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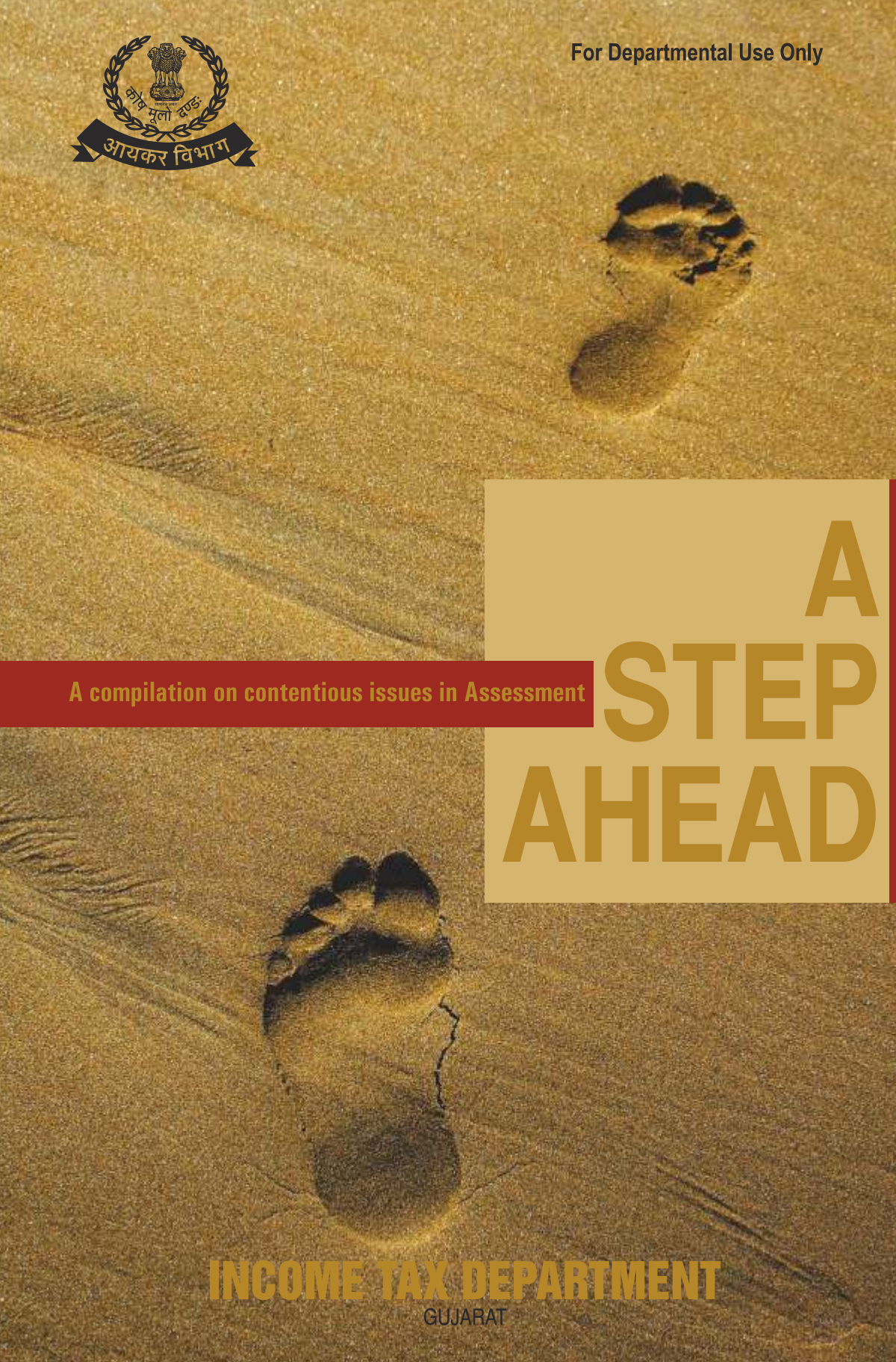

A compilation on contentious issues in Assessment

A STEP AHEAD

INCOME TAX DEPARTMENT

GUJARAT

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1st Edition - 2013

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एम.डी. काबरा, *आईआरएस*
M.D. Kabra, *IRS*

भारत सरकार
GOVERNMENT OF INDIA
आयकर महानिदेशक (अन्वेषण),
आयकर भवन, अहमदाबाद– 380 009.

DIRECTOR GENERAL OF INCOME – TAX, (INV.)
AHMEDABAD,AAYAKAR BHAVAN,
AHMEDABAD-380009.

Message

I have experienced that lot of data, statistics and reports are collected and compiled in the Department for one purpose or the other. It puts tremendous strain on the highly depleted workforce. Despite all this, there is no serious effort to make intelligent use of the information so collected. It is well known that making assessment order is one of the most important function of the officers of the Department. All other functions such as appeal, recovery, audit etc. revolve around it. So, it is of paramount importance that due attention is paid to the framing of Assessment orders.

Improving the quality of Assessment orders will definitely lead to relieving pressure on the depleted workforce for recovery and collection. It was with these objectives that attempt was made to make intelligent use of compilation of 100 quality Assessment orders collected from each CCIT charge as per the initiative of Shri S. S. Rana, Member, CBDT. Analysing of these orders showed that there are only nineteen sections / issues in respect of which most of the additions are made. It was, therefore, contemplated that in-depth study of these sections / issues concerning factual aspects, law aspects and Judicial decisions will be of immense help to the Assessing Officers.

I congratulate Shri Dileep Shivpuri, CCIT (CCA), Ahmedabad and Shri Sushil Chandra CCIT IV, Ahmedabad for implementing these ideas and giving it a concrete shape. I also want to pay compliment

to Ms. Priyanka Devi, ACIT, Ahmedabad, Sh Shri Prakash Dubey, JCIT, Ahmedabad and Shri Ramanand K Nair, ITO, Ahmedabad for getting involved in this project and putting their heart and and soul into it. All the officers of the Experts committee who contributed to the book by way of carrying out in-depth analysis of each issue and putting in their experience deserve laudable appreciation. I would also like to congratulate the members of the Editorial Board who went into each topic and shaped it into a form which not only is recent but also relevant and readily referable by the officers in the field.

M.D.KABRA

Date: 31.1.2013. *Director General of Income-tax (Inv.)*
Ahmedabad.

दिलीप शिवपुरी, *आईआरएस*
Dileep Shivpur, *IRS*

भारत सरकार
GOVERNMENT OF INDIA
मुख्य आयकर आयुक्त, अहमदाबाद -३८०००१
(संवर्ग नियंत्रण अधिकारी)
आयकर भवन, अहमदाबाद- 380 009.
CHIEF COMMISSIONER OF INCOME – TAX,
AHMEDABAD.(CCA),
AAYAKAR BHAVAN, AHMEDABAD-380009.

Foreword

The global economy is undergoing massive changes every day leading to fresh challenges and fresh opportunities for everyone involved. This scenario was anticipated by Alvin Toeffler in his book "The Future Shock" wherein he predicted that the pace of change in today's world would become faster every year.

The Income-tax service being a technical service, it is essential that we keep ourselves abreast of the changes in the global economy and the challenges it throws up for the tax collectors. If the Income-tax Department and the officers therein have to stay relevant in today's world, they have to strive for excellence in the field of taxation.

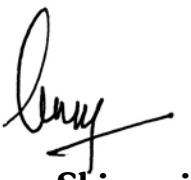
Excellence cannot be achieved without a thirst for knowledge, and the will and the efforts needed to acquire it.

"The heights by great men reached and kept
Were not attained by sudden flight
But they, while their companions slept
Went toiling upwards in the night"

'A Step Ahead' is the product of the toil of nineteen officers of our department stationed in Gujarat who have contributed their knowledge in authoring nineteen essays on subjects of topical interest which form chapters in this book. It is a small step towards quenching the thirst for knowledge related to the taxation field. I

hope that this book will prove useful to officers and staff of the Income-tax Department not only in the State of Gujarat but also in other parts of this wonderful country.

If the response to this book is positive, we propose to take out a second compilation analyzing the various industries in the State of Gujarat soon.



Dileep Shivpuri

Date : 31.01.2013

Chief Commissioner of Income-tax,
Ahmedabad (CCA),
Ahmedabad

सुशील चन्द्रा, *आईआरएस*
Sushil Chandra, *IRS*

भारत सरकार
GOVERNMENT OF INDIA
मुख्य आयकर आयुक्त, अहमदाबाद - IV,
आयकर भवन, अहमदाबाद- 380 009.
CHIEF COMMISSIONER OF INCOME – TAX,
AHMEDABAD-IV,
AAYAKAR BHAVAN, AHMEDABAD-380009.

Preface

The genesis of this book is an exercise carried out to compile best quality assessment orders passed in each Chief C.I.T region of Gujarat during the Financial Year 2011-12. On analyzing these orders it emerged that majority of additions were relatable to issues pertaining to 19 topics. Therefore it was decided to constitute an expert committee for providing suggestions and draw guidelines on legal points on various relevant sections of the I.T. Act which would enable the Assessing Officers to frame better quality assessment orders. The committee consisted of 19 officers of the rank of CsIT & Addl. CsIT. / JCIT. Each member was assigned a topic for in-depth analysis with the view to guide and help A.Os' to understand the intricacies of various provisions of law.

2. In order to ensure that officers get these expert-inputs at a place, it was decided to compile these write-ups received from the members of the Expert Committee into a book form. An Editorial Board was formed to study the write-ups to ensure that the compilation is up-to-date, precise, easy to refer and act upon by the field officers.

3. Officers across in the field have to grapple with different contentious issues involving collection and investigation of various facts and application of relevant law. "A Step Ahead" is a compilation to assimilate the expertise and experience of the officers of the department and bring it up in such a

form that it is easy to refer and can be effectively utilized by the field officers to tackle these issues in the best possible manner. I must say that this is the beginning of sharing and utilizing the experience and knowledge among all officers of the field. After all, to recognize and take the first step towards excellence is itself an important act which can only be bettered over a period of time.

4. On behalf of editorial team, I am privileged to present "A Step Ahead" to the officers of the department. I would like to place on record my sincere thanks to Shri M.D. Kabra, DGIT (Investigation), Ahmedabad, for visualizing this idea and initiating the process of identifying the contentious issues faced by the assessing officers of this region. On behalf of the Editorial Board, I would also like to express my sincere thanks to Shri Dileep Shivpuri, CCIT (CCA), Ahmedabad, for giving us the opportunity to bring out this publication, "A Step Ahead". I am also thankful to my editorial team members who in record time edited the various articles and gave final shape to the compilation. They have taken pains in arranging and framing the articles in such a way that they are easy to comprehend and implement by the field officers. My thanks are also due to all the officers of the department. who have contributed articles with their valuable experience.

5. I am sure that this compilation will be of immense help to the officers of this department in discharging their duties. Any suggestion to improve the book will be welcome.

Sushil Chandra

Date : 31.01.2013

Chairman, Editorial Board

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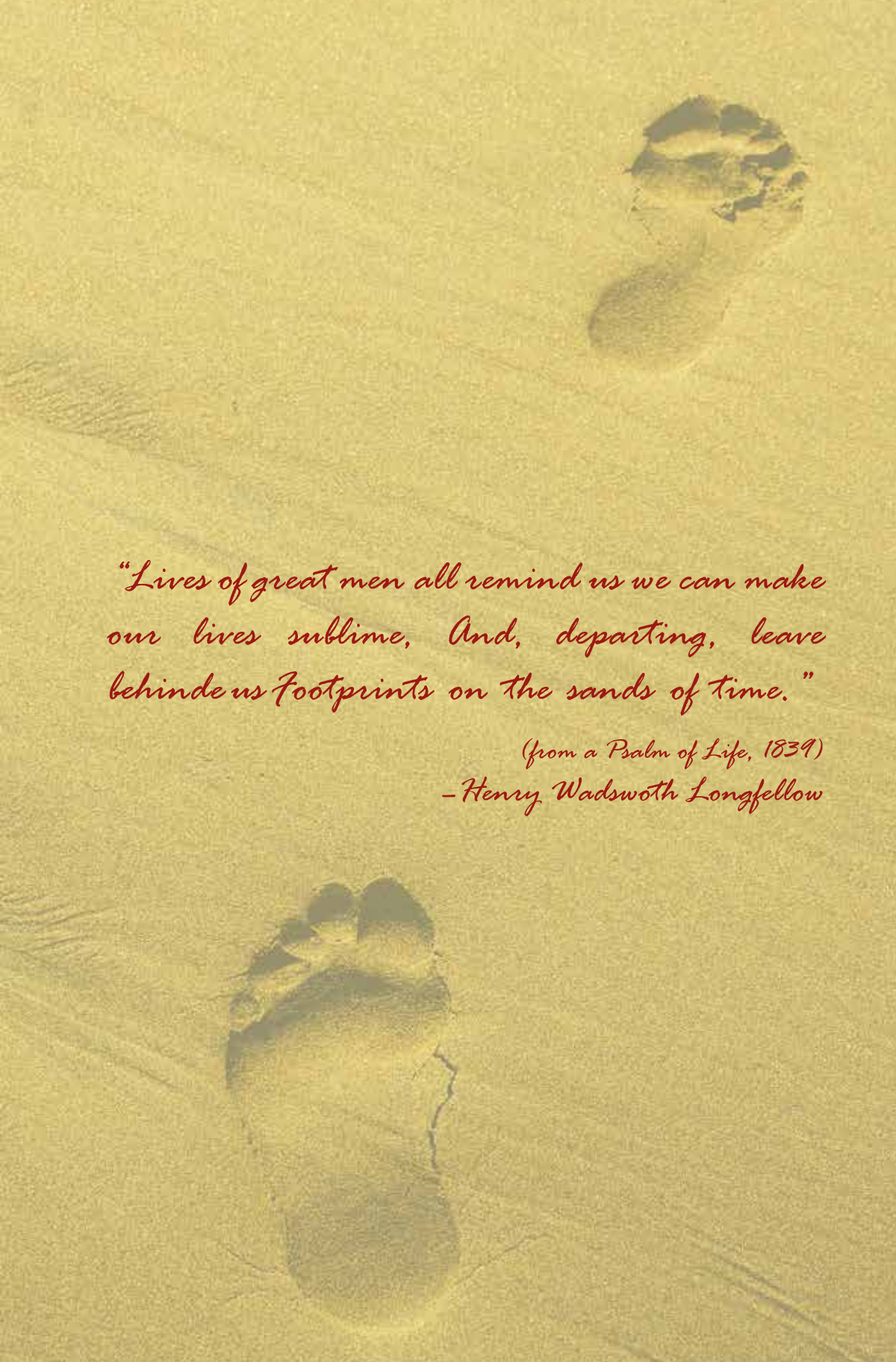


"Lives of great men all remind us we can make
our lives sublime, And, departing, leave
behind us Footprints on the sands of time."

(from a Psalm of Life, 1839)
–Henry Wadswoth Longfellow

1 Understanding Deemed Dividend - Section 2(22)(e)

Rajnish K Vohra
JCIT (TDS), Ahmedabad

- **Section 2(22)(e) of the IT Act'1961 deals with the issue of "deemed dividend."**
- **Provisions of Section 2(22)(e) are as under:**

"dividend" includes-

(e) any payment by a company, not being a company in which the public are substantially interested, of any sum (whether as representing a part of the assets of the company or otherwise) [made after the 31st day of May, 1987, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent of the voting power, or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest (hereafter in this clause referred to as the said concern)] or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits.

The then Finance Minister while describing the purpose of insertion of clause (e) to Section 6(A) in the 1922 Act stated that it is being done to bring within the tax net monies paid by the closely held companies to their principal shareholder in the guise of loan and advances to avoid payment of tax. Therefore, if the said background is kept in mind, it is clear that provisions of Section 2(22)(e) of 1961 Act, which is pari materia with

Section 2(6A)(e) of 1922 Act, plainly seeks to bring within the tax net accumulated profits which are distributed by closely held companies to its shareholder in the form of loans. The purpose being that persons who manage such closely held companies should not arrange their affairs in a manner that they assist the shareholder in avoiding the payment of taxes by having these companies pay or distribute, what would legitimately be dividend in the hands of the shareholder, money in the form of an advance or loan.

2. From the above it is clear that provisions of Section 2(22)(e) are applicable to all the corporate entities in which public is not substantially interested i.e. closely held companies only. Section 2(22)(e) of the Income Tax Act deals with the issue of "Deemed Dividend". Nomenclature of this section connotes that this section has been brought on statue as "Deeming Fiction". It means that the income termed as dividend is actually not dividend distributed by a closely held company but the amount paid is still treated as dividend and hence the term "Deemed Dividend".

3. Analogous provision of deemed dividend was there in Section 2 of the Income Tax Act'1922 in the form of Section 2(6A)(e). Therefore, it may be seen that the provisions of Section 2(22)(e) are preceded by Section 2(6A)(e) of the old act. The legislative intent to bring this provision in the statue related to taxation of any advance or loan to a share holder, being a person who is the beneficial owner of shares holding not less than 10% of voting power, in a closely held company, as deemed dividend in the hands of shareholder. Shareholder for the purpose of Section 2(22)(e) means being a person who is the beneficial owner of shares (not being shares entitled

to a fix rate of dividend whether with or without a right to participate in profits). It means only equity shareholder who has substantial interest in a company in which public is not substantially interested has to have substantial interest in the lending company i.e. 10% or more of voting power. As far as voting power is concerned, in a case where individual is a shareholder not only in his individual capacity but also a shareholder in the capacity of a 'Karta' of HUF, then the voting power computation would include the total voting power in both the capacities. Similarly, if an individual is a shareholder (Major) in his individual capacity and also hold voting power on behalf of a minor shareholder, then also the total voting power would be taken into account.

4. The fiction of deemed dividend is not restricted to a beneficial owner of shares only, but is extended to any concern also, in which such share holder is a member or a partner and in which he has a substantial interest. Substantial interest means, that person is entitled to not less than 20% of the income of such concern.

5. In order to attract the provisions of Section 2(22)(e), the important consideration is that, there should be loan/advance by a company to is shareholder. Every amount paid must make the company a creditor of the shareholder of that amount. But at the same time, every payment by company to its shareholder may not be a loan/advance and thereby fall within the ambit of Section 2(22)(e) i.e. "Deemed Dividend."

6. The scope of Section 2(22)(e) widened as a result of amendment made by Finance Act'1987, i.e. w.e.f. A.Y. 1998-99. If any payment is made after 31/05/1987, by a closely held company, of any sum by way of advance or loan to a shareholder, who

is beneficial owner of shares holding not less than 10% of voting power or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest, then such loan/advance will be treated as "Deemed Dividend" in the hands of such shareholder/concern. Besides, only a loan/advance can be deemed to be dividend and that too only to the extent that the company has on the date of the payment "accumulated profits". Thus, from the above, it is abundantly clear that following conditions must be satisfied,

a. The company must be a company in which public are not substantially interested i.e. a closely held company. It means that the company which is paying loan/advance should be a closely held company but the company which is receiving such loans/advances can be a public company or a listed company on the stock exchange.

b. The borrower must be a shareholder having a substantial interest in the company on the date on which loan/ advance is given. (Not less than 10% of voting power).

c. Loan advanced by company can be deemed to be dividend only to the extent the company possesses accumulated profits on the date of loan/advance being given.

d. The loan must not have been advanced by company in the ordinary course of its business.

e. Loan/advance given to a concern, in which share holder has substantial interest (entitled to 20% or more of the income of such concern).

f. Loans and advances given during the year i.e. year under consideration can only be taken into account for the purpose of deemed dividend and loans and advances

given in earlier years should not be added to the loans and advances of year under consideration.

g. Further, as per the provisions of Section 194, TDS under Section 194 is required to be deducted by the company, even when the loans and advances given to a shareholder is being treated as deemed dividend in the hands of shareholder. However, the provisions of Section 194 are restricted to registered shareholder of the company. The AO should refer the matter to the AO of TDS section in this regard.

h. The loan or advance mentioned in Section 2(22)(e) includes any deposit including Inter Corporate Deposit (ICD).

i. As far as the addition to be made on account of deemed dividend under Section 2(22)(e) is concerned, the same can be made in the course of assessment proceedings of search cases under Section 153A of the IT Act also.

7. The explanation 1 & 2 appended to Section 2(22)(e) defines accumulated profits and states that it will include all the profits i.e. commercial profits. The apex court in the case of P.K. Badiani (1976) 105 ITR 642 has held that the term "Profits" appearing in Section 2(6a)(e) of Indian Income Tax Act'1922, which corresponds to Section 2(22)(e) of the 1961 Act, means profits in the commercial sense, i.e. profits made by company in the usual and true sense of the term. It has also been held that development rebate reserves created out of the company's profits constitute a part of the accumulated profits of a company. In view of this judgment it is clear that all the reserves created by company would form a part of accumulated profits for the purpose of Section 2(22)(e). Accumulated profit for the purpose of this section is required to be calculated till the date

of payment of each loan/advance. This is in accordance with the decision of the supreme court in the case of Tarulata Shyam vs. CIT (1977) 108 ITR 345(SC). Further, any repayment of loan/advance during the same year after the advancement of the loan is not to be deducted from the accumulated profits. Moreover, in the case of NCK Sons Exports (P) Ltd. vs. ITO (2006) 102 ITD 311 (MUM), it was held that, there is no ambiguity in the definition of "accumulated profits given in explanation 1 and 2 of Section 2(22)(e) and for the purpose of this section the accumulated profits include all profits of the company upto the date of distribution or payment referred to in sub clause (e). Explanation 2 of Section 2(22)(e) very clearly says that accumulated profit referred to in sub clause (e) shall include all profits of the company upto the date of distribution or payment. Meaning thereby, in case the date of payment falls within the year under consideration then the whole year profit will be taken into account to compute the profit upto the date of payment i.e. if payment is made after 200 days from the beginning of the financial year then the profit of the year till the date of payment would be 200/365* Profit of the year. As far as a closely held company, being a builder and following project completion method is concerned, accumulated profit has to be determined till the date of payment of advance/loan.

8. Explanation 3 appended to Section 2(22)(e) defines concern and it means a HUF, or a firm or an AOP or BOI or a company. Explanation 3 also defines substantial interest in a concern other than a company means beneficially entitled to not less than 20% of the income of such concern. In fact Bombay High Court in the case of Sadhna Textile Mills (p) Ltd. vs. CIT(1991) 188 ITR 318 has dealt with question of holding and subsidiary companies and has held that section

2(22)(e) applies to a holding company and a subsidiary company. Therefore, High Court in this case has held that loan given by subsidiary company to the holding company would fall within the ambit of Section 2(22)(e).

9. As far as the issue of giving loan/advance to a firm is concerned, the same was decided by Delhi High Court in the case of CIT vs. National Travel Services (2012) 347 ITR 305, wherein, it was held that for the purpose of Section 2(22)(e), partnership firm is to be treated as the shareholder and it is not necessary that firm has to be a registered shareholder. In this case the loan was given to partnership firm and partnership firm was not the registered shareholder of the company, but the partners of the firm were registered shareholders.

10. It is a moot question as to whether the expression, "being a person as a beneficial owner of shares qualifies the word shareholder:" i.e. whether to attract the provisions of Section 2(22)(e), the person to whom the loan or advance is made should be a shareholder as well as beneficial owner. In the above mentioned case of CIT vs. National Travel Services, Delhi High Court concluded that the beneficial owner may not be a registered shareholder or vice versa. However, Allahabad High Court in the case of CIT vs. Rajkumar Singh and company (2007) 295 ITR 9 held that conditions stipulated in Section 2(22)(e) were not satisfied where a firm was not shareholder of a company which gave the loan and the partners of the firm were shareholder in the books of company. This judgment was rendered following Supreme Court judgment in the case of C.P. Sarathy Mudaliar's case (1972) 83 ITR 170, wherein, in Supreme Court held

that only loan advanced to Shareholder could be deemed dividend under Section 2(6)(A)(e) of the old Act. However, Delhi High Court in the case of National Travels Services (supra) elaborately analyzed this issue and concluded that in case it is accepted that firm not being a legal entity cannot become a shareholder of a company and in case loan has been advanced to a firm whose partners are shareholders, then it would frustrate the provisions of Section 2(22)(e), and will lead to absurd results. Therefore, loan received by a firm, whose partners are registered shareholders of the company which advanced the loan, would fall within the ambit of Section 2(22)(e).

11. The next issue relates to loan and advances given by closely held company to its shareholders per se and in which circumstances it will fall within the ambit of Section 2(22)(e) of the IT Act'1961. Only two exclusions have been provided in the section itself. First, if the company is in the business of money lending and secondly if the payment is made in ordinary course of business. A company can be held to be in the business of money lending only when it has license from RBI or company is an NBFC.

12. In this regard, catena of judicial pronouncements reveal that normally all the loan/advances given by closely held company to its shareholder are treated as deemed dividend in the hands of shareholder. Ratio-decidendi of various cases decided in favor of revenue is as under:-

    - **P. Sarada Vs CIT(SC) 229 ITR 444:** "The fact that loan or advance was ultimately adjusted at the end of the year against the credit balance of another shareholder will not alter the position. Account of another shareholder was

not debited on various dates of withdrawals and hence it cannot be said that the assessee was paid money out of the funds lying to the credit of the other shareholder."

- **Tarulata Shyam & Ors. Vs CIT(SC) 108 ITR 345:** "Loan advanced to a shareholder was re-paid within 23 days still deemed dividend under Section 2(22)(e)- If the assessee comes under the letter of law, he has to be taxed, however great the hardship may appear to the judicial mind to be."
- **Rajesh P. Ved Vs ACII (ITAT, Mum) 1 ITR (Trib) 275:** "Accumulated profits means profits upto the date of payment of loan – subsequent repayment of loan not to be considered amount credited to wards remuneration of shareholder cannot be set off against the alleged loan considered as deemed dividend."
- **CIT Vs P.K. Abubucker (Mad) 259 ITR 507:** "Advance to shareholder for building construction which will be later on taken on lease by company- As per the agreement, such advance to be set off against future rent- still deemed dividend arises and is taxable."
- **M.D. Jindal vs CIT(Cal) 164 ITR 28:** Building material advanced to shareholder for construction advance to be set off against purchase consideration when the company buys some flats from assessee later on- value of advance in kind is also taxable as deemed dividend."
- **L. Alagusundaram Chettiar vs CIT(SC) 252 ITR 893:** "Company advancing large amount to low-paid employee. Employee advancing loan to assessee, the Managing Director of the said company. Deemed dividend to be assessed in the hands of assessee."

- **CIT vs. T.P.S.H. Sokkalal (99) 236 ITR 981 (MAD):** Shares held on behalf of minor children has to be included as the guardian can exercise voting power in respect of those shares in addition to shares held by guardian in his individual capacity.

13. The Assessing Officer has to give a finding of fact that loan/ advance has been made during the year under consideration. Assessing Officer has to further describe the details of each and every date during the year along with amounts paid by closely held company to the shareholder on each date. These amounts have to be compared with accumulated profit on the day of advance and then it must be analyzed whether company giving loan/advance is in business of money lending or not and whether such loan is being given in ordinary course of business. Actual cash payment is not necessary, relationship of debtor and creditor is sufficient to invoke the provision of Section 2(22)(e) as held in the case of T. Sundaram Chattiar & ANR. vs. CIT(Mad) 49 ITR 287.

14. **Action Points for the Assessing Officers:-**

I. AO needs to go through the payments made by a closely held company i.e. analysis of balance sheet of the company.

II. Payment made to a person by the company should be beneficial owner of shares i.e. holding not less than 10% of the voting power or to any concern in which such shareholder is a member or partner. Holding of 10% voting power in a closely held company means holding not less than 10% of equity shares, either in individual capacity or in addition to voting power as a "Karta" of HUF or on behalf of a minor. Share holding pattern in the holding company

is of utmost importance. Similarly, ascertaining the profit ratio in concern where shareholder is a member or partner to have substantial interest is also equally important.

III. It should be confirmed that company making payment of loan/advance is a closely held company and its shareholders holding 10% or more voting power should also hold substantial interest in such concern (Person who is entitled to not less than 20% of the income of such concern). The concern may be a firm or AOP/BOI or a company including a public limited/listed company.

IV. In case loans/advances including ICDs/Deposits etc are made to shareholders/concerns in which shareholders have substantial interest or made on behalf of shareholders, then investigation should be made to ascertain the incidence of "Deemed Dividend."

V. The closely held company should have accumulated profits which includes reserves and also include proportionate profit, of the profit of the whole year.

VI. In no case quantum of "Deemed Dividend" under Section 2(22)(e) can exceed the amount of accumulated profits on the date of payment of loan/advance.

VII. Loan/advance paid during the year under consideration only, can be treated as "Deemed Dividend" and repayment made during the year should not be reduced from the loan/advance paid.

VIII. Any advance or loan given including a running account can be treated as "Deemed Dividend" except in a case where loan/advance made to a shareholder or the said concern by a company in the course of business of money lending.

