma (Allahabad High Court) }

A search warrant u/s 132 (1) (c) was issued in the **joint names** of the assessee and her spouse. Subsequently, a block assessment of undisclosed income was made u/s 158BC in the **individual name** of the assessee. In appeal against such assessment, the assessee raised a preliminary objection that the search warrant having been issued in the joint names of the assessee and her spouse, the assessment on the assessee in the individual capacity was invalid. The objection was upheld by the Tribunal. The department appealed to the High Court. HELD, dismissing the appeal:

S. 132 (1) (c) empowers the officer to enter the premises etc and search it if he has "reason to believe" that "any person" is in possession of any money, bullion etc representing undisclosed income. **As the search warrant was issued in the joint names of the assessee and her spouse, it means that the officer had reason to believe that the undisclosed assets and income were held jointly. If so, it is not open for the AO to assess the assessee individually on the basis of the assets and documents seized during the course of search in pursuance to the said warrant but the assessment ought to have been only in the capacity of AOP or BOI**.

- ❖ Reasons for search action u/s 132 need not be given to the Assessee. { Genom Biotech vs. DIT (Bombay High Court) }

Search & seizure action u/s 132 was undertaken at the assessee's premises. Thereafter an order of provisional attachment u/s 281B was passed. The assessee filed a writ petition challenging the validity of the search and the provisional attachment. HELD dismissing the Petition by stating that Search action u/s 132 can be initiated only if the designated authority forms a reasonable belief on the basis of information that one of the three conditions of s. 132 exist. **However, it is not the mandate of s. 132 that the reasonable belief recorded by the designated authority must be disclosed to the assessee**.

- ❖ <u>AO deemed to have applied his mind if facts are on record and reopening u/s 147 on change of opinion is not permissible even within 4 years. { CIT vs. Kelvinator of India (Supreme Court) }</u>

In **CIT vs. Kelvinator of India Ltd** the Full Bench of the Delhi High Court held that when a regular order of assessment is passed in terms of section 143 (3) of the Act, **a presumption can be raised that such an order has been passed on application of mind. It was held that if it be held that an order which has been passed purportedly without application of mind would itself confer jurisdiction upon the Assessing Officer to reopen the proceeding without anything further, the same would amount to giving premium to an authority exercising quasi-judicial function to take benefit of its own wrong. It was held that section 147 of the Act does not postulate conferment of power upon the Assessing Officer to initiate reassessment proceedings upon a mere change of opinion**. On appeal by the department to the Supreme Court, HELD dismissing the appeal:

Apex Court held that though the power to reopen under the amended s. 147 is much wider, one needs to give a schematic interpretation to the words "reason to believe" failing which s. 147 would give **arbitrary powers to the AO to re-open assessments on the basis of "mere change of opinion", which cannot be per se reason to re-open**. One must also keep in mind the conceptual difference between power to review and power to re-assess. The AO has no power to review; he has the power to re-assess only.

- ❖ <u>Assessment order is not effaced in respect of items that are not subject of reassessment. Time limit for s. 263 begins from date of original order for such items. { Ashoka Buildcon vs. ACIT (Bombay High Court) }</u>

An assessment order u/s 143(3) was passed on 27.12.2006. A reassessment order u/s 147 was passed on 27.12.2007. A show-cause notice u/s 263 was issued by the CIT on 30.4.2009 in respect of issues that were not the subject matter of the reassessment order. The s. 263 notice was time-barred if reckoned from the date of the assessment order but was within time if reckoned from the reassessment order. The revenue urged that the time limit should be reckoned from the date of the reassessment order on the basis of **ITO vs. K.L. Srihari (HUF)** 250 ITR 193 (SC) where it was held that the reassessment order "made a fresh assessment of the entire income of the assessee" and "the original order stood effaced by the reassessment order". HELD rejecting the plea of the department:

In **CIT vs. Alagendran Finance** 293 ITR. 1 (SC) it was held that the doctrine of merger does not apply where the subject matter of reassessment and original assessment is not one and the same. **Where the assessment is reopened on a specific ground and the reassessment is confined to that ground, the original assessment continues to hold the field except for those grounds on which a reassessment has been made**. Consequently, an appeal on the grounds on which the original assessment was passed and which does not form the subject of reassessment continues to subsist and does not abate. **The order of assessment is not subsumed in the order of reassessment in respect of those items which do not form part of the order of reassessment**. Consequently, the time limit for exercise of power u/s s. 263 with reference to **issues which do not form the subject of the reassessment order commences from the date of the original order** and not the reassessment order.

❖ Validity of s. 147 reopening has to be determined on the basis of law prevailing on date of issue of s. 148 notice and not on retrospectively amended law.{Rallis India vs. ACIT (Bombay High Court) }

In respect of AY 2004-05, the assessee computed its book profits u/s 115JB by claiming a deduction for provision for doubtful debts and advances and the same was allowed vide order u/s 143 (3). **Within 4 years**, the AO issued a notice u/s 148 inter alia on the ground that the provision for doubtful debts had to be added back to the book profits. The assessee filed a writ petition to challenge the reopening. HELD allowing the Petition:

U/s 115JB as it stood at the relevant time, the AO was authorized by cl (c) of Expl (1) to s. 115JB to add back "amounts set aside to provisions made for meeting liabilities, other than ascertained liabilities". In **HCL Comnet Systems** the Supreme Court held that a provision for doubtful debts was a provision for diminution in the value of the assets and did not fall under the said provision. To supercede this judgement, cl (i) was inserted in the Expl to s. 115JB by the FA 2009 w.r.e.f 1.4.2001 to provide that even amounts set aside as provision for diminution in the value of an asset had to be added to the book profits. **The retrospective amendment was of no avail because it was enacted after the issue of the s. 148 notice**. T**he validity of the reopening has to be determined on the basis of the law as it stands on the date of issue of the s. 148 notice**. As the retrospective amendment to s. 115JB was not and could not have formed the basis for reopening the assessment, the same could not be relied upon to justify the reopening. **The validity of the s. 148 notice must be determined with reference to the recorded reasons and the same cannot be allowed to be supplemented on a basis which was not present to the mind of the AO and could not have been so present on the date on which the power to reopen the assessment was exercised**. Consequently, the reopening was without jurisdiction.

- Even if there is no assessment u/s 143 (3), reopening u/s 147 is bad if there are no proper "reasons to believe". AO cannot go beyond the recorded reasons. { Prashant S. Joshi vs. ITO (Bombay High Court) }

The assessee was a partner in a firm. Upon retirement, he received an amount of Rs. 50 lakhs in addition to the balance lying to his credit in the books of the firm in full and final settlement of his dues. The assessee filed a return in which the said amount was not offered to tax on the ground that it was a capital receipt. **No assessment order was passed**. The AO issued a notice for reopening u/s 148 on the ground that as in the assessment of the firm the amount paid by it to the assessee had been allowed as a revenue deduction, the amount received by the assessee had to be assessed as income. Reliance was also placed on ss. 28 (iv) & (v). The assessee filed a Writ Petition to challenge the reopening. HELD allowing the Petition of the assessee.

The basic postulate which underlines s. 147 is the formation of the belief by the AO that income chargeable to tax has escaped assessment. The AO must have reason to believe that such is the case before he proceeds to issue a notice u/s 147. **The reasons which are recorded by the AO for reopening an assessment are the only reasons which can be considered when the formation of the belief is impugned**. The recording of reasons distinguishes an objective from a subjective exercise of power. The requirement of recording reasons is a check against arbitrary exercise of power. **The validity of the reopening has to be decided on the basis of the reasons recorded and on those reasons alone**. **The reasons recorded while reopening the assessment cannot be allowed to grow with age and ingenuity, by devising new grounds in replies and affidavits not envisaged when the reasons for reopening an assessment were recorded**. The only reason recorded by the AO was that as the firm had been held eligible to claim a deduction of the amount paid to the assessee, the amount received by the assessee was chargeable to tax. However, this is unsustainable because **the law is well settled that what the partner gets upon dissolution or retirement is the realization of a pre-existing right or interest which is not assessable to tax**.