IX. All the factual details i.e. shareholding pattern of closely held company status of recipient of loan/advance i.e. beneficial shareholder either in individual capacity or as a member/partner of a concern, quantum of accumulated profits should be clearly mentioned in the body of assessment order.

X. Assessing Officer of TDS wing should be intimated about "Deemed Dividend" as it entails TDS under Section 194 of the IT Act, regarding which action has to be taken by AO of TDS wing.

2 Exemption Under Special Provisions - Sections 10A/10AA/10B

S. K. Gupta
DIT(Exemption), Ahmedabad

A Section 10A.

Special provision in respect of newly established undertakings in free trade zone, etc.

The benefit in respect of newly established Industrial Undertaking in FTZ, EHTP SEZ or STP is Available to **all** Assessees on Export of Certain Articles or things or software

Subject to the following Conditions: -

(i) Should not be formed by splitting up or reconstruction of unit already in existence

(ii) Should not be formed by transferring machinery or plant previously used. In certain conditions as specified in the Act second hand machinery is allowed.

(iii) Sale proceeds should be brought in convertible forex within 6 months from the end of P.Y.

(iv) Report in Form No.56F

(v) Filing of return within due date under Section 139(1)

(vi) **Tax Holiday: - For units which have begun prior to AY 2003-04,**100% profit from export of such article, thing, software for 10 consecutive A.Y. from the A.Y. relevant to P.Y. in which it begun to manufacture subject to some conditions and restrictions mentioned in the Act. However for AY 2003-04 it is 90%. **For units which have begun on or after AY 2003-04** the deduction is

100% for first 5 years and 50% for next 2 years and next 3 years 50% subject to creation of "Special Economic Zone Reinvestment Allowance Reserve Account" and fulfillment of conditions relating thereto failing which the unutilized or wrongly utilised Reserve would be deemed income as per the provisions of the Act and the Rules.

(vii) **No deduction for A.Y.2012 – 13 or thereafter**

(viii) The computation of profits is as per the following formula:-

$$\text{Profit from the business of the undertaking} \times \frac{\text{Export Turnover}}{\text{Total Turnover of Undertaking}}$$

(ix) No deduction shall be allowed under Section 80HH or Section 80HHA or Section 80-I or Section 80-IA or Section 80-IB in relation to the profits and gains of the undertaking

(x) No loss referred to in sub-section (1) of Section 72 or sub-section (1) or sub-section (3) of Section 74, in so far as such loss relates to the business of the undertaking, shall be carried forward or set off where such loss relates to any of the relevant assessment years [ending before the 1st day of April, 2001]

(xi) In computing the depreciation allowance under Section 32, the written down value of any asset used for the purposes of the business of the undertaking shall be computed as if the assessee had claimed and been actually allowed the deduction in respect of depreciation for each of the relevant assessment year.

(xii) Market value of goods to be transferred to be as per market rate on the date of transfer and as per arms length price as per the provisions of sub-section (8) and sub-section (10) of Section 80-IA.

(xiii) The provisions of this section does not apply to any undertaking, being a Unit referred to in clause (zc) of section 2 of the Special Economic Zones Act, 2005, which has begun or begins to manufacture or produce articles or things or computer software during the previous year relevant to the assessment year commencing on or after AY 2006-07 in any Special Economic Zone.

(xiv) **Provisions related to amalgamation and demerger:-** The benefit under this section is not available to the amalgamating or the demerged company for the previous year in which the amalgamation or the demerger takes place; and it is available to the the amalgamated or the resulting company as it would have been available to the amalgamating or the demerged company if the amalgamation or demerger had not taken place.

2. Definitions. – For the purposes of this section, –

1. "computer software" means –

   (*a*) any computer programme recorded on any disc, tape, perforated media or other information storage device; or

   (*b*) any customized electronic data or any product or service of similar nature, as may be notified by the Board,

   which is transmitted or exported from India to any place outside India by any means;

2. "export turnover" means the consideration in respect of export [by the undertaking] of articles or things or computer software received in, or brought into, India by the assessee in convertible foreign exchange in accordance with sub-section (3), but does not include freight, telecommunication charges

or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India;

3. The Assessing Officer should look into the following important factual areas:

Section 10A:

i) The year in which the manufacture or production begins must be noted as this is very crucial for the allowance of deduction.

ii) The undertaking must be a new undertaking and must not be formed by splitting or re-construction or transfer of old machinery, plant etc.

iii) The undertaking must be in a Free Trade Zone, or Economic Trade Zone or Software Technology Park or SEZ.

iv) The sale proceeds must be obtained in foreign exchange from export outside India within 6 months from the end of previous year.

v) There must be an audit report as prescribed along with the return of income.

vi) The assessee must not be claiming deduction under Sections 80HH, 80HHA, 80I, 80IA, 80IB with respect to the same undertaking.

vii) The assessee must be allowed, even if not claimed, depreciation under Section 32.

viii) The sale proceeds of the goods must be on market value and not understated.

ix) If the claim is made for the 8th, 9th or 10th year, then it is

only allowed on creation of reserved account. This must be seen.

x) If reserved account is not utilized within the specified period, or utilized for some other purpose, it would be a deemed income.

xi) Deduction is not available for A.Y.2012-13 and subsequent years.

xii) The export turnover does not include freight, telecommunication charges or insurance attributable to the goods outside India or any expenses incurred in foreign exchange in rendering of services outside India.

xiii) The deduction is not available on other income like interest etc.

4. Critical Areas in draft of assessment order:

- The date of issue and service of original and first notice under Section 143(2) must be mentioned in the beginning of the assessment order.
- While drafting the assessment order, the Assessing Officers must bring out the facts very clearly on the basis of which the deduction is being reduced or disallowed.
- If any inquiry has been made, then report of the inquiry or the statement recorded which are being used against the assessee must be confronted to the assessee before making the disallowance or reducing the claim. The fact of confronting the inquiry report to the assessee must also be brought on record and mentioned in the assessment order.
- If statement of any third party is being relied upon against the assessee then cross-examination opportunity must be provided to the assessee. These facts of providing cross-

examination opportunity must be brought on record and mentioned in the assessment order.

- The reply of the assessee to the inquiry report or the statement recorded under cross-examination must also be part of assessment order.

B Section 10AA.

Special provisions in respect of newly established Units in Special Economic Zones.

The benefit in respect of newly established Industrial Undertaking in SEZ is Available to all Assessees on Export of Certain Articles or things or software

Subject tothe following Conditions: -

i. Begin its production, etc. on or after 01-04-2005 relevant to AY 2006-07.

ii. Should not be formed by splitting up or reconstruction of unit already in existence

iii. Should not be formed by transferring machinery or plant previously used. In certain conditions as specified in the Act second hand machinery is allowed.

iv. Report in Form No.56F

v. **Tax holiday:-** 100% of the profits from the export for the first 5 years from the beginning and 50% for next 5 years and for further 5 Years 50% subject to creation of "Special Economic Zone Reinvestment Allowance Reserve Account" and fulfillment of conditions relating thereto failing which the unutilized or wrongly utilised Reserve would be deemed income as per the provisions of the Act and the Rules.

vi. The computation of profits is as per the following formula:-

$$\text{Profit from the business of the undertaking} \times \frac{\text{Export Turnover}}{\text{Total Turnover of Undertaking}}$$

vii. Loss referred to in sub-section (1) of Section 72 or sub-section (1) or sub-section (3) of Section 74, in so far as such loss relates to the business of the undertaking, being the Unit shall be allowed to be carried forward or set off

viii. No deduction shall be allowed under Section 80HH or Section 80HHA or Section 80-I or Section 80-IA or Section 80-IB in relation to the profits and gains of the undertaking

ix. No loss referred to in sub-section (1) of Section 72 or sub-section (1) or sub-section (3) of Section 74, in so far as such loss relates to the business of the undertaking, shall be carried forward or set off where such loss relates to any of the relevant assessment years [ending before the 1st day of April, 2006]

x. In computing the depreciation allowance under Section 32, the written down value of any asset used for the purposes of the business of the undertaking shall be computed as if the assessee had claimed and been actually allowed the deduction in respect of depreciation for each of the relevant assessment year.

xi. The Market value of goods to be transferred to be as per market rate on the date of transfer and as per arms length price as per the provisions of sub-section (8) and sub-section (10) of Section 80-IA.

xii. The profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.

xiii. **Subject to some conditions mentioned in the Act the Deduction is available only for unexpired period if claim made under Section 10A**

xiv. **Provisions relating to amalgamation or demerger:-** The benefit under this section is not available to the amalgamating or the demerged company for the previous year in which the amalgamation or the demerger takes place; and it is available to the the amalgamated or the resulting company as it would have been available to the amalgamating or the demerged company if the amalgamation or demerger had not taken place.

2. Definitions

a. "export turnover" means the consideration in respect of export by the undertaking, being the Unit of articles or things or services received in, or brought into, India by the assessee but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things outside India or expenses, if any, incurred in foreign exchange in rendering of services (including computer software) outside India;

b. "export in relation to the Special Economic Zones" means taking goods or providing services out of India

from a Special Economic Zone by land, sea, air, or by any other mode, whether physical or otherwise;

3. The Assessing Officer should look into the following important factual areas:

Section 10AA:

i) This is applicable to newly established units in SEZs and must have begun manufacture or production or articles in A.Y.2006-07 onwards.

ii) The unit must not be formed by splitting or re-construction of an already existing business and old machineries must not be used.

iii) The assessee must file audit report along with the Income-tax return.

iv) The assessee must not be claiming deduction under Sections 80HH, 80HHA, 80I, 80IA, 80IB with respect to the same undertaking.

v) The assessee must be allowed, even if not claimed, depreciation under Section 32.

vi) The sale proceeds of the goods must be on market value and not understated.

vii) If the unit/undertaking has already claimed benefit under Section 10A, then under this section benefit is available only for unexpired period.

viii) The benefit is available for 6th year onwards only on creation of SEZ re-investment reserve account.

ix) If the amount credited to the reserve account is not utilized before the expiry of the specified period or utilized for

some other purpose, then it will be treated as deemed income.

x) The export turnover does not include freight, telecommunication charges or insurance attributable to the goods outside India or any expenses incurred in foreign exchange in rendering of services outside India.

xiv) The deduction is not available on other income like interest etc.

4. Critical Areas in draft of assessment order:

- The date of issue and service of original and first notice under Section 143(2) must be mentioned in the beginning of the assessment order.
- While drafting the assessment order, the Assessing Officers must bring out the facts very clearly on the basis of which the deduction is being reduced or disallowed.
- If any inquiry has been made, then report of the inquiry or the statement recorded which are being used against the assessee must be confronted to the assessee before making the disallowance or reducing the claim. The fact of confronting the inquiry report to the assessee must also be brought on record and mentioned in the assessment order.
- If statement of any third party is being relied upon against the assessee then cross-examination opportunity must be provided to the assessee. These facts of providing cross-examination opportunity must be brought on record and mentioned in the assessment order.
- The reply of the assessee to the inquiry report or the statement recorded under cross-examination must also be part of assessment order.

C Section 10B

Special provisions in respect of newly established hundred percent export-oriented undertakings.

The benefit in respect of newly established 100% Export Oriented Units is Available to **all** Assessees on Export of Certain Articles or things or software

Subject to the following Conditions:

(i) Undertaking must be approved as a 100% EOU.

(ii) The Income Tax Return must be filed on or before the due date under Section139(1).

(iii) The assessee has a choice not to claim the deduction for any particular AY if he makes a declaration before the AO, before the due date of filing of return for that AY.

(iv) Manufacture of any article thing or software

(v) Should not be formed by splitting up or reconstruction of unit already in existence

(vi) Should not be formed by transferring machinery or plant previously used. In certain conditions as specified in the Act second hand machinery is allowed.

(vii) There must be repatriation of sale proceeds into India within 6 months.

(viii) Report in Form No.56G

(ix) Audit of Books of Accounts.

(x) **Tax Holiday: -** 100% profit from export of such article, thing, software for 10 consecutive A.Y. from the A.Y. relevant to P.Y. in which it begun to manufacture. The deduction is 90% for AY 2003-04.

(xi) No deduction for A.Y.2012 – 13 or thereafter

(xii) The computation of profits is as per the following formula:-

$$\text{Profit from the business of the undertaking} \times \frac{\text{Export Turnover}}{\text{Total Turnover of Undertaking}}$$

(xiii) No loss referred to in sub-section (1) of Section 72 or sub-section (1) or sub-section (3) of Section 74, in so far as such loss relates to the business of the undertaking, shall be carried forward or set-off where such loss relates to any of the relevant assessment years [ending before the 1st day of April, 2001];

(xiv) No deduction shall be allowed under Section 80HH or Section 80HHA or Section 80-I or Section 80-IA or Section 80-IB in relation to the profits and gains of the undertaking; and

(xv) In computing the depreciation allowance under section 32, the written down value of any asset used for the purposes of the business of the undertaking shall be computed as if the assessee had claimed and been actually allowed the deduction in respect of depreciation for each of the relevant assessment year.

(xvi) The Market value of goods to be transferred to be as per market rate on the date of transfer and as per arms length price as per the provisions of sub-section (8) and sub-section (10) of section 80-IA.

(xvii) The profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits

and gains derived from the export of computer software outside India

(xviii) For the purposes of this section, "manufacture or produce" shall include the cutting and polishing of precious and semi-precious stones

(xix) **Provisions relating to amalgamation or demerger**:- The benefit under this section is not available to the amalgamating or the demerged company for the previous year in which the amalgamation or the demerger takes place; and it is available to the the amalgamated or the resulting company as it would have been available to the amalgamating or the demerged company if the amalgamation or demerger had not taken place.

2. Definitions

- "export turnover" means the consideration in respect of export [by the undertaking] of articles or things or computer software received in, or brought into, India by the assessee in convertible foreign exchange in accordance with sub-section (3), but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India;
- "hundred per cent export-oriented undertaking" means an undertaking which has been approved as a hundred per cent export-oriented undertaking by the Board appointed in this behalf by the Central Government in exercise of the powers conferred by section 14 of the Industries (Development and Regulation) Act, 1951 (65 of 1951), and the rules made under that Act;

3. The Assessing Officer should look into the following important factual areas:

Section 10B:

i) This is applicable to newly established 100% export oriented undertakings.

ii) No deduction is allowed under this section for any undertaking for A.Y.2012-13 and subsequent years.

iii) For claiming the deduction return has to be furnished on or before due date of filing the return.

iv) The undertaking must be a new undertaking and must not be formed by splitting or re-construction or transfer of old machinery, plant etc.

v) The sale proceeds must be obtained in foreign exchange from export outside India within 6 months from the end of previous year.

vi) There must be an audit report as prescribed along with the return of income.

vii) The assessee must not be claiming deduction under Sections 80HH, 80HHA, 80I, 80IA, 80IB with respect to the same undertaking.

viii) The assessee must be allowed, even if not claimed, depreciation under Section 32.

ix) The sale proceeds of the goods must be on market value and not understated.

x) The export turnover does not include freight, telecommunication charges or insurance attributable to the goods outside India or any expenses incurred in foreign exchange in rendering of services outside India.

xi) The deduction is not available on other income like interest etc.

4. Critical Areas in draft of assessment order:

- The date of issue and service of original and first notice under Section 143(2) must be mentioned in the beginning of the assessment order.
- While drafting the assessment order, the Assessing Officers must bring out the facts very clearly on the basis of which the deduction is being reduced or disallowed.
- If any inquiry has been made, then report of the inquiry or the statement recorded which are being used against the assessee must be confronted to the assessee before making the disallowance or reducing the claim. The fact of confronting the inquiry report to the assessee must also be brought on record and mentioned in the assessment order.
- If statement of any third party is being relied upon against the assessee then cross-examination opportunity must be provided to the assessee. These facts of providing cross-examination opportunity must be brought on record and mentioned in the assessment order.
- The reply of the assessee to the inquiry report or the statement recorded under cross-examination must also be part of assessment order.

D. CASE LAWS RELEVANT FOR Section 10A, 10AA &10B

1. Condition that return should be filed within due date is mandatory.

M/s. Saffire Garments vs. ITO (ITAT Special Bench) (Rajkot) 04.12.2012

S. 10A: Condition that ROI should be filed within due date is mandatory. For AY 2006-07, the assessee filed a ROI on 31.1.2007 when the due date was 31.12.2006. The assessee claimed s. 10A deduction. The AO &CIT(A) rejected the claim by relying on the Proviso to s. 10A(1A). The Special Bench had to consider whether the Proviso to s. 10A(1A) was mandatory or directory and whether s. 10A deduction could be allowed even to a belated return. HELD by the Special Bench: The Proviso to s. 10A(1A) provides that "no deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under Section 139(1)". The assessee's argument that the said Proviso is merely directory and not mandatory is not acceptable. The Proviso is one of the several consequences (such as interest under Section 234A) that befall an assessee if he fails to file a ROI on the due date. As the other consequences for not filing the ROI on the due date are mandatory the consequence in the Proviso cannot be held to be directory (**Shivanand Electronics** 209 ITR 63 (Bom) & other judgements distinguished).

2. **Specific conditions of sections under which claim is made has to be followed.**

Commissioner of Income tax VS. Regency Creations Ltd. [2012] 27 taxmann.com 322 (DELHI)Assessment years 2003-04, 2004-05, 2006-07 and 2007-08 – **Whether though considerations which apply for granting approval under Sections 10-A and 10-B may to an extent, overlap, yet deliberate segregation of these two benefits by statute reflects Parliamentary**

intention, that to qualify for benefit under either, specific procedure enacted for that purpose has to be followed - Held, yes – Whether, therefore, approval granted to a 100 per cent EOU set up under Software Technology Park Scheme cannot be deemed to be an approval under section 10-B - Held, yes [Para 14] [In favour of revenue] Circulars and Notifications : Circular Nos. 1 of 2005, dated 6-1-2005, 149/194/2004/TPL, dated 6-1-2005, 200/20/2006, dated 31-3-2006 and 694, dated 23-11-1994; Instruction No. 1 of 2006, dated 6-1-2005

3. **Reopening under Section 147 justifiable even after 4 years under certain conditions.**

Siemens Information Systems Ltd. VS. Assistant Commissioner of Income-tax[2012] 20 taxmann.com 666 (BOM.) / [2012] 207 TAXMAN 132 (BOM.) (MAG.) / [2012] 343 ITR 188 (BOM.) Assessment year 2004-05 - Assessee-company claimed deduction under section 10A which was allowed by Assessing Officer without specifically dealing with eligibility of assessee to said claim - During course of assessment proceedings for subsequent assessment year 2006-07, materials on record revealed that units of assessee were not independent units; no independent accounts were maintained and there was an overlapping of work and use of resources amongst units and several non section 10A activities were being carried on in section 10A units - On basis of such disclosure Assessing Officer sought to reopen assessment - **Whether even if reopening of assessment had taken place beyond a period of four years of end of relevant assessment year reopening**

assessment under section 147 was justified - Held, yes [In favour of revenue]

4. **Deduction is to be allowed only after allowing depreciation.**

   Siemens Information Systems Ltd. VS. Deputy Commissioner of Income-tax, Circle 7(2) [2012] 19 taxmann.com 6 (MUM.) / [2012] 135 ITD 196 (MUM.) / [2012] 146 TTJ 303 (MUM.) Assessment year 2006-07 - **Whether deduction under section 10A/10B has to be allowed only after deducting depreciation from profits of eligible business even though such a claim for depreciation has not been raised by assessee - Held, yes** [In favour of revenue]

5. **Conditions for Adjustment of unabsorbed depreciation.**

   - **Phoenix Lamps Ltd. VS. Additional Commissioner of Income-tax, Range, Noida** [2009] 29 SOT 378 (DELHI) / [2009] 126 TTJ 945 (DELHI) - Assessment year 2003-04 - **Whether in view of Circular No. 7/2003, dated 5-9-2003 where unabsorbed depreciation for assessment years 1993-94 to 1995-96 pertained to period ended before 1-4-2001, same could not be set off against income of assessment year 2003-04 - Held, yes.**CBDT's Circular No. 7 of 2003, dated 5-9-2003

   - **Commissioner of Income-tax, Cochin VS. Patspin India Ltd.** [2011] 15 taxmann.com 122 (KER.) / [2011] 203 TAXMAN 47 (KER.) / [2011] 245 CTR 97 (KER.)- Assessment years 2001-02 to 2005-06 -

Whether deduction under Section 10B on export profit of EOU has to be computed after setting off carried forward unabsorbed depreciation as provided under Section 32(2) - Held, yes

- **Commissioner of Income-tax, Karnataka I, Bangalore VS. HimatasingikeSeide Ltd.** [2006] 156 TAXMAN 151 (KAR.) / [2006] 206 CTR 106 (KAR.) / [2006] 286 ITR 255 (KAR.) Assessment year 1994-95 - Assessee was 100 per cent export oriented industrial unit in terms of Section 10B - Assessee filed nil return claiming exemption under Section 10B and it also adjusted brought forward unabsorbed depreciation against income from other sources - Assessing Officer, accepting assessee's claim, assessed total income at nil - Commissioner, in exercise of powers under Section 263, set aside assessment order holding that exemption under Section 10B was allowed on an inflated amount without deducting unabsorbed depreciation from export income - **Whether since Section 10B provides 100 per cent exemption for export income and not for other income, assessee could not have adjusted unabsorbed depreciation against other income so as to take exemption from payment of tax even for other income - Held, yes - Whether, therefore, order of Commissioner was to be sustained - Held, yes**

- **Assistant Commissioner of Income-tax VS. Jewellery Solutions International (P.) Ltd.** [2009] 28 SOT 405 (MUM.) - Assessment year 2003-04 - **Whether deduction under Section 10B is to be**

allowed from total income of assessee after adjusting unabsorbed depreciation - Held, yes

6. **Carry forward of losses**

Sword Global (I) (P.) Ltd. VS. Income-tax Officer, Co. Ward-II(1), Chennai [2010] 122 ITD 103 (CHENNAI) / [2008] 119 TTJ 427 (CHENNAI) - Assessment year 2003-04- **Whether carry forward losses of earlier assessment years have to be set off first against total income of relevant assessment year and, it is out of balance income only that deduction under Section 10B can be granted - Held, yes**

7. **Conversion of existing unit**

- **Infrasoft Technologies Ltd. Vs. Deputy Commissioner of Income-tax, Circle 11(1)(, New Delhi** [2012] 19 taxman.com 86 (DELHI)/[2012] 135 ITD 19 (DELHI)/[2012] 114 TTJ 622 (DELHI) – Assessment Year 2002-03 – Assessee-company set up its industrial undertaking in assessment year 1996-97 in domestic tariff area – Assessee-company received approval of STPI on 28/3/2000 – Thereupon, assessee claimed deduction under Section 10A which was rejected on two grounds (i) there was conversion of undertaking established in assessment year 1996-97 into STPI unit and (ii) ownership/beneficial interest had been transferred in year under consideration in terms of Section 10A(9) read with Explanation 1 – On instant appeal, it was noted that there was neither any whisper of a word in STP registration application suggesting that assessee had intended to set up a new unit nor such intention could be gathered from conduct of assessee

while seeking STP from competent authority – Rather, assessee had categorically mentioned in application for conversion of existing unit – It was also apparent that assessee had included infrastructure, staff and skilled labour etc. of existing unit in STP registration application form – **Whether on facts, finding of Commissioner (Appeals) that it was a case of conversion of an existing software export unit to STP unit which would connote conversion of a unit already set up, was to be upheld – Held, yes – Whether, moreover, since it was apparent that share holding of five persons as on 31/3/2002 had declined to 37.66 per cent from 100 per cent in the previous year when undertaking was set up, assessee's case was squarely covered by provisions of section 10A(9) – Held, yes – Whether in view of aforesaid, revenue authorities were justified in rejecting assessee's claim – Held, yes.**

- **Chenab Information Technologies (P.) Ltd. VS. Income-tax Officer, Ward 8(1)2[2008] 25 SOT 432 (MUM.)** - Assessment year 2001-02 - Assessee had established a software unit at SEEPZ which was not eligible for exemption under Section 10A - In order to take benefit of new policy of Government to exempt income from Software Technology Park Unit (STP Unit), assessee set up a new unit which was approved as STP unit - However, assessee's claim for exemption under Section 10A for certain amount being income of new unit was rejected by Assessing Officer holding that software development activity in new unit had been

carried out mainly by employees of existing unit and, thus, it was a mere case of splitting/reconstruction of existing business - On appeal, Commissioner (Appeals) upheld order of Assessing Officer –

Whether since existing business of assessee was development of software and in new unit also, assessee had done same business using same employees, it could not be a case of different business requiring different specialization, being taken up for which setting up of a new unit could be said to have become a business necessity - Held, yes – Whether, moreover, merely because customers in new unit were different, it could not be a basis to hold that new unit was separate and independent - Held, yes – Whether, therefore, authorities below rightly concluded that new unit had been set up by splitting up of business of old unit and was, thus, not eligible for deduction under Section 10A - Held, yes

- **Income-tax Officer Ward-(1), Range-1, Trivandrum VS. Stabilix Solutions (P.) Ltd.** [2010] 8 taxmann.com 45 (COCH) - Assessment year 2004-05 - Assessee-company set up a 100 per cent export oriented undertaking by taking on sub-lease 4000 sq.ft. built up area from STPL which held leasehold rights in total area of 6000 sq.ft. - STPL also leased out plant and machinery to assessee-company in excess of statutory limit of 20 per cent - Both companies manufactured same product i.e., computer software and sold same to a particular company abroad - Even

employees of both companies, who represented human capital were headed by same functional head - **Whether, on facts, it could be concluded that assessee's undertaking stood formed almost wholly by transfer of resources, including plant and machinery, from STPL, and, therefore, it was not entitled to deduction under Section 10B as it failed to fulfill conditions stipulated under section 10B(2) - Held, yes**

8. **Sale proceeds must be brought in India in foreign exchange.**

- **Commissioner of Income-tax, Cochin VS. Electronic Controls & Discharge Systems (P.) Ltd**. [2011] 13 taxmann.com 193 (KER.) / [2011] 202 TAXMAN 33 (KER.) / [2011] 245 CTR 465 (KER.) Assessment years 2003-04 and 2004-05 - **Whether Section 10A provides for exemption only on profits derived on export proceeds received in convertible foreign exchange - Held, yes – Whether, therefore, benefit of exemption under section 10A cannot be extended to local sales made by units in Special Economic Zone, whether as part of domestic tariff area sales or as inter-unit sales within zone or units in other zones - Held, yes** [In favour of revenue]

- **Swayam Consultancy (P.) Ltd. VS. Income-tax Officer**[2012] 20 taxmann.com 803 (AP.) / [2011] 336 ITR 189 (AP)- Assessment year 2007-08 - **Delivery of goods to a foreign buyer in India does not amount to export.**

- **Assistant Commissioner of Income-tax, Range 1, Hyderabad VS. Bodhtree Consulting Ltd.** [2010] 41 SOT 230 (HYD.) / [2010] 134 TTJ 214 (HYD.) - Assessment year 2004-05 –

Whether in order to avail deduction under section 10B sale proceeds must be receivable in convertible foreign exchange - Held, yes – Whether sale proceed received in convertible foreign exchange means 'actual receipt' and not deemed receipt - Held, yes – Whether if that object is kept in mind, amount received by an assessee in form of investment in equity shares in foreign exchange cannot be considered to be received in form of convertible foreign exchange - Held, yes – Whether merely because an assessee takes permission from RBI to receive foreign exchange in form of equity investment it does not lead to conclusion that assessee has received export proceeds in foreign exchange, as RBI has no role to play to suggest whether any investment/income for capitalization of expenditure is genuine or otherwise in terms of section 10B - Held, yes – Whether, therefore, an assessee would not be eligible for benefit of section 10B on such investments - Held, yes

9. **Transactions must be at Arm's Length pricing and the basis of calculation of export turnover and total turnover should be same.**

ADP (P.) Ltd. VS. Deputy Commissioner of Income-tax, Circle 1(1) [2011] 45 SOT 172 (HYD.) / [2011] 10 taxmann.com 160 (HYD.) / [2012] 144 TTJ 520 (HYD.) / [2012]

15 ITR(TRIB.) 203 (HYD.) **Assessment year 2004-05 – Whether in view of provisions of Rule 10B(4), data to be used in analyzing comparability of an uncontrolled transaction with an international transaction shall be data relating to financial year in which international transaction has been entered into, with only exception being that data of earlier two years may also be considered, if such data reveals facts which could have an influence on determination of transfer prices in relation to transactions being compared - Held, yes - Whether in view of above, data of subsequent period cannot be considered for comparison while determining arm's length price - Held, yes.** Section 10A of the Income-tax Act, 1961 - Free trade zone - Assessment year 2004-05 **- Whether while computing amount of exemption under section 10A in respect of software development services, if data link charges are reduced from export turnover, then same should also be reduced from total turnover - Held, yes**