Though **Explanation (2) (b) to s. 147** creates a deeming fiction of income having escaped assessment in cases where an assessment has not been made, the act of taking notice cannot be at the arbitrary whim or caprice of the AO but **must be based on a reasonable foundation**. Though the sufficiency of the evidence or material is not open to scrutiny by the Court, the existence of the belief is the sine qua non for a valid exercise of power. On facts, it was impossible for any prudent person to form a reasonable belief that the income had escaped assessment. Consequently, the s. 148 notice was quashed.

- Reopening u/s 147 not valid if there is no finding regarding failure to disclose material facts.{ Bhavesh Developers vs. AO (Bombay High Court) }

In AY 2002-2003, the assessee claimed deduction u/s **80-IB (10)** of Rs. 3.85 crs which was allowed by the AO vide s. 143 (3) order. The assessment was reopened u/s 147 after the expiry of four years from the end of the assessment year on the ground that the **claim for deduction u/s 80IB (10) included ineligible items of other income** such 'society deposit', 'stilt parking' and sundry credit balances and that income had thereby escaped assessment. The assessee filed a writ petition to challenge the s. 148 notice. HELD upholding the challenge:

Under the proviso to s. 147, an assessment made u/s 143 (3) can be reopened after the expiry of 4 years from the end of the assessment year <u>only if</u> there is a failure on the part of the assessee to disclose fully and truly all material facts necessary for the assessment;

On facts, the assessee had furnished details of the claim u/s 80IB (10) including the breakup of the other income. **Even the recorded reasons showed that the inference that the income has escaped assessment was based on the disclosure made by the assessee itself. Further, there was no finding in the recorded reasons that that there was a failure to disclose necessary facts.** Accordingly, the condition precedent to a valid exercise of the power to reopen the assessment was absent. An exceptional power has been conferred upon the Revenue to reopen an assessment after a lapse of four years and the conditions prescribed by the statute for the exercise of such a power must be strictly fulfilled and in their absence, the exercise of power would not be sustainable in law.

- <u>Limitation period u/s 154 (7) for rectification begins from date of appeal order. { CIT vs. Tony Electronics (Delhi High Court) }</u>

S. 154 (7) provides that a rectification order can be passed within four years "from the end of the financial year in which the order sought to be amended was passed". The AO passed an assessment order u/s 143 (3) on **24.11.1998** in which he committed the mistake of reducing the depreciation instead of adding to the income resulting in double deduction. The assessee went up in appeal **on other issues** to the CIT (A) who decided the appeal on **28.6.2004**. The AO gave effect to the CIT (A)'s order vide order dated **23.7.2004**. The AO thereafter passed an order u/s 154 dated **26.4.2006** by which he rectified the mistake committed in the order dated 24.11.1998. On the question whether the said order was barred by limitation, the Tribunal decided the issue in favour of the assessee on the ground that the rectification order was passed beyond four years. On appeal by the department, HELD reversing the Tribunal.

Under the **Doctrine of Merger**, once an appeal against the order passed by an authority is preferred and is decided by the appellate authority, the order of the said authority merges into the order of the appellate authority. **With this merger, the order of the original authority ceases to exist and the order of the appellate authority prevails, in which the order of the original authority is merged**. For all intent and purposes, it is the order of the appellate authority that has to be seen. The word "order" in s. 154 (7) has not been qualified in any way and it does not mean only the original order but includes the appeal – effect order. On facts, **the assessment order dated 24.11.1998 merged in the CIT (A)'s order dated on 28.6.2004**. This date had to be considered for computing the limitation period of four years. **The fact that the error sought to be rectified occurred in the original assessment order and was not subject matter of appeal is irrelevant**.