10. **What is manufacture**

- **Deputy Commissioner of Income-tax VS. Girnar Industries** [2010] 35 SOT 11 (COCH)(URO)/[2009] 124 TTJ 517 (COCH) - Assessment year 2004-05 - Assessee-firm, engaged in activities of blending and export of different grades of tea, claimed exemption under section 10A –

Whether since term 'manufacture' as mentioned in section 10A did not include activity of 'blending' at relevant time, assessee's claim could not be allowed - Held, yes

- **ToniraPharma Ltd. VS. Assistant Commissioner of Income-tax, Bharuch Circle, Bharuch** [2010] 39 SOT 28 (AHD.) - Assessment year 2002-03 - **Whether in order to claim benefit of section 10B, essence of determining whether new article or thing is manufactured or produced lies in identity and use of commodity before undergoing processing and after processing - Held, yes – Whether if identity and character of article remain same then there is no manufacturing or production but where identity and character get transformed then it would be a manufacturing or production of new article or thing - Held, yes** - Assessee-company was engaged in business of manufacturing and export of bulk drugs, drugs intermediates, fine chemicals (organic/inorganic), etc. - During relevant assessment year, assessee purchased ascorbic acid FCC Grade IV and after processing, sold it as ascorbic acid IP Grade - Assessee's claim for exemption under section 10B was rejected –

  Whether since there was no material on record to show that use of ascorbic acid FCC Grade IV and ascorbic acid IP Grade was different, it was to be held that no manufacturing or production of any new article or thing had taken place and, therefore, assessee's claim was rightly rejected by authorities below - Held, yes

11. **Income having direct nexus with export only is eligible.**

- **Deputy Commissioner of Income-tax, Company Circle I(1), Chennai VS. Astron Document**

Management (P.) Ltd. [2011] 16 taxmann.com 33 (CHENNAI) / [2012] 49 SOT 46 (CHENNAI)(URO) - Assessment year 2004-05 - **Whether gains derived by an assessee on conversions of funds from EEFC account into Indian rupee account, does not have any proximate or direct nexus with export transaction and, therefore, will not be eligible for deduction under section 10B - Held, yes** - Section 10B of the Income-tax Act, 1961 - Export oriented undertaking - Assessment year 2004-05 –

Whether telecommunication charges attributable to delivery of software outside India by assessee-exporter had to be excluded from export turnover for working out deduction under section 10B whether or not billings of assessee specifically included such telecommunication expenses - Held, yes

- **Orchid Chemicals & Pharmaceuticals Ltd. VS. Joint Commissioner of Income-tax, Special Range-X**[2005] 97 ITD 277 (CHENNAI) / [2005] 98 TTJ (CHENNAI) 32 - Assessment year 1997-98 –

  Whether an assessee is entitled to claim deduction under section 10B of amount which it derives as direct profit by export of goods manufactured in its newly established hundred per cent export oriented unit [EOU] and any indirect or incidental profit cannot be regarded as profit earned out of main business activity - Held, yes – Whether deduction under section 10B can be allowed on interest income earned

by EOU from margin money deposited with bankers for obtaining letter of credit for import of raw materials - Held, no

- **Tocheunglee Stationery Mfg. Co. (P.) Ltd. VS. Income-tax Officer, Company Ward III(1)** [2006] 5 SOT 428 (CHENNAI) - Assessment years 2000-01 and 2001-02

  Whether for purpose of claiming deduction under section 10B, income should be derived from export business and form part of export turnover and assessee should show that profit was received from export for assessment year under consideration - Held, yes – Whether interest received by assessee on deposit made for purpose of getting bank guarantee in favour of Government of India to import goods free of duty was eligible for deduction under section 10B - Held, no

  Whether excess provision towards incentives and bonus for earlier years written back in books of account under section 41(1), refund of sales-tax, and resale value of special import licence, could be construed as income from export or as forming part of export turnover so as to be eligible for deduction under section 10B - Held, no

- **Tricom India Ltd. VS. Assistant Commissioner of Income-tax, Central Circle 41, Mumbai** [2010] 36 SOT 302 (MUM.) - Assessment year 2005-06 - Assessee was engaged in business of providing I.T. (Information Technology) enabled services and BPO transactions - During relevant assessment year, it claimed deduction under section 10B - On examination

of details of profits, Assessing Officer found that profit declared by assessee included interest on fixed deposits, miscellaneous income, etc. - Assessing Officer opined that under section 10B(1), deduction was allowable only on profits derived from export of articles or things or computer software and, therefore, no deduction was possible on interest income - Commissioner (Appeals) upheld order of Assessing Officer – **Whether expression 'derived from' cannot be ignored in Section 10B(1) because said expression involves only those items of profit eligible for deduction which are derived from such undertaking - Held, yes – Whether since, in instant case, interest income was generated from interest, on FDRs and surplus funds, same could not be held to have been derived from export of I.T. Services - Held, yes – Whether, therefore, authorities below rightly rejected assessee's claim in respect of interest income - Held, yes.** Words &Phrases : Words 'derived from' as occurring in section 10B of the Income-tax Act, 1961

- **Taj International Jewelers VS. Income-tax Officer, Ward 33(2), New Delhi** [2008] 19 SOT 587 (DELHI) – A.Y.2004-05 - Assessee entered into agreement with export house for export of its goods through them - In course of business assessee disclaimed certain export benefits in favour of export house and in lieu thereof received commission as reimbursement of expenses - Assessee claimed that said amount should have been treated as its business income for

purpose of deduction allowable under section 10B - Assessing Officer did not accept assessee's claim and held amount in question as income from other sources; consequently, he denied exemption under section 10B - Commissioner (Appeals) upheld order of Assessing Officer –

Whether since assessee had disclaimed export benefits in respect of certain goods and incentive was received in lieu of said disclaimer, proximate source of receipt was disclaimer of benefits and not export activities per se - Held, yes – Whether, therefore, while income might be attributable to export oriented unit of assessee, it could not be said that same was derived from unit - Held, yes - Whether, in such circumstances, authorities below rightly rejected assessee's claim - Held, yes

12. **Interest Income.**

- **Cadila Exports (P.) Ltd. VS. Deputy Commissioner of Income-tax** – [1994] 51 ITD 217 (AHD.) / [1994] 50 TTJ (AHD.) 603 Assessment year 1986-87 –

  Whether income earned by way of interest on deposits of surplus funds could be regarded as incidental to production of goods at industrial undertaking established in free trade zone and, therefore, exemption under section 10A could be allowed on such income - Held, no.

- **India Comnet International VS. Income-tax Officer**[2009] 185 TAXMAN 51 (MAD.) / [2008] 304 ITR 322 (MAD.) - Assessment year 2002-03 –

Whether interest income earned by assessee-company, being a 100 per cent export-oriented unit, on amount of export proceeds kept in foreign currency deposit account as permitted by FERA under Banking Regulations, would qualify for exemption under section 10A - Held, no

- **Commissioner of Income-tax VS. MenonImpex (P.) Ltd.** [2003] 128 TAXMAN 11 (MAD.) / [2003] 180 CTR 40 (MAD.) / [2003] 259 ITR 403 (MAD.) - Assessment year 1985-86 - Assessee had set up a new industrial undertaking in free trade zone - In course of business, assessee was required to open letters of credit with banks for which deposits were made - Interest earned on such deposits was claimed to be exempt on ground that it was derived from newly set up industrial undertaking - Such claim was negatived by Assessing Officer but was allowed by Tribunal –

  Whether mere fact that deposit made was for purpose of obtaining letters of credit which letters of credit were, in turn, used for purpose of business of industrial undertaking did not establish a direct nexus between interest and individual undertaking, and, therefore, assessee was not entitled to get benefit under section 10A - Held**, yes**

- **MKR Frozen Food Exports Ltd. VS. Income-tax Officer, Ward 6(1), New Delhi** [2010] 126 ITD 1 (DELHI) - Assessment year 1998-99 - Assessee was engaged in business of export of frozen foods and meals - For this purpose, overdraft facilities were

taken from bank to meet liquidity requirements - Subsequently, when assessee earned profit, money so generated was placed in fixed deposits with a bank - Assessee contended that deposits were placed with a view to reduce interest liability, and, therefore, interest income would partake character of profits and gains of business and became eligible for deduction under section 10B - **Whether since interest earned from bank deposits did not have direct or proximate connection with business of export of EOU, same would be taxable under residuary head, i.e., 'Income from other sources' and was not eligible for deduction under section 10B - Held, yes**

- **Assistant Commissioner of Income-tax VS. Shiva Shankar Granites (P.) Ltd.** [2004] 89 ITD 625 (HYD.) / [2004] 83 TTJ (HYD.) 802 - Assessment year 1993-94 –

  Whether interest on deposit towards bank guarantee money in favour of Central Excise & Customs Department as well as interest on deposit with State Electricity Board cannot be said to have been derived from industrial undertaking, and as such, are not eligible for benefit of exemption under section 10B - Held, yes

- **CG International (P.) Ltd. VS. Assistant Commissioner of Income-tax, Cir. 10(3), Mumbai** [2007] 13 SOT 280 (MUM.)Assessment year 2001-02 - Assessee-company, a hundred per cent export oriented unit, was engaged in business of manufacturing of plain and studded Jewellery and export thereof - Assessee claimed exemption qua interest income on

ground that interest was earned during ordinary course of export business as same was earned by it from fixed deposits kept with bank for issue of bank guarantees for business purposes and from EEFC account maintained with Bank of India - **Assessing Officer rejected assessee's reply and assessed interest income as assessee's income from other sources and, accordingly, held same as not exempt under section 10B - Whether Assessing Officer was justified - Held, yes**

13. **For computing the deduction all expenses relatable to that unit must be deducted.**

Nahar Spinning Mills Ltd. VS. Joint Commissioner of Income-tax, Range VII, Ludhiana[2012] 25 taxmann. com 342 (CHD.) / [2012] 54 SOT 134 (CHD.)(URO)-Assessment year 2007-08 - **Whether while computing profits and gains of eligible units under section 10B all expenditure relatable to such units are to be deducted for computing eligible profits - Held, yes – Whether therefore, remuneration paid to managing director being common expenditure between eligible units and non-eligible unit run by assessee-company it needed to be allocated in order to determine eligible profits of business under section 10B - Held, yes**

14. **Onus is on the successor company to prove that it is the successor.**

Synergies Casting Ltd. VS. Dy. Commissioner of Income-tax, Circle 3(2)/ Assistant Commissioner of Income-tax, Circle 3(3), Hyderabad[2011] 13

taxmann.com 17 (HYD.) / [2011] 139 TTJ 627 (HYD.) / [2011] 47 SOT 82 (HYD.)(URO)- Assessment years 2006-07 and 2007-08 - **Whether unless assessee who claims benefit under section 10B for unexpired period, establishes that it is a successor of a lessor and it fulfils all other necessary conditions in each year, it cannot claim benefit under section 10B for balance unexpired period - Held, yes –** 'SDAL' had an industrial undertaking with facilities of manufacturing of aluminium alloy wheels and was claiming relief under section 10B - Assessee-company took said unit on lease-license for operating and maintaining same to carry on manufacturing activity - Assessee claimed continuation of relief under section 10B for balance unexpired period, which was denied by revenue –

Whether since assessee-company had not proved that it was a successor to predecessor who was enjoying benefit of Section 10B and it was found to be only a lessee, having a right to use plant and machinery, claim of exemption under section 10B could not be allowed - Held, yes Circulars and Notifications : CBDT Circular F..No. 15/5/63-IT[A1]

15. **First year of claim must be established.**

- **Sami Labs Ltd. VS. Assistant Commissioner of Income-tax**[2012] 20 taxmann.com 785 (KAR.) / [2011] 239 CTR 510 (KAR.) / [2011] 334 ITR 157 (KAR.)- Assessment year 2002-03 –

  Starting point of limitation for claiming benefit flowing from section 10B would commence from year of manufacture or production of

undertaking; assessee would not be able to claim such deduction in subsequent years unless said initial test on date of starting point of limitation has been satisfied

- **Income-tax Officer, Ward 31(4), New Delhi VS. VinodChhabra**[2008] 20 SOT 328 (DELHI) - Assessment year 2001-02 - For relevant assessment year, assessee, a hundred per cent export oriented undertaking (EOU), claimed exemption under section 10B - Assessing Officer denied exemption under section 10B for certain reasons - He, however, allowed deduction under section 80HHC to assessee in respect of profits and gains derived from export of goods out of India - Commissioner (Appeals), on basis of exemption allowed under section 10B to assessee for assessment year 1994-95, allowed assessee's claim for exemption under section 10B - **Whether since from assessment order for assessment year 1994-95 it was not clear as to in which year assessee started hundred per cent EOU and further since neither Assessing Officer nor Commissioner (Appeals) had examined matter in light of provisions of section 10B, issue was required to be remitted to file of Assessing Officer to examine claim of assessee in light of provisions of section 10B - Held, yes – Whether if exemption under section 10B would be allowed, assessee would not be eligible for deduction under section 80HHC - Held, yes.** Assessment year 2001-02 - Assessee was deriving income from a hundred per cent EOU (Export Oriented Unit) and claimed deduction under section

10B in respect of interest earned on FDRs - **Whether since interest income earned by assessee on FDRs was not derived from export of eligible goods of hundred per cent EOU, assessee would not be eligible for exemption under section 10B in respect of interest income - Held, yes**

16. **Speculation profit not eligible.**

Assistant Commissioner of Income-tax, Circle-11(5), Bangalore VS. K. Mohan & Co. (Exports) (P.) Ltd. [2010] 126 ITD 59 (BANG.) / [2010] 130 TTJ 719 (BANG.) / [2011] 7 ITR(TRIB.) 507 (BANG.) - Assessment year 2005-06 - Assessee was engaged in business of manufacture and export of readymade garments - In order to avoid risk of loss due to foreign exchange fluctuation, it entered into forward contracts in respect of foreign exchange to be received as a result of export - During relevant assessment year, assessee claimed deduction under section 10B in respect of its entire income including profits derived from forward contracts –

Whether since forward contracts had been taken in respect of 46 per cent of export turnover and it was not an isolated transaction, in view of Explanation 2 to section 28, profit from forward contracts was to be assessed as profit from speculation business - Held, yes – Whether since for purpose of computing deduction under section 10B, speculation business cannot be considered as business of undertaking, Assessing Officer was justified in rejecting assessee's claim for deduction in respect of profits derived from forward contracts - Held, yes.

3 Expenditure Incurred in Relation to Income not included in Total Income - Section 14A

Rajeev Agarwal
CIT (A), Gandhinagar

1 Legislative History

1.1 **Section 14A** was first inserted by the **Finance Act, 2001**. However, same was inserted with **retrospective effect from 1-4-1962**. The inserted section reads as under:-

'14A. *Expenditure incurred in relation to income not includible in total income.* – For the purposes of computing the total income under this Chapter, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under this Act.'

Purpose for which the section was introduced, and given in the **explanatory memorandum** issued with the **Finance Bill, 2001**, the most relevant part reads as under:-

'.....It is proposed to insert a new section 14A so as **to clarify the intention of the Legislature,** since the inception of the Income-tax Act, 1961, **that no deduction shall be made in respect of any expenditure incurred by the assessee in relation to income which does not form part of the total income under the Income-tax Act.** The proposed amendment will take effect retrospectively from 1st April, 1962 and will, accordingly, apply in relation to the assessment year

1962-1963 and subsequent assessment years.'

1.2 The introduced section was legally correctly being used by the Assessing Officers for reopening the assessments as section was retrospectively effected. When the Government realized the hardship caused to the assessees; another amendment was made by the Finance Act, 2002 and sub-section (2) of section 14A was inserted as under:-

' **Provided** that nothing contained in this section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the 1st day of April, 2001.'

1.3 It was found that the assessing officers were finding it difficult to arrive at a figure of disallowance required on the facts of the cases and unsubstantiated adhoc additions were being made. Subsequently, another amendment by the Finance Act, 2006 to section 14A enlarged the scope of applicability of section 14A. The new sub-sections w.e.f. 1-4-2007 read as under: –

'14A....

(2) The Assessing Officer shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under this Act **in accordance with such method as may be prescribed,** if the Assessing Officer, having regard to the accounts of the assessee, **is not satisfied with the correctness of the claim of the assessee in respect of such expenditure**

in relation to income which does not form part of the total income under this Act.

(3) The provisions of sub-section (**2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part** of the total income under this Act'

The reasons for the above amendment were explained in explanatory statement for the Finance Act, 2006 under Circular No.14/2006, dated 28-12-2006 in para 11. It is reproduced hereunder:-

11. Method for allocating expenditure in relation to exempt income.

11.1 Section 14A of the Income-tax Act, 1961, provides that for the purposes of computing the total income under Chapter-IV of the said Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Income-tax Act. In the existing provisions of section 14A, however, no method of computing the expenditure incurred in relation to income which does not form part of the total income has been provided for. Consequently, there is considerable dispute between the taxpayers and the Department on the method of determining such expenditure.

11.2 In view of the above, a new sub-section (2) has been inserted in section 14A so as to provide that it would be mandatory for the Assessing

Officer to determine the amount of expenditure incurred in relation to such income which does not form part of the total income in accordance with such method as may be prescribed. However, the Assessing Officer shall follow the prescribed method if, having regard to the accounts of the assessee, he is not satisfied with the correctness of the claim of the assessee in respect of expenditure in relation to income which does not form part of the total income. Provisions of sub-section (2), will also be applicable in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income.

11.3 Applicability from assessment year 2007-08 onwards.'

1.4 **Subsequently, Rules for determination of disallowance were prescribed *vide* I.T. (5th Amend.) Rules, 2008, w.e.f. 24-3-2008.**

1.5 Further, **under Form 3CD, a column was also inserted w.e.f. 23-8-2006** *vide* the Income-tax (Ninth Amendment) Rules, 2006 regarding amount of disallowance under section 14A. Hence, it is the liability of tax auditor to give appropriate finding in this regard. After prescribing formula for determination of disallowance under section 14A the scope of liability to disclose relevant facts has also been enlarged.

2. Scope of Section 14A

The scope and applicability of Section 14A w.e.f. 1-4-2007 is as under:-

- The assessee must have an exempted income which is not includible in his total income.
- The assessee must have incurred an expenditure in relation to income which is exempted under the Income-tax Act, 1961.
- However, actual earning of income is not sine qua non for deciding deduction of expenditure laid out or expended wholly or exclusively for purpose of earning such income.
- Just because the income earned is subject to taxation in some other form/other stage in hands of other assessees; it does not preclude the application of Section 14A; e.g. dividend income taxed otherwise under Section 115O or share from partnership firm.
- Rule 8D is prospective in application w.e.f. 24-3-2008 i.e. from AY 2008-09 only. However, the AO can disallow the expenses in earlier assessment years also after recording clear finding that the expenses on earning exempt income shown by the assessee are not correct and applying the reasonable and acceptable method of apportionment to determine such amount.
- Prescribed formula under Rule 8D can be applied only where the Assessing Officer is not satisfied with the accounts of the assessee with regard to correctness of the claim of expenses or assessee claims that no expenditure has been incurred

3. Important Judicial Pronouncements

3.1 **Just because the income earned is subject to taxation in some other form/other stage in hands of other assessees; it does not preclude the application of section 14A; e.g. dividend income taxed otherwise under 115O.**

i) Pradeep Kar 319 ITR 416 (Kar)

In my view, on the same principle expenses on earning the share of profits from the partnership firm may be tried to be disallowed.

3.2 **Actual earning of income is not sine qua non for deciding deduction of expenditure laid out or expended wholly or exclusively for purpose of earning such income i.e. if dividend is not earned it doesn't prevent the expenses on investment of shares etc., from being disallowed.**

i) Shankar Chemical Works- 12 Taxmann.com 461 (Ahd ITAT)

ii) Technopak Advisors P Ltd-18 Taxmann.com 146 (Delhi ITAT)

3.3 **In terms of section 14A(2) condition precedent for Assessing Officer to determine amount of expenditure incurred in relation to exempt income is that he must record his dissatisfaction with correctness of claim of expenditure made by assessee or with correctness of claim made by assessee that no expenditure has been incurred. Therefore, determination of amount of expenditure in relation to exempt income under rule 8D would only come into play when Assessing Officer rejects claim of assessee in this regard-**

i) Maxopp Investment Ltd-15 taxmann.com 390 (Delhi)

ii) Consolidated Photo & Finvest Ltd-25 Taxmann.com 371 (Delhi)

3.4 As a corollary to the above, when no expense has been proved to be incurred**, no disallowance can be made.**

i) Hero Cycles Ltd – 323 ITR 518 (P&H)

ii) Winsome Textile Inds Ltd-319 ITR 204 (P&H)

3.5 **Mere fact that shares were old ones and not acquired recently was immaterial; it was for assessee to show by production of materials that those shares were acquired from funds available in its hand at relevant point of time without taking benefit of any loan. Since no such material was produced by assessee, authorities below had rightly disallowed proportionate amount of interest having regard to total income and income from exempt source.**

i) Dhanuka & Sons – 12 Taxmann.com 227 (Cal)

ii) Haryana Land Reclamation and Development Corpn., 302 ITR 218 (P&H)

iii) In similar circumstances, case was remanded after ITAT allowed relief in the case of Machino Plastic Ltd-20 Taxmann.com 819 (Del)

3.6 **Rule 8D is prospective in application w.e.f. 24-3-2008 i.e. from AY 2008-09 only. However, the AO can disallow the expenses in earlier assessment years also after recording clear finding that the expenses on earning exempt income shown by the assessee are not correct and applying the reasonable and acceptable method of apportionment to determine such amount.**

Godrej & Boyce Mfg. Co. Ltd. v. Dy. CIT [2010] 328 ITR 81 / 194 Taxman 203 (Bom.).

Catholic Syrian Bank Ltd-9 Taxmann.com 148 (Ker)

Maxopp Investment Ltd-15 taxmann.com 390 (Delhi)

3.7 **Object or purpose of investment does not affect operation of section 14A inasmuch as any expenditure incurred for earning tax free income is not an allowable deduction by virtue of**

operation of said section. Therefore, even though purchase of tax free bonds was for meeting SLR requirements, interest and other expenditure incurred on borrowals for investment in tax free bonds was to be disallowed.

i) State Bank of Travancore-16 Tamann.com 289 (Ker)

3.8 **'Non-maintenance of separate accounts by assessee with regard to expenditure incurred for earning non-taxable income is no justification for assessee to claim immunity from operation of section 14A'**

i) Catholic Syrian Bank Ltd-9 Taxmann.com 148 (Ker)

4. SUGGESTIONS / GUIDELINES FOR ASSESSING OFFICERS FOR FRAMING QUALITY / SUSTAINABLE ASSESSMENT ORDERS.

- The AO should concentrate on the **investments in the balance sheets** which would result in incomes not includible in taxable income; for e.g. **tax free bonds, equities held as investments, PPF, LIC investments, capital in partnership firm or agriculture assets, assets pertaining to incomes exempt under Section 10 etc.**
- **In Form 3CD, a column was also inserted w.e.f. 23-8-2006** *vide* the Income-tax (Ninth Amendment) Rules, 2006 regarding amount of disallowance under section 14A. This is column 17 (l), which reads as follows:

  (l) amount of deduction inadmissible in terms of Section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income;

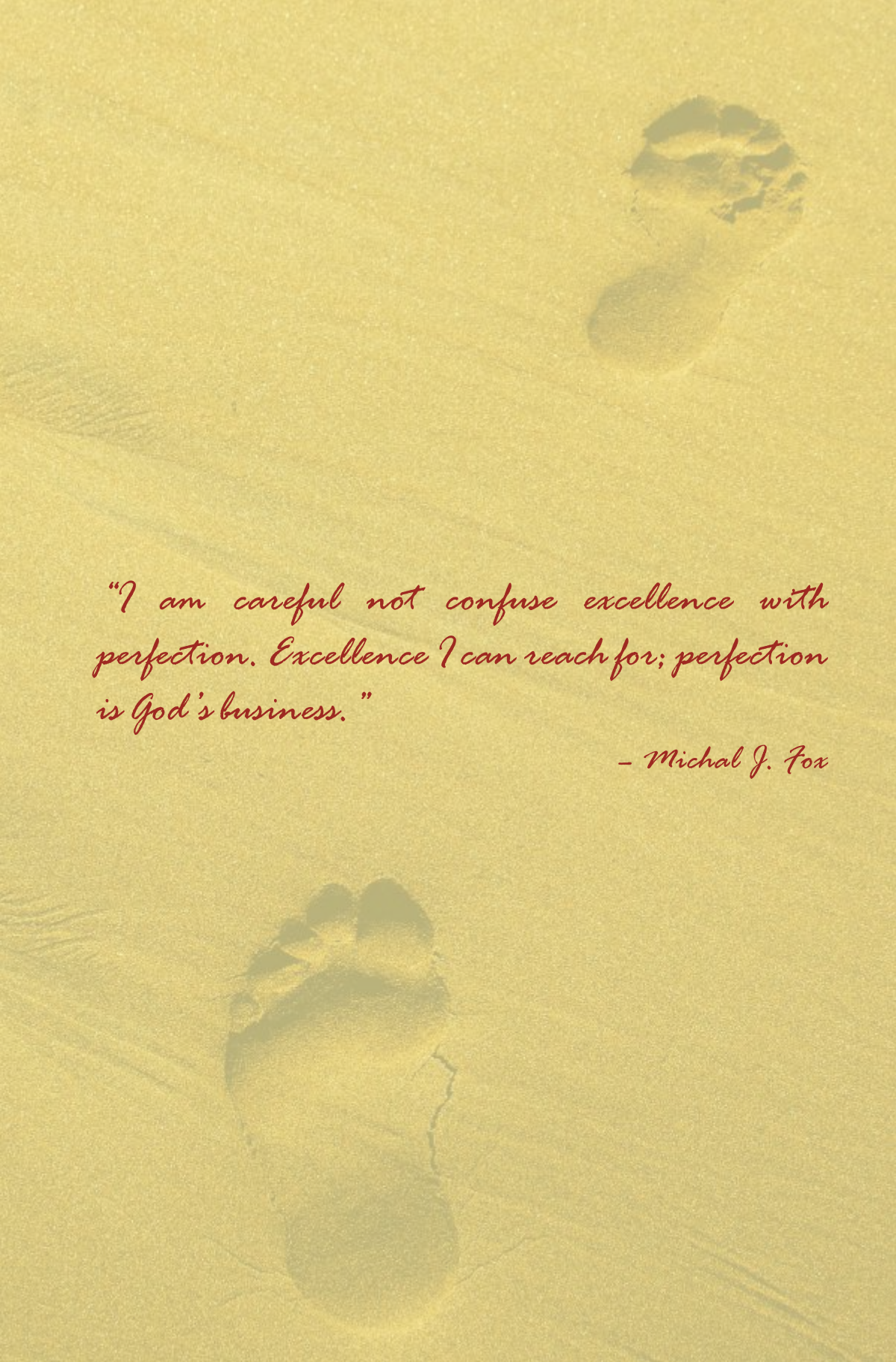
The chartered accountant is supposed to give specific information, and this should specifically gone through and made use of.

- The assessee's claim of expenditure incurred in relation to exempt income or the claim that no expenditure has been incurred has to be first seen from the computation of income filed with the return or Notes on Account. If the AO finds it difficult to ascertain it from the **return of income; specific queries must be raised and categorical replies taken.**
- Before any **further disallowance is made, it is absolutely mandatory for the AO to record his dissatisfaction** with correctness of claim of expenditure made by assessee or with correctness of claim made by assessee that no expenditure has been incurred (refer to the case law in **para.3.3 & 3.4,** above)
- The **dissatisfaction of the AO should be based on substantive facts and logical conclusions based on facts**. The Courts and judicial authorities do not appreciate, summary satisfactions based on conjectures like '**some expenditure must have been incurred etc.'**
- In most of the cases, the **assessee claims** that the investments whose income is not part of total income; **is old and from own interest free funds**. **Ignoring or summarily dismissing the assertion** would almost certainly result in the **disallowance being deleted**. The correct course is **categorically asking** the assessee to **submit proof of its claim**. Then **the onus shifts** on the assessee and when it fails to discharge it, the disallowance would most likely be upheld (refer to the case law in **para.3.5,** above). The **requisition of such**

proof from the assessee should be meticulously recorded in the order-sheet and the assessment order (referring to letter no. and date or the date of order sheet entry etc.**).** The **failure on the part of the assessee** to supply documentary details and proofs **should also be preferably got recorded** in **the order sheet** and **mentioned** in the assessment order. The disallowance under Rule 8D after that becomes highly sustainable in appeal.

- **Rule 8D is prospective in application w.e.f. 24-3-2008 i.e. from AY 2008-09 only**. **However, the AO can disallow the expenses in earlier assessment years** also after recording clear finding that the expenses on earning exempt income shown by the assessee (appellant) are not correct and applying them **reasonable and acceptable method of apportionment to determine such amount. From assessment year 2008-09;** the disallowance **cannot be adhoc or by any other method** but only by method prescribed **under Rule 8D.**

- The AOs are **advised to go through the legislative history and important decisions on the section, as given in a very concise form earlier**. It would help them to appreciate the scope of the section fully. They should understand that many controversies like '**dividend income is subject to taxation in some other form/ other stage in hands of other assessees'** or **'the investment not yielding any actual income in the year of assessment' have been decided in favour of department(refer para. 3.1 & 3.2).**



"I am careful not confuse excellence with perfection. Excellence I can reach for; perfection is God's business."

– Michal J. Fox

4 Income From House Property

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Sections 22 to 27 of the Act deal with the subject of taxation of "Income from house property".

Section 22	:	Annual value of property is taxable under the head "Income from House property".
Section 23	:	Determination of 'Annual value'
Section 24	:	Allowable deductions from "Income from House property"
Section 25	:	Amounts not deductable from "Income from House property"
Section 25AA	:	Unrealised rent realised subsequently after 1.4.2001
Section 25B	:	Arrears of rent received
Section 26	:	Property owned by co-owners
Section 27	:	Situations where the ownership shall be deemed, for taxing income from house property

2. Section 22 provides for taxation of '**annual value'** of a property consisting of **any buildings** or **lands appurtenant** thereto. The term 'buildings' includes any building- office building, godown, storehouse, warehouse, factory, halls, shops, stalls, platforms, cinema halls, auditorium etc. as long as they are not used for business or profession by owner. Land appurtenant includes land adjoining to or forming a part of the building. It would depend on the nature of the land, whether it is appurtenant to the residential building, factory building, hotel building, club house, theatre etc. and will include courtyards,

compound, garages, car parking spaces, cattle shed, stable, drying grounds, playgrounds and gymkhana.

2.1 Some critical issues on Section 22

- Tax imposed under section 22 is a tax on `annual value' of house property. The purpose for which the building is used by the tenant is also immaterial.
- Income arising out of the building or a part of the building is covered under this section. Existence of a building is an essential prerequisite.
- Any income, arising out of vacant land, is not covered under this section even though it may be received as rent, ground rent or lease rent. Such income would be assessable as income from other sources. Even rent, arising out of open spaces, or quarry rent, is taxed as income from other sources.
- It does not make any difference, if the property is owned by a limited company, a firm, a HUF or individual.
- When the property is used by the owner for his business or profession, the 'annual value' of property is not charged in the hands of the owner.
- When a firm carries on business or profession in a building owned by a partner, no income from such property is added to the income of the partner, unless the firm pays the partner any rent for the same.
- For the purpose of section 22, the owner has to be a legal owner. However, the Supreme Court in the case of CIT v/s. Podar Cement (P) Ltd. etc. 226 ITR 625 (SC). held that 'owner' is a person who is entitled to receive income from the property in his own right. The requirement of registration of the sale deed in the context of Section 22 is not warranted.

- Annual value of property is assessed to tax under section 22 in the hands of owner even if he is not in receipt of income or even if income is received by some other person.
- If the assessee is not the owner of the building, but is a lessee and he sublets the property, he would be taxed under the head 'Income from other sources'.
- Co-ownership: In case where property is owned jointly by two or more persons, and where shares of such joint owners are definite and ascertainable, the income of such house property will be assessed in the hands of each co-owner separately. For the purpose of computing income from house property the rent/ annual value will be taken in proportion to his share in the property. In such an eventuality, the relief admissible under section 23(2) shall also be separately allowable to each such person [Explanation to Section 26]. However, where the share is not definite, the income of the property shall be assessed as that of an Association of persons.(s 26)

3. Deemed ownership (Section 27)

In the following situations the ownership shall be deemed for taxing income from house property in view of Section 27 of the Act:

i. When house property is transferred to spouse (otherwise than in connection with an agreement to live apart) or minor child (not being a married daughter) without adequate consideration (Section 27(i))

ii. In the case of holder of an impartible estate (Section 27(ii))

iii. A member of a cooperative society, company etc. to

whom a building or part thereof has been allotted or leased under a house building scheme (Section 27(iii)). Thus, when a flat is allotted by a cooperative society or a company to its members/shareholders who enjoy the flat, technically the co-operative society/company may be the owner. However, in such situations the allottees are deemed to be owners and it is the allottees who will be taxed under this head.

iv. A person who is allowed to take or retain possession of any building (or part thereof) in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882, is deemed as the owner of that building (or part thereof) [Sec. 27 (iiia)].

v. A person who acquires any rights (excluding any rights by way of a lease from month to month or for a period not exceeding one year) in or with respect to any building (or part thereof) by virtue of any such transaction as is referred to in section 269UA(f) [i.e. if a person takes a house on lease for a period of 12 months or more, is deemed as the owner of that building or part thereof] [Sec. 27 (iiib)].

4 Determination of 'annual value' of the property [Sec. 23]

'Annual Value' is inherent capacity of property to yield income. The inherent capacity has been defined as the sum for which the property might reasonably be expected to be let from year to-year. It is not necessary, that the property should be actually let. It is also not necessary that the reasonable return from property should be equal to the actual rent realized when the property is, in fact, let out. Under Section 23 (1) of the Income tax Act, annual value of property shall be deemed to be the following:

i. The sum for which the property might reasonably be expected to be let out from year to year;

ii. Where the property or any part of the property is let and the actual rent received or receivable by the owner in respect thereof is in excess of the sum referred to in clause (a), the amount so received or receivable;

iii. Where the property or part of the property is let and was vacant during the whole or any part of the previous year and, owing to such vacancy, the actual rent received or receivable by the owner in respect thereof is less than the sum referred to clause (a) the amount so received or receivable.

4.1 Annual value to be calculated as under:

1. Where RC Act applicable

(i) Standard rent under the Rent Control Act; or

(ii) Actual rent received

Whichever is higher

2 Where RC Act is not applicable:

(i) Municipal Value or

(ii) Fair Rent or

(iii) Rent Received

whichever is higher

Sub-section 2: The annual value of a house or part of a house shall be taken as nil if the property

- is occupied by the owner himself for the purpose of his own residence or,
- if such house or part thereof cannot be occupied by him because his employment, business or profession is carried

on at any other place and, he has to reside at that other place in a building that does not belong to him.

4.2 Some critical issues, on annual value:

- ALV would not be taken nil if the house or part thereof is actually let during the whole or any part of the previous year; or if any benefit there from is derived by the owner.
- If the property consists of more than one house, ALV would be taken nil in respect of only one of such houses, at the option of the assessee.
- The annual value of the house(s), (other than the house in which the assessee has exercised option) shall be determined under sub-section (1) as if the house (s) had been let out
- From the annual value as determined above, municipal taxes will be deducted only if the property is let out during the whole or any part of the previous year and Municipal taxes are borne by the land lord and paid during the year.
- Where the municipal taxes have become due but not been actually paid, the same will not be allowed. Municipal taxes are allowed only on payment basis even if the taxes belonged to a different year.
- Unrealised rent will be excluded from rent received/ receivable only if the conditions are satisfied: (Expl. to Section 23(1) r.w Rule 4). These conditions are (1) the tenancy is bona fide (2) the defaulting tenant has vacated, or steps have been taken to compel him to vacate the property (3) the defaulting tenant is not in occupation of any other property of the assessee and (4) the assessee has taken all reasonable steps to institute legal proceedings for the recovery of the unpaid rent or satisfies the Assessing Officer that legal proceedings would be useless.

5. Deductions permitted from Income from house property [Sec. 24]

Amount left after deduction of municipal taxes is net annual value. Following permissible deductions are allowed from Annual Value in cases of let out properties (Section 24).

(1) Deduction equal to 30% of the annual value, irrespective of any expenditure incurred by the taxpayer (s.24(a)). No other allowance for depreciation, repairs, maintenance etc. would be allowable.

(2) Interest on borrowed capital (s.24(b)). Interest on borrowed capital is allowable as deduction on accrual basis (even if account books are kept on cash basis) if capital is borrowed for the purpose of purchase, construction, repair, renewal or reconstruction of the house property.

5.1 Some critical issues on deduction of interest:

1 The interest is deductible on 'payable' basis i.e. on accrual basis. Hence it should be claimed on yearly basis even if no payment has been made during the year.

2 For claiming interest, it is not necessary that the lender should have a charge on the property for the principal amount or the interest amount.

3 Interest payable for outstanding interest is not deductible (Shew Kissan Bhatter v. CIT (1973) 89 ITR 61 (SC).

4 Taxpayer cannot claim deduction for any brokerage or commission paid for arranging loan either as a onetime arrangement or on periodical basis till the loan continues.

5 In terms of circular No. 28 dated 20th August 1969, if an assessee takes a fresh loan to pay back the earlier loan, the interest on the fresh loan would be deductible.

6 Interest on borrowing can be claimed as deduction only by the person who has acquired or constructed the property with borrowed fund. It is not available to the successor to the property (if the successor has not utilized borrowed funds for acquisition, etc).

7 In case of Central Government employees, interest on house building advance taken under the House Building Advance Rules (Ministry of Works and Housing) would be deductible on the basis of accrual of interest which would start running from the date of drawl of advance. The interest that accrues in terms of rule 6 of the House Building Advance Rules is on the balances outstanding on the last day of each month (Circular No. 363, dated June 24, 1983).

8 Interest for pre-construction period: In such a case, interest paid/ payable before the final completion of construction or acquisition of the property will be aggregated and allowed for five successive financial years starting with the year in which the acquisition or construction is completed. Please note that this deduction is not allowable if the loan is utilized for repairs, renewal or reconstruction.

9 **Interest payable to Non resident:** As per section 25, interest chargeable under the Income tax Act, which is payable outside India on which tax has not been paid or deducted (and in respect

of which there is no person in India, who may be treated as an agent under section 163) shall not be deducted in computing the income chargeable under the head "Income from house property".

6. Set off and carry forward of loss in cases of house property :

(1) Where the property has been let out, loss from one house property can be set off against the income from another house property. The remaining loss, if any, will be set off against incomes under any other heads like salary, business etc. In case the loss does not get wiped out completely, the balance will be carried forward. (Sections 70 and 71)

(2) In regard to carried forward losses, Section 71B will apply. Carried forward loss under the head "Income from house property" shall be allowed to be carried forward and set off in subsequent years (subject to a limit of 8 assessment years) against income from house property.

7. Income from house property is wholly exempt from tax in following situations

i. Income from any farmhouse forming part of agricultural income;

ii. Annual value of any one palace in the occupation of an ex-ruler; Section 10(19A)

iii. Property Income of a local authority; Section 10(20)

iv. Property Income of an authority, constituted for the purpose of dealing with and satisfying the need for housing accommodation or for the purposes of planning development or improvement of cities, towns and villages or for both. (The Finance Act, 2002, w.e.f. 1.4.2003 shall delete this provision.);

v. Property income of any registered trade union; Section 10(24)

vi. Property income of a member of a Scheduled Tribe;

vii. Property income of a statutory corporation or an institution or association financed by the Government for promoting the interests of the members either of the Scheduled Castes or Scheduled tribes or both;

viii. Property income of a corporation, established by the Central Govt. or any State Govt. for promoting the interests of members of a minority group;

ix. Property income of a cooperative society, formed for promoting the interests of the members either of the Scheduled Castes or Scheduled tribes or both;

x. Property Income, derived from the letting of godowns or warehouses for storage, processing or facilitating the marketing of commodities by an authority constituted under any law for the marketing of commodities;

xi. Property income of an institution for the development of Khadi and village Industries;'

xii. Self-occupied house property of an assessee, which has not been rented throughout the previous year;

xiii. Income from house property held for any charitable purposes;

xiv. Property Income of any political party. Section 13A

8. House Property income of NRI's in India

Property is a favourite Indian asset because of its ability to generate regular cash flows through rent. As per section 5(1) of Income-tax Act, global income of the Resident is taxable in India. In case of non-resident, income which is received or

deemed to be received or accrues or deemed to accrue in India is taxable as per section 5(2). As per section 9(1)(i), income from property is taxable in India. Definition of NRI for the purposes of repatriation will be that of the FEMA and for the purposes of income tax, it is given in section 6.

8.1 Some critical issues on NRI income from property

- Rent proceeds can be credited to the NRE or NRO account. Rent proceeds received in these accounts can be freely repatriated. If the NRI does not have an NRE or NRO account, the proceeds can also be directly remitted abroad, but the NRI would need an appropriate certificate from a chartered accountant certifying that all taxes have been duly paid.

- As per section 195, tax will be deducted at source by the payer of the rent. The payer of the rent must obtain a TAN number and deduct TDS from the rent amount. He must also provide a TDS certificate to the NRI.

- NRI is also a resident of another country for tax purposes. In most cases, countries levy tax on residents on their global income. In such cases, we need to refer to the Double Taxation Avoidance Agreements (DTAA) that India has entered into with various countries.

- India-US DTAA for instance, provides that rent from immovable property will be taxed in the country in which the property is situated. So NRIs who are residents of US would have to pay tax on rental income in India. However they would still have to declare that income while filing their tax returns in US. They would get credit for taxes paid in India.

- **Deemed rental income will also apply to NRI:** There will be no income tax on a self-occupied property. The other property, whether rented out or not, will be deemed to be given on rent. If the NRI has not shown the rent on second property, it has to be calculated as per provisions of section 23.
- Income Tax Act does not specify if either or both these properties must be situated only in India. From the reading of the IT Act, the rule of 'more than one property' will apply to global properties, not just to the properties situate in India. In other words, if an NRI owns a house in any other country and lives there, he will have to pay tax on the property in India. Example, if an NRI is resident in USA and he owns and lives in a house in USA. He also owns a house property in India. Even if he does not give the property in India on rent, he would have to pay income tax on deemed rent in India determined as per section 23.
- Inherited property: Once an NRI inherits a property, he becomes the owner. Therefore, the property qualifies for the same tax rules as if he had purchased the property.
- As per the provisions of the Income Tax Act, NRI must also pay advance tax.

9. Some critical issues on House Property income

- If the tax payer constructed a house property by borrowing interest free loan; and he had to take interest bearing loan to repay the above interest free loan. Interest paid on such loan borrowed for repayment of original loan for acquiring house property is allowed even though the original loan is interest free;
- When the owner of the building gets along-with the

rent, rent or hire of other assets (furniture) or charges for different services provided in the building, then if the composite rent is separable then the portion of rent for building will be taxed as "income from house property" and the rent for other things under "Income from other sources" depending on facts.

- When the composite rent is not separable then, the composite rent is taxed as "Income from house property" or "Income from other sources" depending on the facts of the case.
- Main criteria for deciding whether the rent is assessable as income from house property or as business income depends upon the fact that whether the assets are exploited commercially or whether the same are let out for enjoying the rent.
- Even if a company is formed for the sole object of acquiring and letting out immovable properties, the rental income would be taxable as "Income from House property" and not as business income.
- The annual value of property, owned by a person during the previous year, is taxable in the relevant Assessment year, even if the assessee is not the owner of the property during the assessment year.
- Unrealised rent subsequently recovered would be taxable in the year of receipt. However, in such case, it is not necessary that the assessee continues to be the owner of the property in the year of receipt also.(Section 25AA)
- When the owner of a building receives arrears of rent from such a property, the same shall be deemed to be the income from house property of the year of receipt irrespective of whether or not the assessee is the owner

of the property in that year. 30% of the receipt shall be allowed as deduction towards repairs, collection charges etc. No other deduction will be allowed. (Section 25B)

- When flat is registered in both the spouse's names, full EMIs are paid by only one spouse, then that spouse remains the deemed owner of the house (Section 27) and income from house property will be added in transferor spouse's income.
- Depreciation cannot be claimed on the property on which income from house property is admitted and 30 % of the annual value is claimed as deduction. The AO has to disallow the depreciation of the properties (if claimed) from which property income is assessed under Income from House property.

10. Documents/ Information to be collected by the A.O. for examining Income from House Property:

a. Nature of property given on rent (Bungalow/ Flat/ Land etc.)

b. Location of property, Size (extent of Property/ Built-up area) of property.

c. Rent Agreements/lease agreements/leave and license agreement by whatever name called

d. Details of Deposits received in connection with renting/ leasing of property and the interest payable on the said deposits.

e. Details of other immovable properties owned and usage of the properties.

f. In case of vacant property – Rent Control Act, Municipal Valuation of Property for the purpose of determination of Annual Letting Value.

g. Agreement for services, furniture & fixtures, in case part of payment relates to services or provisions other than property.

h. In case of co-ownership, shares and documentary evidence.

i. Evidence for deductions claimed under Section 24 of the I.T. Act.

j. In case of Home loan taken for the property, interest certificate from the Bank

k. In case of other loans taken for purchase of property, necessary bank documents/statements for the interest claimed.

l. In case second loan taken to repay the first loan taken for the property, necessary linkage documents.

m. Relevant documents depending on the situation to examine the ownership or otherwise under Section 27 of the I.T. Act.

n. In case of claim of set off of loss under House property, necessary IT Returns of earlier years for loss allowed to be carry forward.

o. In case rent is paid to Non Resident, proof of TDS under Section 195 of the Act and proof of payment in to government account.

p. In case interest is paid to Non Resident, proof of TDS under Section 195 of the Act and proof of payment in to government account. (Section 25). In case TDS is not deducted, details of person assessable as agent of the NRI

q. In case of Non Resident claiming credit for the tax paid outside India under DTAA, proof of tax paid given by the authorities of that country.

11. Case Laws on Income from House Property

Note : Case laws given in the book "Case Laws In favour of the Department" may be verified for more information.

- Under common law 'owner' means a person who has got valid title generally conveyed to him after complying with the requirements of law such as the Transfer of Property Act, Registration Act etc. But in the context of Section 22 of the Income tax Act, having regard to the ground realities and further having regard to the object of the Income tax Act, namely, "to tax the income'', 'owner' is a person who is entitled to receive income from the property in his own right. The requirement of registration of the sale deed in the context of Section 22 is not warranted.

  CIT v. Podar Cement (P) Ltd. 226 ITR 625 (SC).

- Contribution of capital by partners in the form of land – No document evidencing Registration of transfer by partner in favour of partnership under Registration Act. – Transfer not genuine – Land does not become property of firm – House property income to be assessed in the hands of partners

  CIT Vs Kashiram Ramgopal Agencies (Gau) 231 ITR 10

- Firm transferring its immovable property to partners without a registered deed – Transfer is invalid – Rental income from property to be assessed in the hands of firm.

  CIT Vs Palaniappa Enterprises (Mad) 234 ITR 635
  Jansons Vs CIT (Kar) 154 ITR 432
  Ram Narain & Brothers Vs CIT (All) 73 ITR 423
  S.N. Syed Mohammed Saheb & Bros. Vs CIT (Ker) 68 ITR 791

- Purchase of properties in joint names of partners with funds of firm – Properties treated as that of firm right from inception and depreciation claimed on it – Income from properties treated as firm's income and divided among partners – Properties cannot be transferred to partners by book entries of firm – Income from property cannot be assessed as that of AOP but belong to firm.

  Abdul Kareemia & Bros Vs CIT (AP) 145 ITR 442

- A gift by a Mohammedan to his wife in lieu of the dower debt after marriage is sale of property – Such a transfer has to be made by a registered instrument if value of immovable property is more than Rs.100 – Till such registration, house property income to be assessed in the hands of the husband

  CIT Vs Syed Saddique Imam and Others (Patna)111 ITR 475, 117 ITR 62

- Let out property – Fair rental value can be determined under Section 23(1)(a) by ITO If tenant sub-let it at a higher rent, the same can be adopted as fair rental value

  CIT Vs G. Ramesan (Ker) 241 ITR 426
  N. Nataraj Vs DCIT (Mad) 266 ITR 277

- Property let out for less than standard rent – Annual Letting Value is standard rent.

  CIT Vs Parasmal Chordia (Mad) 233 ITR 147
  Visveswaraya Ind. Res. Dev. Centre Vs DCIT (ITAT, Mum) 59 ITD 156

- Where the property has not been let out at all during the year, there is no question of granting any vacancy allowance under Section 23(1)(c) - Period for which a let

out property may remain vacant cannot exceed period for which property has been let out

Vivek Jain Vs ACIT (AP) 202 Taxman 499 ; 63 DTR 174

- Provisions of Section 23(1)(c) dealing with vacancy allowance applies only to a property which is let out – Self-occupied property is not eligible for vacancy allowance

  Ramesh Chand Vs ITO (ITAT, Agra) 21 DTR 257; 29 SOT 570 ; 130 TTJ 12

- Agreement to sell property – Property in occupation of agreement holder and owner not receiving rent – Owner voluntarily foregoing rent – No vacancy allowance.

  CIT Vs Dhun D. Dalal (Mad) 233 ITR 143

- Surcharge on Municipal tax collected by assessee from its tenants – Part of Annual Value.

  ACIT Vs Poddar Projects Ltd. (Kol) 92 ITD 468

- To avail exemption, property must be in the occupation of the owner for his own residence and not by his relative even if it was free of cost

  Jashvidyaben C. Mehta Vs CIT (Guj) 172 ITR 680

- Where property is let out to employer and got re allotted, benefit of self-occupation is not available

  D.R. Sunder Raj Vs CIT (AP) 123 ITR 471

- Building let out to employees of subsidiary company who are separate and independent assesses – Not entitled to exemption since it cannot be treated as used for the purpose of business of assessee

  CIT Vs T.V. Sundaram Iyengar & Sons Ltd. (Mad) 271 ITR 79

- Relief for unoccupied property owing to employment or business at a different place, is available only to an 'individual' and not to an HUF

  Deepak L. Banker Vs CIT (Mad) 145 CTR 489

- Increase of rent with retrospective effect under compromise settlement with tenant – Assessable as arrears of rent

  B.M. Gupta & Sons (HUF) Vs ACIT (Del) 299 ITR 410

- Interest-free security deposit taken by assessee hugely disproportionate to monthly rent charged – Device to circumvent liability to income tax – Notional interest on security deposit to be treated as income from House Property

  CIT Vs Streetlite Electric Corporation (P&H) 336 ITR 348

  ITO Vs Baker Technical Services (P) Ltd. (ITAT, Mumbai-TM) 125 ITD 1

  CIT Vs M/s Transmarine Corporation (SC) SLP CC 8999/09 in CA no. 5470/2011 - order dated 15/07/2011.

- If a particular expenditure (eg. brokerage) is not specifically provided to be deductible, deduction thereof cannot be claimed under Section 24 since the word used is 'namely'

  CIT Vs H.G.Gupta & Sons (Del) 149 ITR 253

  ITO Vs Chunilal Jain (ITAT, Gau) 60 TTJ 448

  Tube Rose Estates (P) Ltd. Vs ACIT (ITAT, Del) 123 ITD 498

  Aravali Engineers P. Ltd. Vs CIT (P&H) 335 ITR 508

  Piccadily Holiday Resorts Ltd Vs DCIT (ITAT, Del) 94 ITD 267

- Deduction of interest on borrowed capital – Assessee to prove nexus with acquisition / construction / reconstruction / repair / renewal of property.

  CIT Vs Four Fields (P) Ltd. (P&H) 231 ITR 262

  K. Sunandamma Vs CIT (Kar) 164 ITR 446

  CIT Vs Indramani Devi Singhania (All) 189 ITR 124

- Assessee inheriting property with mortgage from his father – Assessee also took loan for investment in shares and other business on the security of this property – Taking second loan to pay off all previous loans – Original loan taken by assessee and father not for the purpose of construction / acquisition of House Property – Interest paid on loan not deductible

  K.S. Kamalakannan Vs ACIT (ITAT, Chennai) 10 ITR (Trib) 321

  CIT Vs Murlidhar Kanodia & Sons (HUF) 204 ITR 760 (All)

- Advance received by builder from buyers of flat – Failure to deliver in time and interest paid – Capital not borrowed for construction of property – Not deductible from House Property income.

  Akash & Ambar Trust Vs CIT (Cal) 268 ITR 93

- Only interest on capital / mortgage / charge is deductible from House Property income – Not interest on interest i.e., compound interest.

  Shew Kissen Bhatter Vs CIT (SC) 89 ITR 61

- Interest paid on a mortgage created to secure unpaid consideration for the purchase of the property could not fall under Section 24(1)(iv) or (vi)

  K. Govinda Bhatt Vs CIT (Mad) 235 ITR 528

- Borrowed money utilized for paying a tenant, for handing over possession of property or for surrendering tenancy right – Interest on such loan not allowable as deduction

  ACIT Vs Virender Singh (ITAT, Del) 104 ITD 365

- Partition creating only life interest to karta – During subsistence of his life interest, karta to pay annual charge to his sons and wife – Amount so paid by Karta, not allowable as creation of charge was voluntary.

  CIT Vs Late Sohanlal (by L/H) (Del) 257 ITR 242
  CIT Vs Satyanarayana Sikaria (Gau) 238 ITR 855

- As per lease agreement, lessees were to carry out day-to-day repairs – No deduction to lessor on account of repairs.

  A.K. Mahindra Vs ITO (ITAT, Del) 44 ITD 430

- Damages recovered by tenant by way of adjusting from rent payable- Not deductible.

  ITO Vs Purshottam Lal Roongata Family Welfare Trust (ITAT,SB-Jaipur) 58 ITD 19

- Assessee-company was engaged in business of construction and development of residential/commercial units. It had given some commercial units on lease and received rent there from. Assessee claimed that leasing of residential/ commercial units was also commercial utilization of immovable property and, hence, income derived there from was to be assessed as income from business. Assessee failed to prove that lease rent received by it was from exploitation of property by way of complex commercial activities – therefore income was assessable under head 'Income from house property'

Roma Builders (P.) Ltd. VS. Jt CIT (OSD) 131 ITD 91 (MUM.)

- There was no manufacturing activity during the relevant previous year and it had sold its machinery. But on the other hand, the lease of land and building was continuing. This being so, the lease rental was clearly from exploitation of property which was neither a complex commercial activity nor a lease of property along with machinery, furniture and fittings. Therefore, such lease income had to be assessed under 'Income from house property'. Further, clearly the assessee was not carrying on any business during the relevant previous year. Therefore, its claim that carry forward business losses ought to have been considered for set off against lease rentals could not be accepted

  Asst. CIT Vs. T&R Welding Products (India) Ltd. [2010] 129 TTJ 250 (CHENNAI)

- Deemed owner - Assessee-company acquired on lease office premises in question vide agreement dated 30-3-1995 - Lease period was for ten years with option of further renewal - Assessee let out said premises for a rent for a period of five years with option of renewal - Whether since assessee was in possession of property with full transferable rights and had been receiving rent from sub-tenant in his own capacity being owner of property, lower authority rightly treated assessee as deemed owner under section 27(iiib) - Held, yes [In favour of revenue]

  Radio Components & Transistors Co. Ltd. Vs. ITO, Ward 2(3)(1), Mumbai 50 SOT 237 (MUM.)

- It is not permissible to add notional interest on interest free security deposit to actual rent received for arriving at ALV. If Assessing Officer can show that rateable value under municipal laws does not represent correct fair rent, then he may determine same on basis of material/evidence placed on record.

  CIT, Delhi, Central III VS. Moni Kumar Subba [2011] 333 ITR 38 (DELHI)(FB)

- Assessee-company let out its two properties to wife of one of its Directors, namely 'R' - 'R' sub-letted said properties at a much higher rent within a short span of four months - Assessing Officer thus, held it a colourable device to avoid tax, determined ALV at an amount which 'R' was getting from sub-tenant. On facts, it could be concluded that rent agreement between assessee-company and 'R' was generated as a device not only to reduce tax liability of assessee-company but also with a view to allow 'R' to enjoy fruits of property of assessee-company.

  Pramila Estates (P.) Ltd. VS. ITO [2009] 27 SOT 133 (MUM.)

- Assessee-company was partner in a firm - On dissolution of firm it took over all its assets and liabilities, including a building - It also undertook to pay amounts standing to credits of erstwhile partners and claimed deduction of interest on amount so payable from rental income from building shown as 'income from house property' – Here no relationship of borrower and lender had come into existence and, therefore, it could not be said that assessee acquired building with aid of borrowed capital. Therefore interest paid was not allowable under section 24(1)(vi)

CIT Vs. Four Fields (P.) Ltd [1998] 231 ITR 262 (PUNJ. & HAR.)

- Section 27(iiib), read with Sections 22 and 56 - Deemed owner - Since tenancy was unregistered and on month to month basis, provisions of section 27(iiib) would not apply and, thus, assessee could not be treated as deemed owner of property. Therefore, impugned order passed by authorities below was treating the income under other sources to be upheld.

  Tushar Pravinchandra Shah Vs. Dy CIT, Central Circle-1, Baroda [2011] 129 ITD 178 (AHD.)