- <u>Debatable issues are not "mistakes apparent from the record" u/s 154.{ Mepco Industries vs. CIT (Supreme Court) }</u>

The assessee filed a revision petition u/s 264 in which it claimed that the subsidy received by it from the government was a capital receipt and not chargeable to tax in view of **P.J. Chemicals Ltd** 210 ITR 830 (SC). The Petition was allowed by the CIT. Subsequently, the Supreme Court held in **Sahney Steel and Press Works** 228 ITR 253 that the subsidy received by that assessee was a revenue receipt. Pursuant to this judgement, the CIT passed a rectification order u/s 154 by which he held that the subsidy was a revenue receipt. The assessee challenged the said order by a writ petition before the Madras High Court which was dismissed. On appeal by the assessee, HELD allowing the appeal:

The case was a classic one of change of opinion. The question whether a subsidy is capital or revenue depends on the facts of the case. S. 154 can only apply to a "mistake apparent from the record". A "rectifiable mistake" is a mistake which is obvious and not something which has to be established by a long drawn process of reasoning or where two opinions are possible. A decision on a debatable point of law cannot be treated as a "mistake apparent from the record".

❖ No "succession of business" u/s 170 even on 100% sale of shares. { CIT vs. Panchratan Hotels (HP High Court) }

S. 170 provide that where there is a "succession of business", the predecessor has to be assessed in respect of the income upto the date of succession and the successor has to be assessed thereafter. 100% of the assessee's shares were sold by the existing shareholders to another person. The CIT in revision took the view that the result of the said transfer of shares was that there was a "succession" and that the loss incurred prior to the date of succession could not be allowed to the "successor" assessee. The assessee's appeal was allowed by the Tribunal. On appeal by the Revenue, HELD dismissing the appeal:

The term "succession" in s. 170 has a somewhat artificial meaning. The tests of change of ownership, integrity, identity and continuity of a business have to be satisfied before it can be said that a person "succeeded" to the business of another;

Even if it is accepted that by a transfer of shares u/s 2(47), there is a transfer in the right to use the capital assets of the company, still **s. 170 is not attracted because there is no "transfer of business"**. **A company is a juristic person and owns the business. The share holders are not the owners of the company. By a transfer of the shares, there is no transfer so far as the company is concerned**.

❖ Tests laid down to determine when contract manufacturing will amount to a contract of sale for S. 194C TDS. { CIT vs. Glenmark Pharmaceuticals (Bombay High Court) }

The assessee entered into an agreement with a third party for the manufacture of certain pharmaceutical products under which it provided the formulations and specifications and the manufacturer affixed the trademark of the assessee on the articles produced. The raw materials were purchased by the manufacturer and property in the goods passed to the assessee only on delivery. The agreement was on a principal to principal basis. The AO took the view that the contract was a contract of 'work' and tax was deductible at source u/s 194C though the Tribunal upheld the contention of the assessee that the contract involved a sale and did not represent a 'contract for work' u/s 194C. On appeal by the Revenue, HELD dismissing the appeal:

A contract for sale has to be distinguished from a contract of work. **If a contract involves the sale of movable property as movable property, it would constitute a contract for sale**. On the other hand, if the contract primarily involves carrying on of work involving labour and service and the use of materials is incidental to the execution of the work, the contract would constitute a contract of work and labour. The argument of the Revenue that **the restrictions imposed on the manufacturer** to (a) utilise the formula provided by the assessee, (b) affix the trade-mark of the assessee, (c) manufacture as per specifications provided by the assessee and (iii) deal exclusively with the assessee show that the contract is not one of sale is not acceptable because this has not been the understanding of the law at any point of time even by the CBDT and judicial precedents;

Though a product is manufactured to the specifications of a customer, the agreement would constitute a contract for sale, if (i) the property in the article passes to the customer upon delivery and (ii) the material that was required was not sourced from the customer / purchaser, but was independently obtained by the manufacturer from a third party. This position is now statutorily recognized in Expl. (e) to s. 194C inserted by the FA 2009 to provide that **the expression 'work' shall not include manufacture or supply of a product according to the requirement or specification of a customer by using material which is purchased from a person other than such customer**.