- Assessee had shown rental income of Rs.1 lakh per annum for property having constructed area of 1,23,490 sq ft based on an lease agreement entered into with lessee - Besides that assessee had also received interest-free deposits of Rs.67 crores which had been diverted interest-free to assessee's sister concerns. Approved valuer valued annual letting value of total constructed area at Rs.75,63,360 which was admitted by assessee as fair rental value of property under section 23 and on that basis, Assessing Officer, determined income from house property. Assessing Officer also imposed penalty under section 271(1)(c). Explanation offered by assessee was neither substantiated nor was shown to be bona fide, Explanation (1) to section 271(1)(c) came into play and penalty was rightly imposed upon assessee.

  PSB Industries India P ltd vs CIT 211 Taxman 173 (Delhi)

5 Deduction of Interest Expenses - Section 36(1)(iii)

Rahul Kumar
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Deduction of expenses incurred for earning business income is spelt out in the Sections 30 to 36 of Income Tax Act, 1961. Under Section 36 of Income Tax Act, 1961, there are number of deductions available subject to the conditions laid down. In this discussion, we would take up Section 36(1)(iii) of the Income Tax Act, 1961 and analyse the provision therein from all facets, which will make us understand the deduction in a comprehensive way. In the vortex of legal pronouncements, we will analyse few case laws as well, which throw light on the grey areas that are not captured or construed in the tax legislation. The discussion is in following subheadings:

(i) Meaning and concept.
(ii) The proviso.
(iii) Issues.
(iv) Important case laws.

2. MEANING AND CONCEPT

The bare reading of Section 36(1)(iii) is as follows:

"36(1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in Section 28 –

*(i) and (ii)******

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

Provided that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized in the

books of account or not); for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.

Explanation. - Recurring subscriptions paid periodically by shareholders, or subscribers in Mutual Benefit Societies which fulfill such conditions as may be prescribed, shall be deemed to be capital borrowed within the meaning of this clause."

The sub section has three important words or phrases that are core to understanding of this Section i.e. (i) Interest, (ii) Borrowed and, (iii) For the purpose of business or profession. In the following paras we would elucidate the meaning of these with reference to this particular section.

(i) Meaning of "Interest" - The definition of "interest" in Section 2(28A) means "interest payable in any manner in respect of any moneys borrowed or debt incurred ……". But for Section 36(1)(iii), "interest" is restricted to that on money borrowed and not on debt incurred. In simple words, the essence of interest is that it is a payment which becomes due because the creditor has not had his money at his disposal. It may be regarded either as representing the profit he might have made if he had had the use of his money, or conversely, the loss he suffered because he had not that use. The general idea is that he is entitled to compensation for the deprivation.

(ii) Concept of "borrowed" – Provisions of Section 36(1)(iii) concern capital borrowed and not other debts or liability. A loan of money undoubtedly results in a debt, but every debt does not involve a loan. Liability to pay a debt may arise from diverse sources and a loan is one of such sources. The legislature has, under this clause, permitted as an allowance

interest paid on capital borrowed for the purposes of the business; and the capital, in this context, means money and not any other asset purchased on credit [**Bombay Steam Navigation Co. Pr. Ltd. v. CIT, 56 ITR 52 (SC)**].

- **Importance of loan settlement**. For the loan there must be a settlement / agreement between the parties that particular amount would be given by one party to other party. The terms would be that it would be refunded or returned either on demand or on the directions of the creditors and particular interest / no interest would be paid on the said amount. Thus, for the purpose of loan there must be interaction between the parties and there must be a concluded contract. Thus for Section 36(1)(iii) the necessary precondition is the existence of a loan transaction or a loan agreement between two parties with an established role of creditor and debtor. There is a Gujarat High Court judgment in the case of **Arun Family Trust Vs. CIT 298 ITR 437 (Guj.)** which brings out this fact clearly.

- **Element of refund is a must**. An element of refund or repayment is a must in the concept of borrowing. If there is no obligation to refund the capital provided, interest on such capital is not deductible under Section 36(1)(iii) – **Pepsu Road Transport Corpn. V. CIT 130 ITR 18 (P&H).**

(iii) The phrase "for the purpose of business" – The expression "for the purpose of business" occurs in Section 36(1)(iii) and also in Section 37(1). A similar expression with different wording also occurs in Section 57(iii) which reads as "for the purpose of making or earning..... income".

This issue came up for consideration before the Supreme Court and the Hon'ble Supreme Court while giving judgment in the case of **Madhav Prasad Jatia V. CIT, (SC) 118 ITR 200** has established that the expression occurring in Section 36(1)(iii) is wider in scope than the expression occurring in Section 57(iii). Thus, meaning thereby that the scope for allowing a deduction under Section 36(1)(iii) would be much wider than the one available under Section 57(iii).

This phrase, as held by many legal pronouncement, is the most important yardstick for the allowability of deduction Under Section 36(1)(iii) of Income Tax Act, 1961. While explaining the meaning of this phrase the Hon'ble Supreme Court in the case of **S. A. Builders Ltd. Vs. CIT(A), Chandigarh reported in 288 ITR 1** has used the word **"commercial expediency"**. By using this phrase Hon'ble Supreme Court has given a new dimension and clarified the concept further. In the judgment the Supreme Court has defined commercial expediency as "*an expression of wide import and includes such expenditure as a* ***prudent businessman incurs for the purpose of business****. The expenditure may not have been incurred under any legal obligation, but yet it is allowable as a business expenditure, if it was incurred on grounds of commercial expediency".* Further, following this judgment the High Court of Delhi, in the case of **Punjab Stainless Steel Inds. Vs. CIT 324 ITR 396**, has further elaborated "*The commercial expediency would include such purpose as is expected by the assessee to* ***advance its business interest*** *and may include measures taken for preservation, protection or advancement of its business interests, which has to be* ***distinguished from the personal interest of its directors or partners****, as the case may be. In other words, there has to be* ***a nexus***

between the advancing of funds and business interest *of the assessee-firm. The appropriate test in such a case would be as to whether a reasonable person stepping into the shoes of the directors/partners of the assessee-firm and working solely in the interest of the assessee-firm/ company, would have extended such interest free advances. Some business objective should be sought to have been achieved by extending such interest free advances when the assessee-firm/company itself is borrowing funds for running its business".*

Thus, for allowance of a claim for deduction of interest under this provision following three conditions are there:

(i) **The money, that is capital, must have been borrowed by the assessee**

(ii) **It must have been borrowed for the purpose of business.**

(iii) **The assessee must have paid interest on the borrowed amount i.e. he has shown the same as an item of expenditure.**

The above mentioned three conditions have been established legally by Supreme Court judgment in the case of Madhav Prasad Jatia Vs. CIT, (1979) 118 ITR 200 (SC).

3. Proviso to Section 36(1)(iii)

The proviso to Section 36(1)(iii) was inserted by Finance Act, 2003 w.e.f. 01.04.2004 relating to A.Y. 2004-05 and subsequent years. This was inserted to disallow interest on moneys borrowed for acquiring a capital asset till the date on which the asset was brought to use even if it is for extension of existing business. Following facts are important for consideration.

- This proviso is to operate prospectively as held by Hon'ble Supreme Court in the case of **Deputy Commissioner of Income Tax. Vs. Core Health Care Ltd. (SC) 298 ITR 194**.
- In this proviso, the word "extension" has been used which is to be taken as synonymous to the word "expansion" which is used for Sections 80IC(8)(ix) and 80IE(7)(iii)[as held in case of **Nahar Poly Films Ltd. Vs. CIT, Ludhiana 201 Taxmann 304 (P&H)**]. The word expansion is not different from extension of business and therefore the interest expenditure, on the utilization of borrowed funds for the acquisition of new assets, from the date of its acquisition till the date when the asset is put to use, is to be disallowed.
- An expenditure may **either** relate to a new units on expansion of **existing** business ***or*** it may relate to a totally new business apart from existing business. In the latter case, pre-commencement expenditure of new business would be required to be capitalized. They cannot be charged to the pre-existing business. It is only for the former case, that relates to expansion of existing business, that can be allowed under Section 36(1)(iii). This was analyzed in the case of **CIT Vs. Vadilal Dairy International Ltd. [2010] 328 ITR 544 by Gujarat High Court.**
- Interest paid on capital borrowed for setting up of a **new unit** in the same line of business – capital expenditure – Interest on capital borrowed for the purpose of acquisition of the assets of the new unit is to be allowed as a revenue expenditure only when such assets start yielding income and not for any period prior thereto – Section 36(1)(iii) to be read alongwith Explanation 8 to Section 43(1) – Proviso to Section 36(1)(iii)

added by Finance Act, 2003 is merely clarificatory as it has made explicit what was already implicit. **[CIT Vs. Vardhman Polytex Ltd. (P&H) 299 ITR 152.]**

4. Important Issues

(I) Interest on borrowed capital used for interest free loans.

The law on this issue is settled after the Hon'ble Supreme Court judgment in the case of S. A. Builders Ltd. v. CIT (Appeals) [2007] 288 ITR 1 (SC), in which the concept of **"commercial expediency"** was used. Thus, where the funds of the business a diverted for interest free loans the main criteria for permissibility of interest on those funds are based on whether it was for commercial expediency or not. The phrase "commercial expediency" has following important traits as established by case laws cited supra:

- Such purpose as is expected by the assessee to advance its business interest.
- May include measures taken for preservation, protection or advancement of its business interests.
- To be distinguished from the personal interest of its directors or partners, as the case may be.
- There has to be a nexus between the advancing of funds and business interest of the assessee. Some business objective should be sought to have been achieved by extending such interest free advances when the assessee-firm/company itself is borrowing funds for running its business.

The Hon'ble Supreme Court has also delved into the case where there would be mixed fund at the disposal of the

assessee. It further clarifies that under Section 36(1)(iii) the ultimate use of the fund is important. It **may not be relevant** as to whether the **advances** have been **extended** out of the **borrowed funds** or **out of mixed funds** which include borrowed funds. **The test to be applied in such cases is not the source of the funds but the purpose for which the advances are extended.**

One important case law on this issue is **Punjab Stainless Steel Ltd. 324 ITR 396 (Delhi High Court),** in this the hon'ble High Court has given a finding which is in favour of revenue and has clearly distinguished **Munjal Sales Corp Vs CIT (SC) 298 ITR 298**. In fact, the **Ahmedabad Bench of ITAT** has also followed this principle in Inamulhaq S. Iraki Vs. Addl. CIT, Range-2, Ahmedabad **in ITA No. 243/Ahd/2011 for A.Y. 2007-08 dated 31.01.2012**. In this judgment the Hon'ble ITAT has squarely followed Hon'ble Delhi High Court decision Punjab Stainless Steel Ltd. 324 ITR 396, the relevant para (11) is reproduced below for the sake of ready reference.

"We find that as per this judgment of Hon'ble Delhi High Court, where mixed funds are used for the purpose of giving interest free advances, the only relevant test is as to whether such interest free advances are due to commercial expediency or not. In the present case also, the funds are mixed funds and the assessee could not establish any commercial expediency and hence, in our considered opinion, this issue is squarely covered against the assessee by this judgment of Hon'ble Delhi High Court and respectfully following the

same, this issue is decided against the assessee".

(II) Interest on borrowing utilized for earning non assessable / exempt income.

The issue is **whether to allow the interest** on borrowing utilized **for exempt income or non assessable income.** The primary condition for allowing deduction of interest in the computation of business income is that the interest was paid on capital borrowed for the purpose of business or profession. If the borrowed capital is utilized not in the business whose income is assessable, but in earning some non assessable or exempt income, the interest paid thereon, is not an allowable deduction under these provisions. This analogy flows from Section 14A inserted in Chapter IV of the Act, by the Finance Act, 2011 with retrospective effect from 01.04.1962, which is intended to safeguard the interest of the Revenue on account of wrong claim of expenditure relating to exempt income against taxable income. The Section 14A postulates that only expenditure which is relatable to taxable income should be deducted in computing the total income. Hence, expenditure which is incurred to earn exempt income should not be considered in the computation of total income. This would result in double advantage to the assessee.

Direct judgment which covers this issue is **H.T. Conville Vs. CIT 4 ITR 137**. Where a borrowing is specifically meant for use in a new industrial undertaking covered by Section 10B, such interest would go to reduce the eligible relief. It was, therefore, decided in **Procon Systems P. Ltd. V. ITO 296 ITR 636 (Mad)** that such interest cannot be reduced from eligible profits, because it has already been allowed as a business deduction.

(III) Section 36(1)(iii) vis-à-vis explanation 8 to Section 43(1)

Section 36(1)(iii) allows deduction of the amount of interest paid in respect of capital borrowed for the purposes of business. The deduction is granted under the section, once it is established that the borrowing is for the purposes of business and that the interest is paid on such borrowings. A proviso has been inserted by the Finance Act, 2003, w.e.f. 01.04.2004, to provide that any amount of interest paid in respect of capital borrowed for acquisition of an asset for extension of existing business or profession, whether capitalized or not, for any period beginning from the date on which the capital was borrowed for such acquisition till the date on which such asset was first put to use, shall not be allowed as deduction. Interest for the period up to the date of putting the asset to its first use will not be allowed in cases of extension w.e.f. A.Y. 2004-05.

Interest for the period subsequent to the date of putting the asset to first use, is not allowed to be capitalized as part of the 'actual cost' for the purposes of claiming depreciation and other allowances. This is provided by Explanation 8 which is inserted in under Section 43(1) by the Finance Act, 1986 with retrospective effect from 01.04.1974.

Thus in case of an "extension" there are two facts which are evident:

1. Interest for the period prior to the first use of asset is not allowed as a deduction under the proviso to under Section 36(1)(iii).
2. For the period, subsequent to such use, cannot be capitalized for claim of depreciation as per the said Explanation to under Section 43(1).

Thus **an issue** emerges in respect of the eligibility for claim of interest in cases where an asset is **not put to use during the year**. One view is that such interest shall be allowed once it is established that the borrowing is for the purposes of the existing business, while the other view, strongly relying on Explanation 8 to under Section 43(1), holds that interest for the period up to the date of use is not allowable as deduction. The issue is partly resolved by the proviso in Section36(1)(iii). Further, this issue is resolved by the judgment in **Core Health Care Ltd. Vs. DCIT (SC) 298 ITR 194.** In this judgment Hon'ble Supreme Court has brought out the following interpretations for resolving the above mentioned issue:

1. Section 36(1)(iii) has to be read on its own terms. It is a code by itself. Section 36(1)(iii) is attracted when the assessee borrows the capital for the purpose of his business. It does not matter whether the capital is borrowed in order to acquire a revenue asset or a capital asset, because all that the section requires is that the assessee must borrow the capital for the purpose of his business. **There by meaning that the transaction of borrowing is not the same as the transaction of investment.**

2. Explanation 8 to Section 43(1) has no relevance to Section 36(1)(iii). It has relevance only to Sections 32, 32A, 33 and 41 which deal with concepts like depreciation.

3. The provisions under Section 36(1)(iii) make no distinction between money borrowed to acquire a

capital asset and a revenue asset.

From the above mentioned discussion the following can be safely concluded.

a. The interest on borrowings used for capital expenditure relating to a totally new business apart from existing business is to be capitalized as pre-commencement expenditure as held in the case of **CIT Vs. Vadilal Dairy International Ltd. 328 ITR 544 (Guj.)**

b. Interest paid on capital borrowed for setting up a **new unit** in **same line of business**, before it is put to use, is to be treated as capital expenditure as held in the case of **CIT vs. Vardhman Polytex Ltd. (P&H) 299 ITR 152.**

c. Interest on capital borrowed for the purpose of acquisition of assets of the new unit is to be allowed as revenue expenditure **only when** such assets is put to use and starts yielding income and not for any period prior to it following the proviso to Section 36(1)(iii).

(IV) The allowability of interest on borrowing for imprudent Investment – Does A.O.'s have power to question.

This issue relates to an assessee who borrows money at higher rate of interest and lends it to sister concern for acquiring low yield investment – **Can this be allowed**. This question came up for consideration in **CIT Vs. Rockman Cycle Industries Pvt. Ltd. 326 ITR 291 (P&H)**. The

High Court required reconsideration of the decision in Pankaj Munjal Family Trust's case reported in 326 ITR 286 (P&H). The assessee in this case borrowed moneys at higher rate of interest (18%), but advanced the same to sister concern for acquiring low-yield (4%) investment in another sister concern. **In this case, the claim of the assessee was that, the advance at a lower rate was prompted on grounds of commercial expediency. The Assessing Officer did not question this explanation, but all the same, found that investment was not a prudent one.** Commissioner (Appeals) upheld the addition on the ground that it was a case of tax avoidance. The Tribunal adjudicated the matter in favour of the assessee It held that even if it was a case of imprudent investment, the wisdom of the assessee in choice of investments is not open to question. **[The High Court found that there is no expectation in law, that the assessee's activity should always be prudent, but all the same pointed out, that where it is not prudent, it would require to be examined, whether it is genuine. It was this aspect, which was required to be examined, but not examined by the Tribunal.]** Since the purpose of loan to the sister company was for finding investment in low-yield non-cumulative preference shares, it was felt, that there was similar absence of enquiry on similar investment in Pankaj Munjal Family Trust's case reported in 326 ITR 286 (P&H), so as to require reference of the case before it to a larger bench, so that the other case may also be reconsidered. Such enquiry, it was pointed out, will still be necessary, even if tax avoidance may not be totally impermissible.

Thus following these judgments the Assessing Officer can question the wisdom of assessee in choice of investment and

whether the investment was genuine or not.

(V) Interest on borrowings for purchasing shares

Under this topic the discussion is further sub-divided in following three sub headings i.e. **(a)** Section 36(1)(iii) vis-à-vis Section 57(iii), **(b)** whether dividend on preference shares can be equated with interest on borrowed capital and **(c)** the case of Circular trading.

(a) Section 36(1)(iii) vis-à-vis Section 57(iii)

Where borrowings are made for purchase of shares, question often arises whether interest paid should be allwed as deduction under Section 36(1)(iii) or under Section 57(iii). Here it would be worthwhile to mention that income by way of dividends on shares, whether held on investment portfolio or as stock-in-trade, is specifically assessable, under Section 56(2)(i), as "Income from other sources". Where the shares are held, although on investment portfolio, as an integral part of business, interest on such borrowings is allowable under Section 36(1)(iii). Thus, the qualifying factor in this case is to ascertain whether the borrowings for purchasing shares is an integral part of business of assessee.

Interest can be allowed under Section 36(1)(iii) only if the assessee proves that it was for the purpose of business. But if the shares are acquired not as an investment for earning income therefrom, the inference may well be different as was found in **CIT Vs. Amritaben R. Shah 238 ITR 777 (Bom)**, where it was held that a taxpayer borrowing money to **acquire controlling interest in a company would not be entitled to**

deduction of interest on borrowings. In coming to the conclusion, the High Court followed precedents which are worth noting. The Gujarat High Court in **Sarabhai Sons (P) Ltd. V. CIT 201 ITR 464**, found that where the dominant purpose of expenditure is not for earning income, it could not be allowed as a deduction. In **Chinai and Co. Pvt. Ltd. V. CIT 206 ITR 616 (Bom)**, expenses incurred in fighting another group of shareholders to protect investments in erstwhile managed company was held to be not admissible as business expenditure.

(b) Whether dividend on preference shares can be equated with interest on borrowed capital.

From the provisions of Sections 85 and 205 of the Companies Act, 1956, it is clear that the preference share capital is a contribution to the capital of the company by its subscribers or shareholders and is not a 'borrowing' by the company subject to payment of interest. Similarly, for the very said reason the dividend which is paid to such shareholders is to be paid only out of the profits earned by the company. In common parlance, it can be equated with the share income derived by the shareholders out of the profits of the company. **Therefore, by no stretch of imagination the dividend sought to be paid can be equated with or treated as 'interest' paid on the borrowed capital.** In that view of the matter**,** the assessee-company is **not entitled to deduction of the liability on account of dividend on preference shares by invoking the provisions of Section**

36(1)(iii). [**Kriloskar Electric Co. Ltd. v. CIT,228 ITR 674, 676 (Karn); Kirloskar Electric Co. Ltd. v. CIT,228 ITR 676, 678 (Karn)**].

(C) The case of Circular Trading

Interest on borrowed capital for purposes of business is a deductable expenditure under Section 36(1)(iii), where the assessee is dealing in shares. But what happens when it is proved that the **borrowings were merely an arrangement by way of circular trading solely with a view to avoid tax.** This issue was examined by **Supreme Court** in **CIT Vs. Ashini Lease Finance P. Ltd. 309 ITR 320 (SC)** whereby the decision given by **Gujarat High Court** was **set-aside** by Hon'ble Supreme Court. In this case, the assessee, borrowed funds from the concerns in the same Torrent group for purchase of equity shares of AEC. During the relevant year, the total investment made by the assessee in the take over and acquisition of business of AEC amounted to only Rs. 22,59,969. In addition, the Assessing Officer also found that after acquiring the shares of the company by the group, the same shares of AEC were sold at Rs. 63,57,925 and ultimately AEC Ltd. had been taken over by the Torrent group. The record indicated, prima facie, that the assessee-company had acquired the shares of AEC, through finances arranged mainly from the Torrent group (sister companies) along with two other companies only to enable the Torrent group to acquire and take over the business of AEC. It was on these facts, the prima facie inference was that it is not a normal trade borrowings, but merely an

arrangement by way of circular trading solely with a view to avoid tax. The Supreme Court, therefore, felt that the High Court was not justified in holding that the Tribunal in allowing the deduction had taken a decision on the facts, and that there was no substantial question of law for determination by the High Court. There was a substantial question of law in the light of the inference drawn from admitted facts. The issue was sent back to the High Court for a decision in accordance with law. Thus, if there is a case where it can be proved that the borrowings made are not part of normal trade borrowings and it is merely an arrangement by way of circular trading among companies under the same group, then interest on such borrowings can be disallowed.

(VI) Interest on borrowed capital in the case of Firms.

This issue arises in the case of Firms whereby Section 36(1)(iii) is to be read with Section 40(b)(iv). In this case, if the assessee is a Firm, then to claim deduction in respect of interest paid on capital borrowed from third party (apparently partners), the Firm is required to established two things:

1. It is entitled to claim deduction under Section 36(1)(iii), and
2. It is **not disentitled** to claim such deduction on account of applicability of Section 40(b)(iv).

It is important to note that Section 36(1) refers to 'Other Deductions' whereas Section 40 comes under the heading 'Amounts not Deductible'. Therefore, Sections 30 to 38 are for 'Other Deductions' whereas Section 40 is a limitation on that deduction. It is important to note that Sections 28 to 43C

essentially deal with Business Income. Sections 30 to 38 deal with Deductions. Sections 40A and 43B deal with Business Disallowances. Keeping in mind the said scheme the position is that Sections 30 to 38 are deductions which are limited by Section 40. Therefore, even if an assessee is entitled to deduction under Section 36(1)(*iii*), the assessee (firm) will not be entitled to claim deduction for interest payment exceeding 18/12 per cent *per se.* This is because Section 40(*b*)(*iv*) puts a limitation on the amount of deduction under Section 36(1)(*iii*) **[Munjal Sales Corp Vs CIT (SC) 298 ITR 298]**.

(VII) Distinction between Sections 36(1)(iii) and 37(i)

Section 37(1), which is a residuary general provision, may have application to any expenditure (including interest) which is not of the nature described in Sections 30 to 36. To an extent, Section 36(1)(iii) and Section 37(1), so far as the allowance of interest is concerned, run parallel to each other. But later, they do differ and it can then be discerned whether a given case falls within the phraseology of Section 36(1)(iii) or Section 37(1). Comparing the two, we may see –

	Section 36(1)(iii)		**Section 37(1)**
1.	It must be interest on capital (moneys) borrowed.	1.	It may be interest even on any debt incurred.
2.	The borrowings must be for the "purpose of the business".	2.	The debt incurred must be and exclusively for the purposes of the business.
3.	The borrowed amount may be utilized for even procuring a capital asset related to the business	3.	The debt incurred must not utilized for procuring a capital asset so as to fall within the gamut of "capital expenditure"

One thing is certain that **there can be no double deduction** – once under Section 36(1)(iii) and again under Section 37(1)

– for one and the same amount of interest.

(VIII) Burden of Proof

The burden of proving, that the moneys borrowed has not been utilized for non business purpose and the lending has all ingredients of "commercial expediency", is on the assessee. There are various case laws which supports this contention viz. **CIT Vs. Coimbatore Salem Transport P. Ltd.61 ITR 480 (Mad), Indian Metals & Ferro Alloys Ltd. Vs. CIT,193 ITR 344 (Ori), CIT Vs Abhishek Ind (P&H) 286 ITR 1**. In the case of **R. Dalmia Vs. CIT 133 ITR 169 (Del.)** the Hon'ble High Court decided that "*Where the interest paid concerns the borrowed money for business as well as non business purposes, the claim may be disallowed in its entirety if no adequate material is adduced by the assessee to determine that portion of interest which pertains to business purposes".*

(IX) The extent of disallowance under Section 36(1)(iii)

The Assessing Officer is often confronted with a question as to the extent of disallowance when it is proved that the borrowings were utilized for non business purposes. In such situations, there could be two possible scenario :

(1) **Where there is only borrowed fund and no composite or mixed fund.** In such cases, the disallowance is to be made at the full rate of interest payable on such borrowed money. The amount of interest, if any, realized from such utilization is not to be taken into account for ascertaining the extent of the disallowance **[CIT Vs. India Silk House, 152 ITR 79 (Mad)].**

(2) **Where there is composite or mixed fund,** in such

a case, the Assessing Officer is required to co-relate between the nature of feeding fund with utilization of such fund. After this co-relation the Assessing Officer may devise methods based on factual analysis of the source of fund with the utilization of fund to arrive at the figure of part disallowance of interest expenditure. In this case, there cannot be full disallowance of interest payable by the assessee. Where the funds are mixed up, so that it is not possible to identify the extent of borrowings utilized for such loans, proportionate amount could be disallowed as held in **K. Somasundaram and Brothers Vs. CIT 238 ITR 939 (MAD).**

(X) No allowance for pre-commencement interest

Section 36 falls within the code for computation of business income. Unless a business is actually commenced, no deduction under these provisions can be claimed in respect of interest on moneys borrowed for the period prior to such commencement [**Ritz Continental Hotels Ltd. v. CIT,114 ITR 554(Cal)**].

(XI) No allowance in case of cessation of business

Where the business has ceased to be carried on, no deduction can be claimed in respect of interest on borrowings [**Assam Biscuit Mfg. Co. Ltd. v. CIT,185 ITR 535 (Gauh)**].

(XIII) No allowance on sham or colourable transactions.

It is true that an assessee is entitled to arrange his affairs in such a way as to reduce his tax liability by all legal ways but the arrangement ultimately adopted must be genuine and not sham. If the object of the borrowing was illusory or colourable and not genuinely for business purposes, these provisions will

have no application **[Govan Bros. v. CIT, (1963) 48 ITR 930, 941 (All)].**

(XIII) The Companies Act, 1956

It would be worthwhile to examine the provisions in the Companies Act, 1956 with regard to loans to sister concerns / companies under the same management. The Companies Act, 1956 deals with this issue in Section 370, 370A and 371. In fact it lays down very stringent conditions for making any loans to companies under the same management. The relevant part of Section 370 is reproduce to give an idea about the provision whereby it says that "……*any body corporate, unless the making of such loan, the giving of such guarantee or the provision of such security has been previously authorized by a special resolution of the lending company……*". Thus it talks about making special resolution before giving any loan to related companies. Further, Section 371 deals with penalty for contraventions to any conditions given in Section 370. Thereafter, Section 372A deals with Inter-Corporate loans and investments.

It would be not out of place to take strength from these provisions to make good assessments.

5. Important Case Laws

The following are some important case laws apart from what is discussed in above paragraphs. The illustrations give out cases **in favour of revenue** where interest on borrowed capital was held not allowable.

(i) **Bombay Steam Navigation Co. P. Ltd. V. CIT 56 ITR 52 (SC).**

Payment of interest by a company on unpaid price of the assets taken over is not an affordable expense.

(ii) **Lachhiram Puranmal Vs. CIT 119 Taxman 1 (MP)**

Interest paid on borrowed capital was held not deductible where such capital was utilized for the purpose of agricultural land which was admittedly not a business investment.

(iii) **Malwa Mills Karmchari Paraspur Sahkari Sanstha Ltd. Vs. CIT 140 ITR 379 (MP)**.

Assessee having two units, A and B, made advances from unit A and unit B. Interest debited in unit B held not allowable because the entity was the same.

(iv) **CIT Vs. Ahmedabad Mfg. & Calico Printing Co. Ltd. (Guj.) 215 ITR 735**

Payment of betterment charges is capital expenditure. Therefore, payment of interest on annual installments of the betterment charges will have to be regarded as capital expenditure, because it has no direct nexus with the day-to-day running of the business of the assessee.

(v) **East India Pharmaceutical Works Ltd. Vs. CIT (SC) 224 ITR 627**

The interest that is paid by the assessee on any sum borrowed by him for payment of income tax is not deductible from his net income since it is only application of profits and not expenditure incurred to earn profits.

(vi) **Saraspur Mills Ltd. Vs. CIT (Guj.) 226 ITR 533**

Interest paid for late payment of Income Tax is not deductible as it is not incurred for the purpose of carrying on of the business. The interest takes colour from the nature of the principal.

(vii) **Auto Sales Vs. CIT 227 ITR 790 (All)**

Interest on gifted amount remaining with the assessee firm in the name of the donee to whom gift was made by book entries and the donor partner not having sufficient credit balance to his account, held not allowable because such a transaction of gift could not be treated as a genuine one.

(viii) **Bharat Commerce and Industries Ltd. Vs. CIT (SC) 230 ITR 733**

For VDIS Tax paid in installments with interest, the interest is not deductible as business expenditure or as interest on borrowed capital.

(ix) **Saswad Mali Sugar Factory Ltd. Vs. CIT 236 ITR 706 (Bom)**

Interest on capital for purchase of machinery, which was leased out and income therefrom was assessed under the head "Income from other sources", was held not deductible under Section 36(1)(iii) in view of the finding recorded by the Tribunal that the assessee's intention was not to carry on business, but to let out the business assets as income yielding properties.

(ix) **CIT Vs. Indian Express Newspaper (Madurai) P. Ltd. 238 ITR 70 (Mad).**

Interest paid on amount borrowed by the assessee company and transferred to the investment company floated by it which in turn transferred to same to an associate company of the assessee company which was engaged in the construction of a building was held not deductible because the borrowed amount was not used for the purposes of the assessee's business.

xi) **CIT Vs. Ramkant Mishra 252 ITR 210 (Cal.)**

Interest on cash credit, which have not been explained, has been held not allowable in spite of the fact that no addition was made on account of unexplained cash credit.

(xii) **JCT Ltd. Vs. DCIT (Calcutta) 276 ITR 115**

Section 36(1)(iii), read with Sections 43(1) and 37(1), of the Income-tax Act, 1961 - Interest on borrowed capital - Assessment years 1987-88 and 1988-89 - Whether interest paid on borrowed capital under deferred payment scheme for acquisition of plant and machinery for period relevant till asset was first put to use would not be eligible for deduction under Section 36(1)(iii) or Section 37(1) since it is includible in actual cost of acquisition of asset till asset was first put to use, in view of Explanation 8 to Section 43(1) - Held, yes.

(xiii) **CIT Vs. Swapna Roy (All) 331 ITR 367**

Borrowed funds were invested in financially fragile sister concerns. The court held that there was no intention to earn income but merely to assist sister concerns. Deductions of interest paid on such borrowings is not allowable.

6 Disallowance on account of Non-deduction of TDS – Section 40(a)(ia)

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(i) Analysis of provisions- Legislative History

- The provisions of Section 40(a)(ia) of the Act were brought on Statute by Finance Act 2004, w.e.f. 01.04.2005, i.e the same is applicable for assessment year 2005-06 and subsequent assessment years.
- Under the existing provisions of sub-clause (*i*) of clause (*a*) of Section 40, failure to make deduction at source from payment of interest, royalty, fees for technical services or any other sum which is payable outside India, or in India to a non-resident or to a foreign company or failure to make payment to the account of the Central Government, attracts disallowance of such payments in the hands of the payer. Deduction of such sum is, however, allowed in the computation of income if tax is deducted, or after deduction, paid in any subsequent year in computing the income of that year.
    - As step toward **enforcing compliance** of provisions of TDS it was proposed to extend the provisions of Section 40(*a*)(*i*) to payments of interest, commission or brokerage, fees for professional services or fees for technical services to **residents**, and payments to a resident contractor or sub-contractor for carrying out any work (including supply of labour for carrying out any work), on which tax has not been deducted or after deduction, has not been paid before the expiry of the time prescribed under sub-section (1) of Section 200 and in accordance with the other provisions of Chapter XVII-B. It was also proposed to provide that where in respect of payment of any sum,

tax has been deducted under Chapter XVII-B or paid in any subsequent year, the sum of payment shall be allowed in computing the income of the previous year in which such tax has been paid.

- **Section 40(a)(ia) as introduced through Finance Act 2004**
- **Section 40.**

Notwithstanding anything to the contrary in **Sections 30 to 38**, the following amounts **shall not be deducted** in computing the income chargeable under the head **"Profits and gains of business or profession"**, –

(*a*) in the case of any assessee –

(i) .....

(ia) any interest, commission or brokerage, fees for professional services or fees for technical services payable to a resident, or amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply of labour for carrying out any work), on which ***tax is deductible*** *at source under Chapter XVII-B and* ***such tax*** *has* ***not been deducted*** *or, after deduction, has* ***not been paid during the previous year****, or in the* ***subsequent year*** *before the expiry of the time prescribed under* ***sub-section (1) of Section 200***

Provided *that where in respect of any such sum, tax has been* ***deducted in any subsequent year*** *or, has been deducted in the previous year but* ***paid in any subsequent year after the expiry of the time prescribed under sub-***

section (1) of Section 200, *such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.*

Explanation. – *For the purposes of this sub-clause,* –

*(*i*)* *"Commission or brokerage" shall have the same meaning as in clause (*i*) of the* Explanation *to* ***Section 194H****;*

*(*ii*)* *"Fees for technical services" shall have the same meaning as in* **Explanation 2** ***to clause (*vii*) of sub-section (1) of Section 9;***

*(*iii*)* *"Professional services" shall have the same meaning as in* ***clause (*a*) of the*** **Explanation** ***to Section 194J;***

*(*iv*)* *"Work" shall have the same meaning as in* **Explanation III** ***to Section 194C;***

By the Taxation Laws (Amendment) Act 2006 w.r.e.f 01.04.2006, "rent and royalty" was also brought within the purview of provisions of Section 40(a)(ia) of the Act.

Liberalization of provisions of Section 40(a)(ia) made through Retrospective amendment brought by the Finance Act 2008

- With a view to liberalize provisions of Section 40(a)(ia) of the Act, the Finance Act 2008 brought amendment **w.r.e.f 01.04.2005** as under.
- In Section 40 of the Income-tax Act, in clause (*a*), –

  (*a*) in sub-clause (*ia*), with effect from the 1st day of April, 2005, –

  (*i*) for the words, brackets and figures "has not been paid during the previous year, or in the subsequent year before the expiry of the time prescribed under

sub-section (1) of Section 200", the following words, brackets and figures shall be substituted and shall be deemed to have been substituted, namely: –

"has not been paid, –

(*A*) in a case where the tax was deductible and was so deducted during the last month of the previous year, on or before the due date specified in sub-section (1) of Section 139; or

(*B*) in any other case, on or before the last day of the previous year";

(*ii*) for the proviso, the following proviso shall be substituted and shall be deemed to have been substituted, namely: –

"**Provided** that where in respect of any such sum, tax has been deducted in any subsequent year, or has been deducted –

(*A*) during the last month of the previous year but paid after the said due date; or

(*B*) during any other month of the previous year but paid after the end of the said previous year, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.";

Further liberalization of provisions of Section 40(a)(ia) made through Prospective amendment brought by the Finance Act 2010

- The legislature has brought further liberalization by way of amendment in provisions of Section 40(a)(ia) of the Act **w.e.f. 01.04.2010** as under.

- In Section 40 of the Income-tax Act, in clause (*a*), in sub-clause (*ia*),

  (*a*) for the portion beginning with the words "has not been paid, – " and ending with the words "the last day of the previous year", the words, brackets and figures "has not been paid on or before the due date specified in sub-section (1) of Section 139" shall be substituted;

  (*b*) for the proviso, the following proviso shall be substituted, namely: –

  "**Provided** that where in respect of any such sum, tax has been deducted in any subsequent year, or has been deducted during the previous year but paid after the due date specified in sub-section (1) of Section 139, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.".

Further liberalization of provisions of Section 40(a)(ia) made through Prospective amendment brought by the Finance Act 2012

- With a view to liberalize provisions of Section 40(a)(ia) of the Act Finance Act 2012 brought amendment **w.e.f 01.04.2013** as under.

- **The following second proviso shall be inserted in sub-clause (*ia*) of clause (*a*) of Section 40 by the Finance Act, 2012, w.e.f. 1-4-2013 :**

  Provided further *that where an assessee* ***fails to deduct the whole or any part of the tax*** *in accordance with the provisions of Chapter XVII-B on any such sum but is* ***not deemed to be an assessee in default under the first proviso to sub-section (1) of Section 201****, then, for the purpose of this sub-clause, it shall be deemed that the assessee has deducted and paid the tax on such sum*

*on the **date of furnishing of return of income** by the resident payee referred to in the said proviso.*

Since provisions of Section 40(a)(ia) as amended by Finance Act 2012 is linked to Section 201 of the Act, so it is essential to know and understand the provisions of Section 201 of the Act.

Relevant provisions of Section 201.

(1) Where any person, including the principal officer of a company –

(*a*) who is required to deduct **any sum** in accordance with the provisions of this Act; or

(*b*) referred to in sub-section (1A) of Section 192, being an employer, does not deduct, or does not pay, or after so deducting fails to pay, **the whole or any part of the tax**, as required by or under this Act, then, such person, shall, without prejudice to any other consequences which he may incur, be deemed to be an assessee in default in respect of such tax:

[Provided *that any person, including the principal officer of a company, who **fails to deduct the whole or any part of the tax** in accordance with the provisions of this Chapter on the sum paid to a resident or on the sum credited to the account of a resident **shall not be deemed to be an assessee in default** in respect of such tax if such resident –*

(i) has furnished his return of income under Section 139;

(ii) has taken into account such sum for computing income in such return of income; and

(iii) has paid the tax due on the income declared by him in such return of income,

and the person furnishes a certificate to this effect from an accountant in such form as may be prescribed:]

Salient features of Provisions of Section 40(a)(ia)

- Applicable to **all assessees**, i.e irrespective of its status.
- Applies only for computation of income chargeable under the head **"Profits and gains of business or profession"**.
- Applies to payments made to **resident** only.
- Applies to expenses/payments as specified therein, if otherwise these payments are allowable as deduction **under Sections 30 to 38** of the Act, i.e. the genuineness of expenses/payments and other criteria to be satisfied under Sections 30 to 38 of the Act must be satisfied, otherwise theses expenses/payments will not be allowable under Sections30 to 38 of the Act itself. Hence, when all the conditions/criteria of any particular section are satisfied and the payments are otherwise allowable under Sections 30 to 38 of the Act and if the provisions of Section 40(a)(ia) of the Act are not complied with in any particular financial year, then such payments will not be allowable as expense in that particular financial year.
- Point of TDS made and it's remittance to the Govt. account need to be analysed from assessment year 2005-06 and subsequent years in accordance with the Substantive provisions as brought by Finance Act 2004 and various retrospective/prospective amendments brought therein through various Finance Act in various years.

(ii) Important Issues and Judicial decisions.

A. Constitutional validity

- For violation of TDS provisions the Income Tax Act

already provided for levy of penalty and prosecution, so the assessees had challenged the validity of provisions of Section 40(a)(ia), which provides for disallowance of payments/expenses for TDS default, on the ground/ principle of double jeopardy.

- The Hon'ble Punjab & Haryana HC in the case of **Rakesh Kumar & Co. vs. UOI reported in 178 Taxman 481,** the Hon'ble Madras HC in the case of **Tube Investment of India Ltd & Anr. Vs. ACIT reported in 325 ITR 610** and the Hon'ble Allahabad HC in the case of **Deys's Medical (UP) P Ltd, vs. UOI reported in 316 ITR 445** has **upheld the constitutional validity** of Section 40(a)(ia) of the Act.

B. Amendments - Retrospective vs. Prospective

- The amendment, in respect of point of TDS deducted and remittance thereof in Govt. account, brought through **Finance Act 2008** has been made applicable **retrospectively** from **A.Y. 2005-06** and hence there is controversy for same.

- The amendment, in respect of point of TDS deducted and remittance thereof in Govt. account, brought through **Finance Act 2010** has been made applicable **prospectively** from **01.04.2010**. However some courts/tribunals have held the same to be retrospective on the ground that the same has been brought to rationalize and mitigate the provisions of Section 40(a)(ia) of the Act.

  - **In the case of Bharati Shipyard Ltd. vs. DCIT reported in 13 taxmann.com 101, the Hon'ble Mumbai Special Bench decided the matter in favour of Revenue** and held that

amendment brought out by Finance Act, 2010 to Section 40(a)(ia) with effect from 1-4-2010 being not remedial and curative in nature cannot be declared as having retrospective effect from date of insertion of provision, i.e., 1-4-2005.

- **However the Hon'ble Calcutta High Court in the case of CIT vs. Virgin Creations in ITA No. 302 of 2011 in GA No. 3200/2011, vide its order dated 23.11.2011 has decided the issue against the Revenue,** and after relying on the decision of the Hon'ble SC in the case of Allied Motors P Ltd, and Alom Extrusions Ltd has held that the provisions which has inserted the remedy to make the provision workable, requires to be treated with retrospective operation so that reasonable deduction can be given to the section as well, and accordingly has held the said amendment is retrospective.

C. Paid vs Payable.

- The uses of word **"Payable"**, in Section 40(a)(ia) of the Act has created controversy as to whether payable includes amounts paid during the year. The Courts/ tribunals have given conflicting decisions.

  - **In the case of DCIT vs. Ashika Stock Broking Ltd. reported in 44 SOT 556 the Hon'ble Kolkatta ITAT has decided the matter in favour of revenue** and after following its decision dated 15.01.2010 in the case of Poddar Son's ExL P Ltd vs. ITO in ITA No. 1418(Kol.)/09 has held that provisions of Section 40(a)(ia) of the Act are applicable to even sums paid during the year.

- **In the case of Teja Construction vs. ACIT reported in 39 SOT 13 the Hon'ble Hyderabad ITAT has decided the issue against the Revenue** and has held that provisions of Section 40(a)(ia) of the Act are not applicable in respect of sums/amount paid during the year and which are not payable at end of the year on date of balance sheet, as it is applicable only in respect of "Payable amount" shown in balance sheet as outstanding expenses on which TDS has not been made. Similar laws were laid in various other cases.

- **To resolve the above issue Special Bench was constituted and the Hon'ble Visakhapatnam Special Bench of ITAT in the case of Merilyn Shipping & Transport vs. Addl CIT reported in 20 taxmann.com 244 has decided the issue against the Revenue** and after comparing the proposed and enacted provision which is intended from the replacement of the words in the proposed and enacted provision from the words **'amount credited or paid' to 'payable'** has held that it has to be concluded that provisions of Section 40(a)(ia) are applicable only to the amounts of expenditure which are payable as on the date 31st March of every year and it cannot be invoked to disallow expenditure which has been actually paid during the previous year, without deduction of TDS.

- **However the Hon'ble Andhra Pradesh HC in the case CIT vs. Merilyn Shipping &**

Transports, vide its order dated 08.10.2012 in I.T.T.A.M.P.No.908 of 2012 in I.T.T.A. No.384 of 2012 **has granted interim stay/suspension on the order of the Hon'ble Special Bench.**

D. Applicability to head "Profits and gains of business or profession" or other heads of income also

- A controversy arose as to whether the provisions of Section 40(a)(ia) is applicable for computing the income chargeable under the head "Profits and gains of business or profession" or computation of income under any other heads of income also.

  The Section 40 clearly stipulates that "Notwithstanding anything to the contrary in Sections 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head **"Profits and gains of business or profession"**. Hence it is evident that the provisions of Section 40(a)(ia) is applicable while computing the income chargeable under the head "Profits and gains of business or profession" and it is not applicable to any other heads of income.

  - **In the case of Mrs. Sushila Mallick vs. ITO reported in 19 taxmann.com 233, the Hon'ble Lucknow ITAT** has held that the brokerage had been paid on account of sale of the properties, the income of which had been shown under the head **'short-term capital gain'**. The selling of properties was not the business of the assessee and, as such, the amount involved in the transaction relating to the selling of properties was not the part of turnover of the assessee. In view of same the Hon'ble ITAT held that in facts of the case the provisions of Section 40(a)(ia) of the Act is not applicable.

- **In the case of Mahatma Gandhi Seva Mandir vs. DDIT(Exemp) reported in 21 taxmann.com 321** the Hon'ble ITAT has held that the exception in Section 40 is carved out, only for the purpose of Section 28 and not for computing the exemption of income of a charitable trust under Section 11. The disallowance made under Section 40(a) will only go to enhance the business profit of an assessee whose income is assessable under Section 28 and not otherwise. Hence, provisions of Section 40(a) are not applicable in case of charitable trust or institution where income and expenditure is computed in terms of Section 11.

E. Applicability to Section 30 to 38 or other Sections also

- A question arose whether the provisions of Section 40(a)(ia) is applicable to sums allowable as expenses under Sections other than 30 to 38 of the Act, for computation of income chargeable under the head "Profits and gains of business or Profession".

  Section 40 clearly stipulates that "Notwithstanding anything to the contrary in **Sections 30 to 38,** the following amounts shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession". Hence from the above it is evident that the provisions of Section 40(a)(ia) of the Act is applicable only for sums which are otherwise allowable under Sections 30 to 38 of the Act and not under any other section of the Act.

- In strict sense if any expense is otherwise allowable under **Section 28** of the Act then the same will not be covered by the provisions of Section 40(a)(ia) of the Act. Similar

law has been laid down by the Hon'ble Hyderabad ITAT **in the case of Teja Construction vs. ACIT reported in 39 SOT 13.**

F. Whether the provisions of Section 40(a)(ia) is applicable to Capital expenses.

- As discussed above provisions of Section 40(a)(ia) of the Act is applicable to sums allowable under Sections 30 to 38 of the Act. Hence if any capital expense is allowable as deduction under Sections 30 to 38 of the Act while computing income under the head "Profits and gains from business or profession", the same will be covered under Section 40(a)(ia) of the Act.
- Under Section 35 of the Act expenses incurred on capital assets for research and development is allowable as deduction and hence the same will be covered by the provisions of Section 40(a)(ia) of the Act.
- A question arises where the claim of depreciation under Section 32 of the Act is covered under Section 40(a)(ia) of the Act. The provisions of Section 40(a)(ia) of the Act is applicable to payments specified therein which are allowable under Section 30 to 38 of the Act. Since the claim of depreciation is not payment or expenditure in strict sense but the same is **statutory allowance**, so strictly the claim of depreciation will not be covered under Section 40(a))(ia) of the Act. Further the actual cost and WDV is defined in Section 43 of the Act and provisions of Section 40(a)(ia) of the Act does not override the provisions of Section 43 of the Act.
  - **In the case of Shri Vishnu Anant Mahajan vs. ACIT in ITA No. 3002/Ahd/2009 for**

A.Y. 2006-07 the Hon'ble Special Bench ITAT, Ahmedabad vide its order dated 25.05.2012, after relying on the decision of the Hon'ble SC in the case of Nectar Beverages P Ltd vs. DCIT reported in 314 ITR 314 and of Hon'ble Mumbai ITAT in the case of Hoshang D Nanavati vs. ACIT in ITA No. 3567/Mum/2007 has held that "Depreciation" is not an expenditure but the same is statutory deduction.

G. Whether the provisions of Section 40(a)(ia) of the Act is applicable to computation of presumptive income under Sections 44A, 44AD, 44AE, 44AF etc.

- From the provisions of Section 40(a)(ia) of the Act it is evident that the provisions of Section 40(a)(ia) of the Act will not be applicable while computing **presumptive income** under Section 44A, 44AD, 44AE, 44AF etc.

  - **In the case of Teja Construction vs. ACIT reported in 39 SOT 13 the Hon'ble ITAT** has held that as such, it may be observed that it is only the deductions referred to in Sections 30 to 38 which would definitely fall for consideration of disallowance under Section 40 and they cannot be claimed as deduction under Section 28. This reasoning applies with equal force to the analogous provision of Sections 43, 44AD, 44AE, 44B, 44ABA, 44BBB, 44C and 44D and so on, which all relate to computation of business income and clearly start with a non obstante clause, which is similar to the one in Section 40, but reading 'Notwithstanding anything to the contrary in Sections 28 to 43C'.

- **In the case of ITO vs. Mark Construction reported in 23 taxmann.com the Hon'ble Kolkatta ITAT** has held that in the case of *CIT* v. *Surindra Pal Anand* [2010] 192 Taxman 264 (Punj. & Har.) the Hon'ble Punjab and Haryana High Court has held that once under the special provision of Section 44AD of the IT Act exemption from maintenance of books of account have been provided and the presumptive tax at 8% of the gross receipts itself is the basis for determining the taxable income, the assessee was not under obligation to explain individual entry of cash deposits in the bank unless such entries had no nexus with the gross receipts. In the present case though from the details filed by assessee the ld. AO observed that no TDS has been recovered, in our opinion, since assessee has disclosed the profits more than 8% of the gross receipts and there is no dispute in receipt of the gross receipts the addition made by ld. CIT(A) under Section 40(a)(ia) of the IT Act is not sustainable.

H. Whether under Section 40(a)(ia) of the Act the TDS is required to be deducted under proper section or it is sufficient if any TDS is deducted.

- Situations may also arise where the deduction of tax and its payment is lower than what was required under the law. The issue would be;
  - (i) if the full amount will be allowed as deduction: or
  - (ii) it will only be proportionate to the tax deducted at source: or
  - (iii) no deduction at all will be allowed.

- There are judgments, in the area of short deduction of tax, which show that the issue has to be judged on the basis of the facts and circumstances of each case.
  - **In the case of ITO vs. Premier Medical Supplies & Stores reported in 25 taxmann. com 171 the Hon'ble Kolkatta ITAT** has held that the conditions laid down under Section 40(a) (ia) for making addition are that tax is deductible at source and such tax has not been deducted. If both the conditions are satisfied then such payment can be disallowed under Section 40(a)(ia), but the provisions of Section 40(a)(ia) have two limbs, one is where, inter alia, assessee has to deduct tax and the second where after deducting tax, inter alia, the assessee has to pay into Government Account. There is nothing in the said section to treat, inter alia, the assessee as defaulter where there is a shortfall in deduction. The Section 40(a) (ia) refers only to the duty to deduct tax and pay to government account. If there is any shortfall due to any difference of opinion as to the taxability of any item or the nature of payments falling under various TDS provisions, the assessee can be declared to be an assessee-in-default under Section 201 and no disallowance can be made by invoking the provisions of Section 40(a)(ia).
  - Similar law has been laid down **by the Hon'ble Kolkatta ITAT in the case Dy. CIT v. S. K. Tekriwal [2011] reported in 48 SOT 515, and by the Hon'ble Mumbai ITAT in the case of DCIT vs. Chandabhoy & Jassobhoy reported in 17 taxman.com 158.**

- **The above referred law laid down by the Hon'ble Kolkatta ITAT in the case of S.K. Tekriwal has been confirmed by the Hon'ble Calcutta HC in same case in** ITAT No. 183 of 2012 GA No. 2069 of 2012, wherein the Hon'ble Calcutta HC vide its order dated 03.12.2012.

- In the case of **Diplomat Enterprises** the assessee had deducted on certain payments @ 2.20% as against 2.24%. The assessee had suo motu disallowed the said sum under Section 40(a)(ia) of the Act (mainly due to reason that the assessee was claiming deduction under Section 80IB of the Act). **The AO was of the opinion that disallowance needed to be made only proportionately,** i.e. in other words, proportionate to the tax actually deducted at source. Therefore he **scaled down** the disallowance made by the assessee under Section 40(a)(ia) of the Act. The CIT(A) reinstated the working done by the assessee. **The Hon'ble Chennai ITAT in the case of ACIT vs. Pixie Enterprises reported in 15 taxmann. com 314, wherein the case of Diplomat Enterprises in I. T. A. No. 1557/Mds/2009 was also decided,** held that the line of reasoning adopted by the learned Commissioner of Income-tax (Appeals) is incorrect. He was bound to look into the aspect whether the disallowance suo motu done by the assessee was justified after analysing Section 40(a)(ia) and the effect of allowing such claim, in future years when the assessee made good the short fall in deduction of tax. The disallowance contemplated under Section 40(a)(ia) is where tax

has not been deducted or where, after deduction, it is not paid. Whether such disallowance can be done even when deduction has been effected but at a rate lower than the prescribed one has not been looked into by the learned Commissioner of Income-tax (Appeals). The view of the learned Commissioner of Income-tax (Appeals) that the exercise is futile is not correct since it will have ramifications in future years, when allowances are claimed by the assessee after remitting the short fall. Hence the Hon'ble ITAT set aside the order of the learned Commissioner of Income-tax (Appeals) in this regard and remitted it back to him, for disposal in accordance with law.

- The provisions of Section 40(a)(ia) of the Act uses the words "….on which tax is deductible at source under Chapter XVII-B and **such tax** has not been deducted or, after deduction, has not been paid…..". The use of words "**Such tax"** clearly denotes that the tax has to be deducted at per rate prescribed under the appropriate section in Chapter XVII-B of the Act which is applicable to the sums under consideration. The expression "on which tax is deductible at source under Chapter XVII-B and on which *such* tax has not been deducted" clearly indicates that the disallowance provisions get attracted when *such* tax is not deducted- *i.e.* tax deductible under Chapter XVII-B. So, even if part of tax deductible is not deducted, the disallowance under Section 40(*a*)(*ia*) kicks in.

  The said proposition of law gets further fortified from the proviso inserted by the Finance Act 2012, which provides that "where an assessee **fails to deduct the whole or any part** of the tax in accordance with the provisions

of chapter XVII-B on any such sums". The use of words "whole or any part of the tax" makes it evident that the TDS not only need to be deduct but the same need to be deducted at appropriate rate under applicable section in Chapter XVII-B of the Act.

I. Meaning of tax deductible under chapter XVII for Section 40(a)(ia)

- The courts have held that under Section 40(a)(ia) of the Act there should be legal liability to deduct the tax under Chapter XVII. If there is no such liability to deduct TDS then the provisions of Section 40(a)(ia) of the Act cannot be invoked.

  - **In the case of Pareek Electricals vs. Assistant Commissioner of Income-tax, Circle 2(1), Cuttack reported in 27 taxmann.com 219 the Hon'ble Cuttack ITAT** has held that Where assessee paid rent to land lady, which was below taxable limit, without deduction of tax at source under Section 194-I and filed Form No. 15G being given by land lady, disallowance of rent paid under Section 40(a)(ia) on plea that there were infirmity in Form No. 15G was unjustified.

  - **In the case of ACIT vs. Meerut Rubber Factory reported in 25 taxmann.com 338, the Hon'ble Delhi ITAT has held that** the assessee had not deducted tax at source on the ground that the depositors intended to file form No. 15G/15H in time but Form No. 15G/15H were not filed by the date on which it credited/paid the interest to the depositors. In Section 40 the word

'shall not be deducted in computing the income chargeable under the heads 'Profits and gains of business or profession' have been employed. It is a settled law that where the word 'shall' is used, it is mandatory. Therefore, for allowance of deduction under Section 40(a)(ia), the assessee should have either obtained Form No. 15G/15H on or before the end of the accounting year or it should have deducted tax at source. Since provisions of Section 40(a)(ia) are mandatory in nature, in cases where the assessee had not deducted tax at source, the deduction would not be allowable.

- **In the case of Shyam Sunder Kailash Chand vs. ITO reported in 19 taxmann.com 342 the Hon'ble Jaipur ITAT** has held that where the amount was paid/payable to contractor/sub-contractor and where Form No. 15G was received by the assessee from depositors was submitted to AO late by few days but before framing assessment, interest paid by assessee to depositors without deduction of tax at source could not be disallowed since said forms were available to AO while framing assessment order.

- **In the case of CIT vs. Valibhai Khanbhai Mankad in Tax Appeal No. vide its order dated 01.10.2012, the Hon'ble Gujarat HC has held as under.**

  For application of Section 40(a)(ia) of the Act, the foremost requirement would be of tax deduction at source.

Section 194C, as already noticed, makes provision where for certain payments, liability of the payee to deduct tax at source arises. Therefore, if there is any breach of such requirement, question of applicability of Section 40(a)(ia) would arise. Despite such circumstances existing, sub-section (3) makes exclusion in cases where such liability would not arise. We are concerned with the further proviso to sub-section (3), which provides that no deduction under sub-section (2) shall be made from the amount of any sum credited or paid or likely to be credited or paid to the sub-contractor during the course of business of plying, hiring or leasing goods carriages, on production of a declaration to the person concerned paying or crediting such sum in the prescribed form and verified it in the prescribed manner within the time as may be prescribed, if such sub-contractor is an individual who has not owned more than two goods carriages at any time during the previous year.