❖ S. 271 (1) (c) penalty cannot be imposed even for making unsustainable claims { CIT vs. Reliance Petroproducts (Supreme Court) (**Very Important**) }

The assessee claimed deduction u/s 36 (1) (iii) for interest paid on loan taken for purchase of shares. The AO disallowed the interest u/s 14A and levied penalty u/s 271 (1) (c) on the ground that the claim was unsustainable. The penalty was deleted by the appellate authorities. On appeal by the department to the Supreme Court, HELD dismissing the appeal:

Hon,ble Apex Court had pronounced the following principle :

S. 271 (1) (c) applies where the assessee "has concealed the particulars of his income or furnished inaccurate particulars of such income". The present was not a case of concealment of the income. As regards the furnishing of inaccurate particulars, no information given in the Return was found to be incorrect or inaccurate. ***The words "inaccurate particulars" mean that the details supplied in the Return are not accurate, not exact or correct, not according to truth or erroneous****. In the absence of a finding by the AO that any details supplied by the assessee in its Return were found to be incorrect or erroneous or false, there would be no question of inviting penalty u/s 271(1)(c).*

The argument of the revenue that "submitting an incorrect claim for expenditure would amount to giving inaccurate particulars of such income" is not correct. By no stretch of imagination can the making of an incorrect claim in law tantamount to furnishing inaccurate particulars. ***A mere making of the claim, which is not sustainable in law, by itself, will not amount to furnishing inaccurate particulars regarding the income of the assessee****. If the contention of the Revenue is accepted then in case of every Return where the claim made is not accepted by the AO for any reason, the assessee will invite penalty u/s 271(1)(c). That is clearly not the intendment of the Legislature.*

- No penalty under Expl. 7 to s. 271 (1) (c) for bona fide transfer pricing adjustments.{ DCIT vs. Vertex Customer Services (ITAT Delhi) }

Expl. 7 to s. 271 (1) (c) provides that in the case of an assessee who has entered into an international transaction, **any amount added or disallowed** in computing the total income u/s 92C (4) shall for purposes of s. 271 (1) (c) **be deemed** to represent income in respect of which particulars have been **concealed** or inaccurate particulars furnished **unless the assessee shows that the s. 92C computation was made in good faith and with due diligence**.

The assessee, a call centre, adopted the Transactional Net Margin Method ("TNNM") and showed an operating profit to operating cost at 10.12% on the basis of comparables. The assessee, however, showed a loss of Rs. 4.27 crs from the international transaction after making adjustment for (i) cost relating to first year operation, (ii) cost relating to excess capacity and (iii) provision for doubtful debts towards sums due from the parent company. The adjustments were made on the ground that these were extraordinary costs and required to be excluded in computing the arms' length price under **Rule 10B (e) (iii)** which provides that the net profit margin arising in comparable uncontrolled transactions can be adjusted for differences between the international transaction and the comparable transaction or between the enterprises entering into such transactions which could materially affect the amount of net profit margin in the open market. The TPO rejected the third adjustment on the ground that it being an ordinary item of expenditure did not qualify for adjustment. On merits, the assessee accepted the addition though it challenged the levy of penalty. The CIT (A) allowed the appeal on the ground that the treatment of the provision for doubtful debts as an extraordinary item and not as operational cost was justified. On appeal by the Revenue, HELD dismissing the appeal of the department.

Note: All the case decisions pronounced between the period April 2009 to April 2010 specifically applicable for November 2010 term. Some SC Decisions are very important for exams as well as for practical applications.

*Friends, In case of any query including **Full text of the decisions,** please feel free to contact me or mail your query to bikashbogi@yahoo.co.in.*

Success is not the matter of being the BEST & WINNING the race: Success is a matter of HANDLING the WORST & FINISHING the Race.