The exclusion provided in sub-section (3) of Section 194C from the liability to deduct tax at source under sub-section (2) would thus be complete the moment the requirements contained therein are satisfied. Such requirements, principally, are that the sub-contractor, recipient of the payment produces a necessary declaration in the prescribed format and further that such sub-contractor does not own more than two goods carriages during the entire previous year. The moment, such requirements are

fulfilled, the liability of the assessee to deduct tax on the payments made or to be made to such sub-contractors would cease. In fact he would have no authority to make any such deduction.

The later portion of sub-section (3) which follow the further proviso is a requirement which would arise at a much later point of time. Such requirement is that the person responsible for paying such sum to the sub-contractor has to furnish such particulars as prescribed. We may notice that under Rule 29D of the Rules, such declaration has to be made by the end of June of the next accounting year in question.

In our view, therefore, once the conditions of further proviso of Section 194C(3) are satisfied, the liability of the payee to deduct tax at source would cease. The requirement of such payee to furnish details to the income tax authority in the prescribed form within prescribed time would arise later and any infraction in such a requirement would not make the requirement of deduction at source applicable under sub-section (2) of Section 194C of the Act. In our view, therefore, the Tribunal was perfectly justified in taking the view in the impugned judgment. It may be that failure to comply such requirement by the payee may result into some other adverse consequences if so provided under the Act. However, fulfillment of such requirement cannot be linked to the declaration of tax at source. Any such failure therefore cannot be visualized by

adverse consequences provided under Section 40(a)(ia) of the Act.

When on the basis of the record it is not disputed that the requirements of further proviso were fulfilled, the assessee was not required to make any deduction at source on the payments made to the sub-contractors. If that be our conclusion, application of Section 40(a)(ia) would not arise since, as already noticed, Section 40(a)(ia) would apply when there is a requirement of deduction of tax at source and such requirement is either not fulfilled or having deducted tax at source is not deposited within prescribed time.

J. Effect of Explanation to Section 40(a)(ia) of the Act.

- The effect of Explanation to Section 40(a)(ia) of the Act is that the nature of any sums has to be determined within the meaning of definition of such sums given in the said Explanation.
- **In the case of Sonata Information Technology Ltd vs. DCIT reported in 25 taxmann.com 125** it has been held that for the purpose of Section 40(a)(ia), royalty shall have the same meaning as in Explanation 2 of clause (vi) of sub-section (1) of Section 9. Explanation 4 which was introduced with effect from 1-6-1976 by the Finance Act, 2012 has no effect as that Explanation was not referred to in Section 40(a)(ia). Since the definition of royalty is specifically mentioned in Section 40(a)(ia), the examination of the issue can only be made with reference to Explanation 2 alone.

K. Whether provisions of Section 40(a)(ia) of the Act can be invoked when TDS was deducted but not paid on the ground that in earlier years excess TDS has been paid and refund is arising therein.

- **In the case of HCC Pati Joint Venture vs. ACIT reported in 12 taxmann.com 179 the Hon'ble Mumbai ITAT** has held that the provisions of Section 40(a)(ia) are in the nature of additional measure to ensure the deduction and deposit of the tax (TDS) within time. When the assessee makes more payment than requirement, the CBDT has given a right to the deductor to claim refund or adjust the excess payment, the refund and claim of excess payment has to be decided by the revenue authorities. But in the garb of the claim of excess deposit, the TDS deducted by the assessee on the payment during subsequent year cannot be withheld. The assessee has to deposit the TDS in compliance with the provisions of the Act. Since, the TDS deducted by the assessee is not the assessee's own tax liability but the assessee is under obligation and duty to deposit the same with the Government, non-deposit of the TDS deducted by the assessee is clear contradiction of the provisions of the Act. Moreover, when the TDS is deducted on the payment, the said payment is allowed as expenditure only when the assessee fulfils the conditions as prescribed under Section 40(a)(ia). Therefore, irrespective of the fact that the assessee is entitled to claim the refund or get it adjusted against the tax liability under the provisions of the Act, the assessee cannot withhold the TDS deducted and if the assessee does so then the relevant provisions of the Act are attracted. Therefore, when the assessee

undisputedly deducted the tax but to the extent the same was not deposited with the Government, the provisions of Section 40(a)(ia) were attracted and the claim of the deduction of such expenditure was to be disallowed.

L. Single transactions- Whether maxim of *"Lex Non Cogit Ad Impossibilia"* is applicable.

- Under Section 40(a)(ia) of the Act if tax is deducted and paid in a subsequent year, the business expenditure can be reduced from total income in that year. But tax can be deducted if there is another transaction between the assessee and the same payee or some amount should remain outstanding to enable deduction. However if there was only one transaction and the payment was made in full without deduction of tax, then TDS cannot be deducted in subsequent year and hence such sums will not be allowable in any of the year. In such a situation the assessee may rely on the well-known maxim of *Lex Non Cogit Ad Impossibilia*, which means that the law does not compel a person to do that what he cannot possibly perform. However this is yet to be decided by the Judiciary with respect to Section 40(a)(ia) of the Act.

M. Tax paid voluntarily or collected involuntarily without deduction from the payee

- Another situation would be where the tax was not deducted at source but was paid voluntarily or collected by the Income-tax authorities from the assessee through coercive methods prescribed in Section 201. The way sub-clause (ia) to Section 40(a) is worded, a view can be taken that the assessee will not be entitled to the deduction of the expenditure where tax was not deducted

by him but was voluntarily paid by him or involuntarily collected from him. The main sub-clause (ia) as well as the proviso thereto makes deduction from the payee an essential condition for allowing expenditure as business deduction in the hands of the assessee.

- However, in a similar provision contained in sub-clause (i) of Section 40(a) in respect of payments to non-residents and foreign companies, the **Rajasthan High Court, in Addl. CIT v. Farasal Ltd. (1987) 163 ITR 364 (Raj)**, interpreted the word "paid" in that sub-clause to include involuntary payment of tax collected by the Revenue. In doing so, it took into account the fact that the object of Section 40(a)(i) is to protect the interest of Revenue by ensuring that in respect of the amount chargeable under the Act and payable outside India, the tax is paid by the non-resident or deducted in cases where the non-resident does not have any agent in India from whom the tax can be recovered. From this point of view, it is immaterial whether the Revenue has received payment of the tax due either voluntarily or by initiation of recovery proceedings against him. In all likelihood the courts may take similar views as Rajasthan HC has taken in above referred case.

N. Disharmony between provision to Section 40(a) (ia) and Section 199.

- Section 199 prescribes that the credit for the tax deducted at source will be allowable to the payee in the year in which the income liable to deduction is assessed to tax. Normally, income is assessed on accrual basis. The payee may not get the benefit of the deduction of tax at source if

it is deducted by the assessee in a year subsequent to the year in which it is assessable in the payee's hands. This will also cause problem as the system will show the credit in 26AS in next year and system will not allow credit in any other year.

O. Possible Misuse/Tax planning

- It is possible to misuse of or tax planning through Section 40(a)(ia).
- If any assessee is eligible for deduction under Chapter VIA or exemption under chapter III of the Act at 100% or some other percentage of its income in any particular assessment year, then the assessee may deliberately not deduct or less deduct TDS on the payments on which TDS are required to be made in any particular section under Chapter XVII-B of the Act and disallow such sums in computation of its income and claim exemptions under Chapter III or deduction under Chapter VIA of the Act on such enhanced income in that particular assessment year and in any subsequent assessment year where the assessee is not eligible for exemption/deduction at the rate of 100% or not eligible for any such exemption/ deduction, the assessee pays the TDS and claim such expenses in such year reducing its tax liabilities. There is no express provision under the Act to tackle such a situation. **Similar tax planning was made by the assessee in the case of Diplomat Enterprises, the facts of which are discussed above.**
- Similarly, in case the assessee has huge business loss in any particular assessment year then the assessee may willingly default either fully or partly the TDS

provisions and suo motu make disallowance under Section 40(a)(ia) of the Act in that assessment year and rectify such TDS default in later year and claim such expenses in that later year and get the benefit of extended period of carry forward of business losses.

(iii) Collection of facts and investigation thereof

- The Assessing officers have to go through the various payments debited in the P & L account.
- Identify the payments on which prima-facie the TDS was required to be made in any of the Sections under Chapter XVII-B of the Act.
- Call for details of such payments and nature thereof, including necessary evidences, during the course of assessment proceedings.
- Analyse the nature of payments and ascertain whether the payments were of such in nature on which TDS was required to be made in any particular section in Chapter XVII-B.
- Verify with evidences, i.e. quarterly TDS returns filed by the assessee, as to whether correct TDS have been deducted on such payments and deposited in the Govt. account within the stipulated time under Section 40(a)(ia).
- It is important to note that TDS on payments of one particular nature need to be made under only applicable section and no other section, i.e. various Sections under Chapter XVII-B are mutually exclusive. The CBDT vide **Circular No. 720 dated 30.08.1995** has clarified that each section regarding TDS under Chapter XVII, deals with a particular kind of payment to the exclusion of all other sections in this Chapter. Thus, payment of any

sum shall be liable for deduction of tax only under one section. Therefore, a payment is liable for tax deduction only under one section.

- The AO should go through the **Circular No.5/2002, Circular No. 715 of 2002** and other Circulars wherein the Board has clarified in the form of question and answers and otherwise the liabilities of TDS on various payments made and the liability to deduct TDS should be ascertained in harmony to said Circulars.

- In view of the decision of Hon'ble Gujarat HC in the case of **CIT(TDS) vs. Krishak Bharati Coopeartive Ltd**. in Tax Appeal No. 618 of 2010, order dated 12.07.2011, the CBDT vide **Circular No. 9/120 in F.No. 275/11/2012-IT(B) dated 17.10.2012** has clarified that in case the owner/seller of the gas sells as well as transport the gas to the purchaser till the point of delivery, where the ownership of gas to the purchase is simultaneously transferred, the manner of raising the sale bill (whether the transportation charges are embedded in the cost of gas or shown separately) does not alter the basic nature of such contract which remain essentially a **'contract for sale' and not a 'works contract'** as envisaged in Section 194C of the Act. Here in such circumstances, provisions of Chapter XVII-B of the Act are not applicable on the component of Gas Transportation Charges paid by the purchaser to the Owner/Seller of gas. The use of different modes of transportation of gas by Owner/Seller will not alter the position. It is needless to mention that transportation charges to a third party transporter of gas, either by the Owner/Seller of the

gas or purchaser of the gas or any other person, shall continue to be governed by the appropriate provisions of the Act and TDS shall be deductible on such payment to the third party at the applicable rates.

- In the case of **Mitra Logistic P Ltd vs. ITO** reported in 27 taxmann.com, the Hon'ble Kolkatta ITAT has held that where an expenditure, being fully **reimbursable** by assessee's principal, is not claimed as expenditure by assessee it would not be subject to rigour of Section 40(a)(ia) of the Act.

- In the case of **Pareek Electricals vs. ACIT, reported in 27 taxmann.com 219**, the Hon'ble Cuttack ITAT has held that where the assessee was a franchisee of BSNL and received commission on gross value of purchase and on said commission BSNL had deducted tax at source under Section 194H of the Act. It had also appointed sub-franchise for selling products of BSNL and out of its commission allowed trade discount to sub-franchisees. The AO treated the trade discount as commission and disallowed same by applying Section 40(a)(ia) on plea that the assessee had not deducted tax at source under Section 194H on traded discount. It was held that **trade discount made available to sub-franchise was a compensation by foregoing part of commission already subjected to tax at source by BSNL** and it could not have suffered taxation under Section 194H and hence disallowance under Section 40(a)(ia) was unjustified.

  In the case of **Sri Venkatesh Paper Agencies(Hyd) P Ltd** reported in 24 taxmann.com 52, the Hon'ble

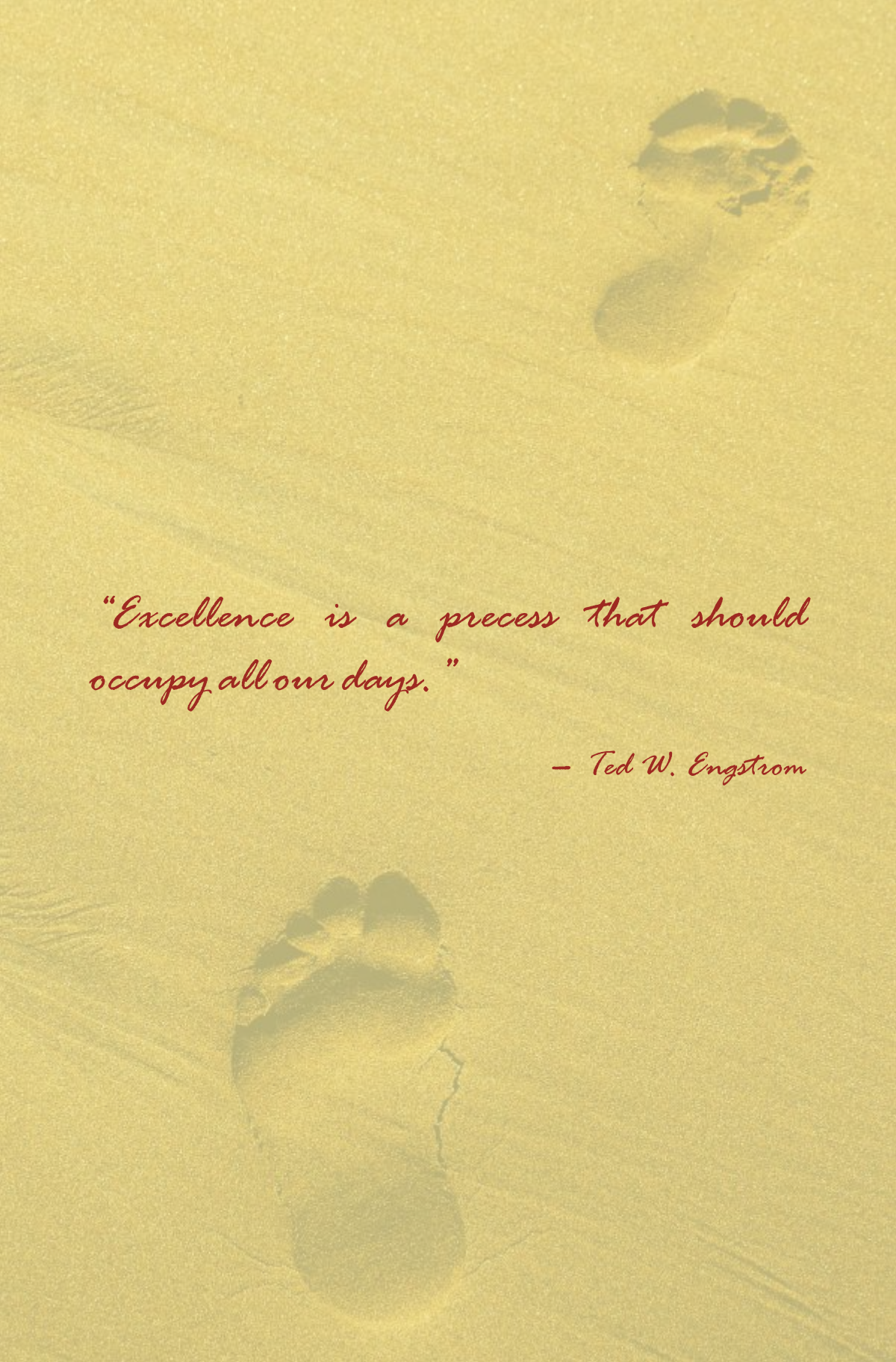
Hyderabad ITAT has held that it is not disputed that the interest paid is not for any loan or debt incurred by the assessee but for the delay in payment of bills for purchases effected from company. Therefore, it has to be seen as to whether such payment is in the nature of interest as envisaged under Section 2(28A). As seen from the order of the ITAT Ahmedabad Bench in the case of **ITO v. Parag Mahasukhlal Shah** 46 SOT 302 the Tribunal has held that a payment which has direct link and immediate nexus with the trading liability being connected with the **delayed purchase payments** will not fall within the category of interest as defined in Section 2(28A). The payment made by the assessee in the present appeal being of similar nature also cannot be termed as interest as defined under Section 2(28A).

(iv) Drafting of assessment vis-à-vis Section 40(a)(ia)

- The drafting of assessment order is an art and dealing the issue of disallowance under Section 40(a)(ia) of the Act is not different from dealing of any other issue.
- The AO must bring all the facts of the case. It is of utmost importance that the AO has to bring all the facts of the case, because if the AO fails to bring all the facts, relevant to the issue, on the record then the same is lost forever until and unless the same is brought on record from some third source of information.
- The law can be taken care of at any stage, i.e. at the assessment or appellate stage as held by the Hon'ble SC in the case of National Thermal Power Co. Ltd vs. CIT, reported in 229 ITR 383. After ascertaining full facts of the case and analyzing the same the AO should ascertain whether the TDS was required

to be made and also the relevant/appropriate section under Chapter XVII-B.

- Once it is established that on any sums/payments the tax was deductible under Chapter XVII-B of the Act, then it should be verified whether the assessee has deducted the tax at applicable rate on not and whether after deducting the tax at source the assessee has remitted/deposited the same within the time stipulated under the provisions of Section 40(a)(ia) of the Act.
- Every default under Section 40(a)(ia) for any payment, should be determined and listed out in detail.
- The assessee should be given show cause pointing out each default committed under Section 40(a)(ia) of the Act.
- Both factual and legal grounds raised by the assessee in response to show cause notice should be dealt elaborately and clear finding on all the grounds raised by the assessee should be given in assessment order while making disallowance under Section 40(a)(ia) of the Act.



"Excellence is a precess that should occupy all our days."

— Ted W. Engstrom

7 Expenses or Payments not Deductible Under Certain Circumstances - Section 40A

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A Section 40A(3)

Section 40A(3) was introduced by the Finance Act 1968 as a provision designed to counter evasion of tax through claims for expenditure shown to have been incurred in cash with a view to frustrating proper investigation by the Department as to the identity of the payee and the reasonableness of the payment.

The section has over the years gone many changes and vide the Finance Act of 2008 w.e.f. 1-4-2009 substantial changes in the whole scheme of Section 40A(3) have been made. Many of the issues relating to Section 40A(3) have been settled vide these latest amendments. For the sake of brevity this note does not delve into the legislative history of amendment to Section 40A(3) and concentrates on issues relevant for AY 2009-10 and beyond.

2. Scheme of Disallowance in Respect of Cash Payments

a. **Disallowance under Section 40A(3):** No deduction is allowed in respect of which a payment or aggregate of payments exceeding rupees twenty thousand are made to a person in a day otherwise than by an account payee cheque drawn on a bank or account payee bank draft. The disallowance under Section 40A(3) are relevant for computation of income under the head "income from business or profession" and by virtue of Section 58(2) these provisions also apply to computation of income under the head "income from other sources".

b. **Subsequent disallowance due to violation of Section 40A(3) in a year other than the year of allowance of deduction of expenses [Section 40A(3A)] :** Where an allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during any previous year a payment is made in violation of Section 40A(3) then such payment is deemed to be the profits and gains of business or profession and accordingly is chargeable to income-tax as income of the subsequent year.

c. **No disallowance under circumstances prescribed in Rule 6DD**

d. **Higher exemption limit of rupees thirty five thousand for cash payment in case of transporters**

3. Applicable Rule of Statutory Interpretation

Being a provision specifically designed to counter evasion of tax the principle of strict literal interpretation generally applicable to Taxing Statutes shall not apply. A provision or statute designed to prevent fraud upon the revenue is more properly a statute against fraud rather than a taxing statute and for this reason is liable for liberal construction in favour of revenue.

State of Tamil Nadu vs Kandaswamy AIR 1975 SC 1871 (para 26) & *Hotel Balaji vs State of AP, AIR 1993 SC 1048.*

4. Burden of proof

Whereas the burden of proof for establishing that payments exceeding rupees twenty thousand are made to a person in a

day otherwise than by an account payee cheque drawn on a bank or account payee bank draft lies on revenue the burden of establishing that the case falls under the exclusionary provisions of Rule 6DD lies on the assessee.

5. Crossed cheque versus account payee cheque

Over the years the provisions of Section 40A(3) have been made stringent. With effect from 13th July, 2006 vide the Taxation Laws (Amendment) Act, 2006 the change over from crossed cheques to account payee cheques was made.

5.1 Rationale of changing over to account payee explained: A crossed cheque or crossed bank draft is not a non-negotiable instrument. This has, at times, resulted in crossed cheques being endorsed making it difficult to trace final payee and thus defeating the provisions of Section 40A(3). However, as per the RBIs instructions to commercial banks, an account payee cheque or account payee bank draft cannot be credited to any account other than the account of the payee. The Act has accordingly amended the aforementioned sub-section (3) and sub-section (4) to substitute the expression a crossed cheque drawn on a bank or by a crossed bank draft, in both the sub-sections, by an account payee cheque drawn on a bank or account payee bank draft in both the sub-sections, by an account payee cheque drawn on a bank or account payee bank draft.

CIRCULAR NO. 1/2007, DATED 27-4-2007

5.2 Crossed cheque: As per Section 126 of the Negotiable Instruments Act, 1881 a crossed cheque is a cheque which is payable only through a collecting banker and not directly at the counter of the bank. Crossing ensures

security to the holder of the cheque as only the collecting banker credits the proceeds to the account of the payee of the cheque.

When two parallel transverse lines, with or without any words, are drawn generally, on the left hand top corner of the cheque. A crossed cheque does not affect the negotiability of the instrument and thus these can be endorsed but unlike a bearer cheque it cannot be encashed across the counter.

5.3 Account payee cheque: Account payee cheques are not defined under the Negotiable Instruments Act, 1881. Making a cheque A/c payee is a result of custom, use and practice and the same is now legally accepted. As per English Law in this type of crossing the collecting banker is supposed to credit the amount of the cheque to the account of the payee only. The cheque remains transferable but the liability of the collecting banker is enhanced in case he credits the proceeds of the cheque so crossed to any person other than the payee.

This position was endorsed in India vide Reserve Bank of India (RBI) circular DBOD.NO.BC.23/21.01.001/92 dated September 9, 1992 which said that banks which credited cheques drawn in their favour by other banks marked 'A/c. payee' to the accounts of constituents who were not named payees therein, without proper mandate of the drawer did so at their own risk and were held responsible for the unauthorized payment.

5.4 After receiving complaints after the IPO (Demat) Scam, the RBI vide circular DBOD.BP.BC No. 56/21.01.001/ 2005-06 dated January 23, 2006 has prohibited the

banks from crediting 'A/c payee' cheque to the account of any person other than the payee named therein. The RBI has since directed that banks that should not collect A/c payee cheques for any person other than the payee constituent and where the drawer/payee instructs the bank to credit the proceeds of collection to any account other than that of the payee, the instruction being contrary to the intended inherent character of the 'A/c payee' cheque, the bank should ask the drawer/payee to have the cheque or the account payee mandate thereon withdrawn by the drawer. After this an 'A/c. payee' is no longer transferable.

5.5 The CBDT have clarified that the word 'cheque', which is not defined in the Income-tax Act, will have the same meaning as in Section 6 of the Negotiable Instruments Act, viz., 'a bill of exchange drawn on a specified banker and not expressed to be payable other than on demand'. It has also been clarified that the word 'bank' as used in Section 40A(3) is wide enough to include any person carrying on the business of banking, and thus would include a co-operative land mortgage bank or any other co-operative society carrying on the business of banking. Indigenous money-lenders' banks are also 'bank', provided they are specifically notified under Section 49A of the Banking Regulations Act

Circular No. 6-P, dated 6-7-1968

6. Law as on the date of making of payment to apply:

One of the new issues being raked up now is that wherein liabilities were incurred prior to 13.7.2006 and payments after this date have been made by crossed cheques no

disallowance can be made as in the year of incurring of liability payment by crossed cheques was allowable. This is an erroneous proposition as (a) Section 40A(3) being an anti-evasion measure a purposive interpretation that curbs the mischief has to be given to the Section (b) In no way can it be held that the assessee gets a vested right in making a payment by crossed cheques in subsequent years as this mode of payment has been held by the Parliament to have defeated the purpose of introduction of the section itself. (c) In past whenever the limit of cash expenses in Section 40A(3) was enhanced the enhanced limit was made applicable to all payments made subsequent to this date irrespective of the fact that in the year in which the liability was incurred a lower limit might have been in place

7. Provision is constitutionally valid –

Section 40A(3) cannot be said to be invalid on the ground that it places a restriction on the right to carry on business and is arbitrary

Attar Singh Gurmukh Singh v. ITO [1991] 191 ITR 667 (SC).

Even after the deletion of sub-clauses (1) and (2) of rule 6DD(j), Section 40A(3) cannot be considered as constitutionally invalid. On the contrary, the objects of curbing the circulation of black money and regulating the business transactions become more strengthened and it avoids any undue advantage being taken by unscrupulous assesses or litigation being multiplied. One cannot plead ignorance of law and make cash payments contrary to law. It is too late in the day to accept any such proposition. In the present day banking scenario the mode of payment by way of crossed cheques or demand drafts

cannot be said to be an onerous duty cast on an assessee, which can be made a foundation for attacking the validity of the provision

Smt. Ch. Mangayamma v. Union of India [1999] 106 Taxman 339/239 ITR 687 (AP).

8. Meaning and scope of word 'expenditure' for purposes of Section 40A(3) :

Section 40A(3) refers to the expenditure incurred by the assessee in respect of which payment is made. It means all outgoings are brought under the word 'expenditure' for the purpose of the sub-section. The expenditure for purchasing the stock-in-trade is one of such outgoings.

Attar Singh Gurmukh Singh v. ITO [1991] 191 ITR 667 (SC).

Even if the payments were made by way of advances and were ultimately treated as discharging the liability to pay the price of the goods purchased, the payments so made must be considered to fall within the expression 'expenditure' incurred for payment of the price of the goods –

Kejriwal Iron Stores v. CIT [1988] 169 ITR 12 (Raj.).

Payment for purchase of goods covered by 40A(3) – Argument that Section 40A(3) deals with only deductions dealt with in Sections 30 to 37 and cost price of goods is covered by Section 28 and hence Section 40A(3) will not apply, was rejected – The expression 'expenditure' used in Section 40A(3) should not be given too narrow a meaning to restrict it from applying to payments for purchase of goods – To give such a narrow interpretation to the expression 'expenditure' and to exclude from its meaning

payments made for goods purchased is to make it difficult for the revenue to properly investigate the payments, to open the door wide to allow evasion and thus to defeat the very object which the provision was designed to achieve.

CIT VS Grewal group of Industries (P&H) 110 ITR 278

U.P. Hardware Store Vs CIT (All) 104 ITR 664

CIT Vs Kishan Chand Maheshwari Dass (P&H) 121 ITR 232

Sajowanlal Jaiswal Vs CIT (Ori) 103 ITR 706

Hari Chand Virender Paul Vs CIT (P&H) 140 ITR 148

9. Payment made in advancing loans and returning the principal amount of borrowed money not covered by Section 40A(3) :

Advancing of loans or repayment the principal amount of the loan do not constitute expenditure deductible in computing the taxable income. However, interest payments made in contravention of provisions of Section 40A(3) are disallowable, as interest is a deductible expenditure-

Press Note : Dated 2-5-1969, issued by Ministry of Finance.

10. Limit applies to cash portion of payment –

Where the payment was made partly in cash and partly by way of post-dated cheques, Section 40A(3) will apply only if the cash payment exceeded the prescribed limit –

H.A. Nek Mohd. & Sons v. CIT [1982] 135 ITR 501 (All.).

11. Limit applies to all items in a bill, and not to individual items –

Section 40A(3) concentrates on the size of the payment and the manner of the payment. If different items are included

in a single bill, it would not be right to dissect the bill and find out whether each item of expenditure is above Rs. 10,000 (now Rs. 20,000); the proper way is to read the entries in a wholesome fashion

- Addl. CIT v. Shree Shanmuga Gunny Stores [1984] 146 ITR 600 (Mad.).

12. Genuineness of transaction not sufficient –

It would amount to defeating objective of enactment, if claim allowed on the basis of transaction is genuine, identity of party established etc. – Assessee has not been able to make out a case of unavoidable circumstances so as to claim benefit of Rule 6DD(j).

- T.G. Mutha Vs ITO (ITAT, Pune) 54 ITD 460

Assessee had bank account in the same place of customers – No reason to issue bearer cheques - Not merely genuineness of transaction, but existence of circumstances warranting cash payment to be proved.

Associated Engg. Enterprise Vs CIT (Gau) 216 ITR 366

Late Smt. Jyoti Chellaram Vs CIT (AP) 173 ITR 358

Evershine Platers Vs CIT (All) 295 ITR 349

Aggarwal Steel Traders Vs CIT (P & H) 250 ITR 738

Even if transaction is entered in the books of other party, unavoidable circumstances to be proven.

CIT Vs Assam Tribune (Gauhati) 221 ITR 488

Running account for commission in the books – Payments made out of them in excess of Rs. 2,500 in cash at various points – Section 40A(3) applies.

Porwal Udhyog (India) Vs CIT (MP) 135 ITR 591

In a place where banking facilities are available, exemption cannot be granted merely because recipient had not opened bank account – Addition under Section 40A(3) upheld.

ITO Vs Kenaram Saha & Subhash Saha (ITAT,SB-Kol) 116 ITD 1

13. Provisions of Section 40A(3) will apply to transactions outside the books of accounts

Where income from an undisclosed business is brought to tax, provisions of Section 40A(3) will come into play. It was necessary to bear in mind that even if an exceptional or unavoidable circumstance was pleaded, the revenue must have data with it to verify the genuineness of the transaction and the identity of the recipient of the cash payment. If what the Tribunal stated was correct, the entire provision would be rendered otiose and that interpretation could never be placed on a provision. This case also held that Section 40A(3) would apply to Block Assessments.

In this case reasoning given by the ITAT while granting relief to the assessee in *48 ITD 202 (Ahd.)* also included the rationale that provisions of Section 40A(3) would be inapplicable where income of assessee is estimated by invoking proviso to Section 145(1) on basis of gross profit by using comparative instances. While reversing this order, the Hon'ble High Court has impliedly also overruled this finding of the ITAT.

CIT Vs Hynoup Food and Oil Ind. P. Ltd. (Guj) 290 ITR 702

After considering the non obstante clause in s. 40A (1), we

hold that certain payments and expenses which would be otherwise deductible under Sections 28 to 43, would not be deductible if the conditions of Section 40A (3) of the Act, are satisfied. Thus, we reverse the conclusion of the CIT(A) on this legal proposition and hold that a disallowance under s. 40A (3) is permitted even in a case where the net profit has been estimated at a flat rate on the receipts.

ITO vs. D. D. HAZARE 45 ITD 595 (Bombay)

As regards Section 40A(3) not being taken into account where assessment is by estimation basis on GP rate, the principle invoked in the judgments relied upon is not of universal application. If the estimated income impliedly takes into consideration the expenditure incurred, the said principle may apply. If the expenditures which are legally not permissible has been taken into account, the same can certainly be disallowed. The judgments relied upon on behalf of the assessee did not discuss the issue of impermissible expenditure. Rule 6DD of the Rules allows cash expenditure to be taken into account if circumstances in which the expenditure is incurred can reasonably explained. In the present case, the assessee has not been able to cover its case under rule 6DD. In the circumstances, the Assessing Officer was justified in disallowing expenditures incurred in contravention of Section 40A(3). This case also held that Section 40A(3) would apply to Block Assessments.

CIT vs. Sai Metal Works 241 CTR 377 (P & H)

Section 40A(3), read with Section 40(b), of the Income-tax Act, 1961 - Business disallowance - Cash payment exceeding prescribed limit - Assessment year 1989-90 - While computing total income of assessee-firm, Assessing

Officer disallowed an amount of Rs. 5,15,000 under Section 40A(3) being amount of interest paid in cash to minor daughter of a partner - Facts revealed that there were no exigencies warranting payment in cash; that interest of Rs. 5,15,000 was paid on Rs. 10 lakhs for a period of four months showing that transaction was of a colourable nature; and that interest received by minor from firm actually represented amount received by partner and, thus, transaction was also hit by provisions of Section 40(b) - Whether on facts, Assessing Officer was justified in disallowing payment of interest - Held, yes.

CIT vs. Muthoot M. George Bankers 220 CTR 517 (Ker.)

14. Rule 6DD

The scope and applicability of certain exceptional situations spelt out in rule 6DD have been explained in CBDT circulars/ judicial decisions, and these are briefly summarised below:

Clause (a)- Payment made to institutions like RBI, SBI etc.

Rule 6DD(a) applies only for payments to institutions referred to therein and not for payment made to any party's account maintained in such institutions – Payments made in cash to the account of the suppliers maintained with banks did not qualify for deduction.

CIT Vs K. Abdu & Co. (Ker) 170 Taxman 297

Clause (b) – Payments made to Government under the rules requiring that such payment be made in legal tender. The CBDT have clarified that payments made to the Railways on account of freight charges or for booking of wagons, and payments towards sales tax/excise duty are to be considered under this clause.

- Circular No. 34, dated 5-3-1970

Clause (d)- Payments made by way of adjustment against the amount of any liability incurred by the payee for any goods supplied or services rendered by the assessee to such payee. This exemption is held to operate only when the adjustment is made directly in the payee's account, and that the prohibition in Section 40A(3) is attracted to cases where book adjustments are not so directly made.

CIT v. Kishan Chand Maheshwari Dass [1980] 121 ITR 232 (Punj. & Har.).

Clause (e) - Payments for agricultural produce - Under this sub-clause, payments for the purchase of agricultural or forest produce is excluded, only where the payments are to be made to the cultivator/grower/producer. If the produce undergoes change and then sold, the exclusion will operate. For example, payments made to a grower or producer of kapas ginned by him, or to a grower of paddy which has been converted by him into rice and then sold, the exclusion will still operate.

Press Note, dated 2-5-1969

Payments to middlemen for the purchase of agricultural produce do not as such come under this sub-clause.

Letter F. No. 1/22/69-TPL (Pt.), dated, 18-4-1969

Similarly, payments to arhatiyas do not fall for exclusion under this sub-clause. Similarly, payments to arhatiyas do not fall for exclusion under this sub-clause - Circular No. 34, dated 5-3-1970.

Circular No. 34, dated 5-3-1970

Rule 6DD(e)(ii) provides relief from the operation of Section 40A(3), inter alia, where the payment exceeding a sum of Rs. 2,500 is made for the purchase of produce of animal husbandry to the producers of such articles. Where, however, the purchases were of hides and skins and the assessee had failed to establish that the payments were made to the producer, the aforesaid relief would not be available.

Ideal Tannery v. CIT [1979] 117 ITR 34 (All.).

Words 'cultivator, grower or producer' occurring at the end of Rule 6DD(e) qualify the words occurring in all the preceding four sub-clauses and not only in sub-clause (iv). Thus, the exemption is confined to grower or producer of forest produce and not available for purchases made from others.

CIT v.Pehlaj Rai Daryanmal [1991] 190 ITR 242 (All.).

Hoshiarpur District Co-operative Milk Producers Union Ltd. cannot be considered to be a producer of milk as its constitution does not permit individual producers to be its members and consequently, payment made by the assessee to the said union cannot be treated as payment made to producer of milk.

Chanchal Dogra Vs ITO (HP) 67 DTR 108

Clause (j)- When bank is on holiday or on strike - This clause was inserted with effect from 1-12-1995, so as to exclude payments required to be made on a day on which the banks were closed either on account of holiday or strike. Prior to 1-12-1995 also, the exclusion was available under executive instructions - Circular No. 250, dated 11-1-1979 and Letter F. No. 142(14)/70-TPL, dated 28-9-1970.

Clause (k)- payment made to agent

Employee is not 'agent'

Dy. CIT v. Vijay Kumar Ramesh Chand & Co. [2007] 108 ITD 626 (Pune - Trib.)

15. Return of paid cheques

In order to facilitate the production of paid cheques to the assessing authorities in order to prove that the payments have been made in the manner laid down in Section 40A(3), the CBDT have clarified that the banks must return the paid cheques to their constituents (i.e., the assessee) after obtaining a formal undertaking from them to the effect that they would retain the paid cheques for a period of 8 years, and produce them before the ITO whenever called upon to do so -*Circular No. 33, dated 29-12-1969.*

16. Documents /Information to be collected by the A.O.

i. Whether the payment of the cash is made directly to the farmer/ cultivator/ grower/ producer etc. or Brokers/Adhatiyas? This can be done from the actual verification of vouchers.

ii. Whether the Goods were purchased through APMC?

iii. In some cases depending upon the facts, cash book can be called for verification to ascertain the quantum of cash payment.

iv. Recipients' location and availability of Banks at the place of transaction.

v. Details of the actual account in which the cheques have been cleared can be obtained from Bank.

B Section 40A(2)

Section 40A(2) was introduced by the Finance Act 1968 and has more or less continued in the same form since then.

Scheme of Disallowance in Respect of Payments Made to Connected Persons

Payment to connected persons as defined in Section 40A(2)(b) and AO is of the opinion that such expenditure is excessive or unreasonable having regard to

- the fair market value of the goods or services or facilities for which the payment is made, or
- the legitimate needs of the business or profession, or
- the benefit derived by or accruing there from

Then such excessive or unreasonable expenditure will not be allowed as deduction.

The disallowance under Section 40A(2) are relevant for computation of income under the head "income from business or profession" and by virtue of Section 58(2) these provisions also apply to computation of income under the head "income from other sources".

2. Applicable Rule of Statutory Interpretation

Being a provision specifically designed to counter evasion of tax the principle of strict literal interpretation generally applicable to Taxing Statutes shall not apply. A provision or statute designed to prevent fraud upon the revenue is more properly a statute against fraud rather than a taxing statute and for this reason is liable for liberal construction in favour of revenue.

State of Tamil Nadu vs Kandaswamy AIR 1975 SC 1871

(para 26) & Hotel Balaji vs State of AP, AIR 1993 SC 1048.

3. Burden of proof

Payment to relatives – Reasonableness has to be proved by assessee and not by Department.

Nund & Samonta Co. P. Ltd. Vs CIT (SC) 78 ITR 268

CIT Vs NEPC India Ltd. (Mad) 303 ITR 271

CIT Vs Shatrunjay Diamonds (Bom) 261 ITR 258

3.1 One of the three requirements alone sufficient :

Section 40A(2) of the Income-tax Act, 1961 - Business disallowance - Excessive or unreasonable payments - Assessment year 1988-89 - Whether for making disallowance under Section 40A(2) Assessing Officer is required to record a finding as to whether expenditure is excessive or unreasonable in relation to any one of three requirements prescribed in section which are independent and alternative to each other; for making disallowance, all three requirements need not exist simultaneously - Held, yes - Whether where Assessing Officer held a part of expenditure on account of repair and maintenance to be excessive having regard to legitimate needs of business and for recording such a finding cogent reasons were assigned by him, he was justified in disallowing such excess payment under Section 40A(2) and there was no need to record a finding on market value of services - Held,

Coronation Flour Mills Vs ACIT (Guj) 314 ITR 1

Commission paid to wife of partner having 50% share in the firm on sales effected by the firm – Wife neither educated

nor trained to carry on such business – Test of commercial expediency not satisfied – Part of commission disallowed.

Ganesh Soap Works Vs CIT (MP) 161 ITR 876

Anandji Shah Vs CIT (Ker) 181 ITR 171 – interest payment @ 24%

K.R. Motilal Vs CIT (Mad) 240 ITR 810 – salary to relative

Expenses incurred on account of transportation of bricks through outside agencies was very low when compared to that of Director's trucks – Section 40A(2) rightly invoked.

ITO Vs Mansi Sales (P) Ltd. (ITAT, Jp) 54 ITD 346

Where assessee received brokerage from various companies on account of investments made by various investors including his family members in mutual fund and out of total brokerage received it had made payment of certain brokerage only to his family members, provisions of Section 40A(2)(b) would be applicable.

Shanti Lal Jain vs. CIT [2012] 21 taxmann.com 261 (Raj.)

3.2 Items not covered by Section 40(b) are alone covered –

Section 40A(2) applies in the case of firms only to payments made in lieu of goods, services and facilities to partners which are not covered by Section 40(b), and to all payments made for the goods, services and facilities to members of the family of a partner, or any relative of a partner. If has to be held that the overriding effect given to Section 40A(2) is only in respect of matters not covered by Section 40(b).

N.M. Anniah & Co. v. CIT [1975] 101 ITR 348 (Kar.).

3.3 Allowance of discount cannot result in any 'expenditure' –

Where the assessee-firm sold goods to another firm in which the close relatives of the partners of the assessee-firm were partners, and on the bills raised for such goods the assessee allowed discount of 6 per cent and raised demands for the net amount of the bills, there was no 'expenditure' which could be disallowed under Section 40A(2)(*a*), since the assessee had charged only the net price and had not parted with any portion of the sale price or its income.

CIT v. *A.K. Subbaraya Chetty & Sons* [1980] 123 ITR 592 (Mad.).

Assessee company doubling director's remuneration - Increased Remuneration claimed as expense - The hike in remuneration disallowed by Assessing Officer holding the same to be excessive and unreasonable under Section 40A(2)(b) - CIT(Appeals) upheld AO's order stating there is negligible business activity in relevant year and assessee is passing through lull phase of business - No justification for doubling director's remuneration.

Shar-Lee Filtorites Private Ltd Vs ACIT 2008-TIOL-500-ITAT-DEL

4. Documents /Information to be collected by the A.O.

i. In case of purchases, the AO can call for the copy of invoices raised by the seller to outside parties and compare these with the invoices raised to related parties. Invoices of related parties and the outside parties should be of similar product and preferably affected on same time or nearest to the time.

ii. For services also, similar exercise can be done as mentioned above.

iii. For interest payment, look for the details whether the assessee has paid lesser interest rate to any outside parties within the category of unsecured loan. Otherwise also, whether the assessee has paid higher interest rate as per the market rate.

iv. Any sharp rise in Salary / Remuneration should be correlated with the increased Turn Over / higher profitability to the concern.

v. **Whether the assessee has paid higher remuneration (in the case of companies) to director-Shareholders in lieu of Dividend?** The A.O can call for the details of dividend payment by the company. In case the assessee-company has not paid dividend, a case can be made out in assessment order that the assessee-company has paid higher salary/ remuneration to avoid payment of dividend distribution tax. The disallowances can be made Under Section 40A(2) as having paid excessively.

8 Treatment of Cessation of Liabilities - Section 41

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Introduction :

Section 41(1) provides for taxing any amount benefit which was obtained by a person with respect to any loss, expenditure or trading liability incurred in any earlier Assessment Years. The Section is re-produced as under:-

" Where an allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee (hereinafter referred to as the first-mentioned person) and subsequently during any previous year,-

(a) the first-mentioned person has obtained, whether in cash or in any other manner whatsoever, any amount in respect of such loss or expenditure or some benefit in respect of such trading liability by way of remission or cessation thereof, the amount obtained by such profits and gains of business or profession and accordingly chargeable to income-tax as the income of that previous year, whether the business or profession in respect of which the allowance or deduction has been made is in existence in that year or not; or

(b) the successor in business has obtained, whether in cash or in any other manner whatsoever, any amount in respect of which loss or expenditure was incurred by the first-mentioned person or some benefit in respect of the trading liability referred to in clause (a) by way of remission or cessation thereof, the amount obtained by the successor in business

or the value of benefit accruing to the successor in business shall be deemed to be profits and gains of the business or profession, and accordingly chargeable to income tax as the income of that previous year.

[Explantion-1 :- For the purposes of this sub-section, the expression "loss or expenditure or some benefit in respect of any such trading liability by way of remission or cessation thereof shall include the remission or cessation of any liability by a unilateral act by the first mentioned person under clause (a) or the successor in business under clause (b) of that sub-section by way of writing off such liability in his accounts.]

[Explantion-2:- For the purposes of this sub-section, "successor in business" means:-

i) where there has been an amalgamation of a company with another company, the amalgamated company;

ii) where the first-mentioned person is succeeded by any other person in that business or profession, the other persons;

iii) where a firm carrying on a business or profession is succeeded by another firm, the other firm;

iv) where there has been a demerger, the resulting company."

2. Loss, Expenditure and trading liability:

2.1 In order to invoke Section 41(1), it is not sufficient that an allowance or deduction have been granted in assessment to the assessee in an earlier year, it is also necessary that the allowance or deduction so granted should relate to a "loss expenditure or trading liability."

2.2 **Loss:**

The expression 'loss' is normally used to denote the minus figure resulting in the trading and reflected in the Profit & Loss A/c. However, even in a case of profit, there may be individual items of losses which may be embedded in the P&L A/c. These losses are called '*itemized*' losses, for eg. Loss of stocking trade by fire, loss of capital or money by embedment etc. Section 41(1) of the I.T. Act deals with losses of such *itemized* losses.

2.3 **Expenditure:**

Section 41(1) of the I.T. Act does not concern itself with the validity or otherwise of an expenditure. It comes into operation the moment that the assessee obtains some amount in respect of any expenditure which have been allowed as deduction in an earlier year. What is material is the allowance or deduction in an earlier year and not the validity or the nature of expenditure. In the case of **Nectar Beverages Pvt. Ltd. Vs. DCIT (2004) 267ITR 385(BOM)** the assessee company deriving income from sale of soft drinks had purchased bottles and crates and had been allowed 100% depreciation under Section 32(1)(ii) and then sold those bottled and crates as scrap in the accounting year relevant to Assessment Year 1991-92. It was held that amount obtained was deemed profits and gains of business under Section 41(1) and was chargeable to tax.

2.4 **Trading liability:**

The concept of trading liability is relevant and arises only where the assessee follows mercantile system of

accounting in so far as the provisions of Section 41(1) are concerned. As regards the other 2 items namely viz. "Loss" and "expenditure", the section would apply irrespective of the method of counting followed.

3. Allowance or Deduction :

3.1 Allowance in earlier year:

Section 41(1) would not be attracted unless deduction or allowances has been made in the assessment of an earlier year . In the case of **Swan Ltd. Vs. CIT (1995) 215 ITR 1 (BOM),** assessee was allowed gratuity liability on accrual basis. Later on he switched over to cash system and wrote back the liability to P&L A/c. Cessation of liability was held to be chargeable under Section 41(1). According to the decision in the case of **Mysore Thermo Electric Pvt. Ltd. Vs. CIT (1996) 221 ITR 504 (KAR),** provisions of Section 41(1) can be invoked to tax the refunds of Excise Duty received even when the part of Excise Duty was not claimed as expenditure in the P & L A/c. of earlier years and the applicant had kept a separate account in respect of collection and demand of excise duty.

3.2 Actual Allowance:

One of the conditions for invoking Section 41(1), is that the allowance or deduction should have been actually allowed in the earlier assessment years. Section 41(1) envisages actual allowance or deduction are not a notional one. In the case of **CIT Vs. AVM Ltd. (1984) 146 ITR 355 (MAD)** , the transfer

of unclaimed security deposits in a later year to P&L A/c. was held not to attract Section 41(1) since no actual allowance or deduction was earlier granted.

3.3. **Burden of proof:**

3.3.1 The burden lies on the Department to prove that such allowance or deduction has been made **(Steel & General Mills Co. Ltd. Vs. CIT - 96 ITR 438)** The section does not warrant a detailed enquiry whereby an assessee is called up on to produce his books of accounts and other documents to establish his case. Any direction to the assessee to produce his accounts and other documents related to the years in which the allowance was supposed to have been granted is not justified. **[CIT Vs. ANCHERRY PAVOO KAKKU (1986) 160 ITR 88 (KER)]**. Hence it is suggested that the Assessing Officers would verify the records available with the department in order to prove the allowance or deduction in any earlier assessment year.

3.3.2 However, the burden of proving that the liability did not cease and still subsists lies on the assessee **[CIT Vs. Haryana Co-operative Sugar Mills Ltd.(1985) 154 ITR 751(P&H) Kesoram Industries & Cotton Mills Ltd. Vs. CIT (1992) 196 ITR 845 (CAL)].**

4. Nexus between amount obtained and loss etc. allowed:

One of the conditions for attracting Section 41(1) of the I.T. Act is that the assessee should have obtained some amount in

respect of the loss or expenditure or some benefit in respect of the trading liability by way of remission or cessation. The word **"Such"** appearing in the second part of Section 41(1) signifies that the amount of compensation or other amount must have been received in respect of the loss, expenditure or trading liability mentioned in the first part of Section 41(1) and there should be nexus between them. So long as the assessee obtains a refund of the amount for which deduction or allowance was granted earlier, the provisions of Section 41 (1) stand attracted and it is not necessary that amount refunded should be of the same nature as the amount earlier paid. In **Panyam Cements and Mineral Industries Vs. Addl.CIT (1979) 117 ITR 770 (AP),** the State Government granted subsidy in respect of power tariff as a result of which the assessee obtained refunds of certain amount in respect of Electricity charges paid earlier to Electricity Board and it was held that the amounts so received back was taxable under Section 41(1). In **CIT Vs. Sahney Steel & Press Works Ltd. (1985) 152 ITR 39 (AP),** the Sales Tax paid by the assessee was allowed as deduction. Part of it was refunded under G.O. issued by the Government with a view to speed up industrial development of the State and the amount of refund was required to be used specifically for the development of industry. It was held that the words "any amounts" and " in respect of" indicated that it was not necessary that Sales Tax paid by assessee should be refunded as sales tax only and it was immaterial that refund was made under an altogether different scheme of a different Department of Government. What was necessary was that the refund should represent **"amount obtained in respect of expenditure"** which was allowed as deduction.

This view was subsequently affirmed by the Supreme Court in **Sahney Steel & Press Works Ltd. Vs. CIT (1997) 142 CTR (SC) 261**.

5. Treatment of refund of Sales Tax, Excise Duty etc:

5.1 Trading receipt:

It is now well settled that sales tax collected by the trader is his trading receipt irrespective of the fact whether there is liability for payment under the relevant Sales Tax Act. Refund of sales tax in a subsequent year which was paid in the earlier year to the Government and allowed as deduction would be deemed to be income under Section 41(1). **[CIT Vs. Taj Gas Service (1980) 122 ITR 1034 (ALL)]**. On the same principle refund of Excise Duty would be deemed as income under Section 41(1) **[D.V. Aswathiah & Bros. Vs. CIT (1993) 201 ITR 711 (ALL)].**

5.2 Pending appeals:

The controversy on the question of taxability of refund of excise duty obtained by the assessee when appeal against refund by Excise Department is pending, has been settled by hon'ble Supreme Court in **Poly Flex (India)(P) Ltd. Vs. CIT (2002) 257 ITR 343 (SC).** It was held that where the assessee obtained refund of excise duty during the relevant previous year, the amount of refund was taxable irrespective of the fact that the Special Leave Petition filed by Excise Department against the grant of refund is pending. Following the above decision it was held that refund of sales tax received by assessee during the relevant year is chargeable to tax

irrespective of the fact that the Dept. of Revenue has filed an appeal against the decision of the High Court [**CIT Vs. Kwality Ice-cream (2008) 304 ITR 384 (DEL)].**

5.3 **Unpaid Sales Tax :**

In the case of **CIT Vs. Markanda Vanspati Mill Ltd. (2009) 311 ITR 306 (P & H)],** it has been held that amount collected towards Sales Tax which remained unpaid and unpayable to the Department, which was also not refunded to the customers, was liable to be treated as income in the hands of the assessee under Section 41(1).

5.4 **Liability towards customers:**

In some cases, submissions have been made to contend that at the time of receipt of refund from the Government, the liability to pass on the refund to the customers subsists. Hence the amount of refund cannot be treated as deemed income under Section 41(1). The High Courts have given different decisions both in favour and against this view. In the case of **CIT Vs. Saraswati Industrial Syndicate Ltd. (1973) 91 ITR 501 (PUN),** the High Court held that the amount collected as Sales Tax was a trading receipt and chargeable to tax. If and when the purchaser demanded the amount of refund and the assessee made actual payment, it would be open to him to claim relief in subsequent years. The Supreme Court, in **Tirumalai Swami & Sons (1998) 146 CTR (SC) 529,** held that the entire amount of sales turnover of the assessee inclusive of the amount of

tax collected was clearly includible in the assessee's taxable income. If any deduction was given from that income and later the same was refunded back to the assessee, the refund will have the character of revenue receipt. It has to be treated as a receipt on the revenue account and had to be assessed as such . The position has been placed beyond doubt by the express provisions of Section 41(1). Admitted, the assessee had not refunded any part of this amount to any one of its customers in the year of account. As and when such refund is made, the assessee will be entitled to claim deduction.

5.5 **Refund of Excise Duty**:

Refund of Excise Duty received during the relevant assessment year would be taxable in that year and mere show cause notice to dispute such refund can not be interpreted to mean that income is not taxable during said year. The assessee shall be entitled to claim expenditure of such excise duty, if it is found payable in pursuance of the show cause notices during the Assessment Year in which such liability is discharged. **CIT Vs. Agarwal Steel Rolling Mills (2010) 321 ITR 290 (P&H),** following the decision in **Poly Flex India P. Ltd. Vs. CIT (2002) 257 ITR 343 (SC).**

6. Remission or Cessation of Trading Liability:

6.1 The remission of the liability arises when the creditor voluntarily gives up the claim . It is a positive act of the creditor. The cessation of the liability arises only when such liability ceases to exist in the eye of law for all intents and purposes.

6.2 **Liability shown in the Balance Sheet**:

In some cases the assessee may be showing certain liability in the Balance Sheet year after year. However, Section 41(1) cannot be applied in each such cases, just because the liability is existing for so many years. In the case of **CIT Vs. Tamil Nadu Warehousing Corporation (2007) 212 CTR (MAD) 228**, an amount representing liability was being shown year after year. It was held that unless and until there is cessation of said liability, Section 41 (1) was not applicable. Since there was no evidence of cessation of liability, the amount was held not assessable as income. In the case of **CIT Vs. Smt. Sitadevi Juneja (2010) 325 ITR 593 (P&H)**, it was held that assessee having shown the impugned liabilities in its balance sheet and filed copies of account of sundry creditors signed by the concerned creditor, such liabilities cannot be treated to have ceased merely because they are outstanding for six years and therefore, the addition made by invoking Section 41(1) cannot be sustained.

6.3 In the case of **CIT Vs. Modern Farm Services (2007) 207 CTR (P&H) 466**, it was held that the amount credited in the Post Warranty Service Scheme Account for more than 3 years from the date of credit has to be treated as income. Any refund claimed by any purchaser would be a permissible deduction in the subsequent years. The plea of the assessee that the amount had not be transferred to P & L A/c., did not make a difference on principle. Considering the terms of the Post Warranty Service Contract , the amount remaining credited in the account for more than 3 years from the date of credit has to be treated as income for the year.

6.4 **Remission or Cessation by Unilateral Act**:

The Finance Act, 1997 w.e.f. 1/4/1997 has inserted Explanation-I, which provides for inclusion of remission or cessation of any liability by any Unilateral Act of the assessee. This explanation is applicable to A.Y. 1997-98 and subsequent assessment years but not the earlier assessment year. Hence, as far as earlier years are concerned, the legal position is that Unilateral entry in the accounts transferring amounts representing unclaimed balances to P & L A/c. would not attract Section 41(1) of the I.T. Act.

7. Treatment of loans and Interest:

Assessee transferred the credit entries to the partner's Capital Accounts thereby neutralizing the liability towards creditors. The assessee's explanation was that the creditors who were relatives, gifted these amounts to the partners. The Court held that on such transfer, the assessee ceased to be liable for the interest liability which was claimed as deduction in the previous years. Therefore the cessation of liability in respect of interest credited to the account of the creditors was assessable under Section 41(1). **[Shree Hanuman Trading Co. Vs. ITO (2010) 328 ITR 662 (KAR)].**

8. Penalty for concealment :

When the assessee does not show the amount taxable under Section 41(1) in its return of income, penalty would be leviable under Section 271(1)(c) for concealment. Once the income has accrued, whether it has actually accrued or deemed to have accrued will not make any difference. As per the provisions of Section 5 (1) of the I.T. Act, 1961, the total income of the previous year, includes all income

received or deemed to be received or accrued in India. **[CIT Vs. Shri Sai Prakash (1990) 83 CTR (P&H) 181].**

9. Method of accounting:

The provisions of Section 41(1) can be invoked both in the case of assessee following the mercantile system of accounting as well as those having the cash system of accounting. For invoking Section 41(1) the system of accounting is not relevant. **[Visnagar Taluka Audyogik Sahakari Mandali Ltd. Vs. CIT (2000) 242 ITR 627 (GUJ)].**

10. Applicability of the section in BIFR cases:

10.1 CBDT originally issued Circular No. 523 dated 5/10/1988. As per the circular, if BIFR sanctions a scheme under Section 17(3) of the Sick Industrial Companies (Special Provisions) Act, 1985, specifically excluding the application of Section 41(1) of the Act, then the Assessing Officer will have to take due cognizance of this order and give effect to the same. Subsequently the above circular was withdrawn by another Circular No.683 dated 8/6/1994 (208 ITR St. 98).

10.2 In view of the last circular on the subject as above, the BIFR makes only recommendation, which may or may not be accepted by the CBDT. According to Section 19 (2) of Sick Industrial Companies (Special Provisions) Act, 1985, all parties concerned with giving financial assistance for the rehabilitation scheme should give their "consent". Each individual

case will be considered on merits for the purpose of 'consent' as contemplated in Section 19(2) of the Sick Industrial Companies (Special Provisions) Act, 1985 and consent or denial will be contemplated to the BIFR by the Central Government. In view of the above, Section 41(1) is applicable even in BIFR cases, unless the CBDT has consented to the provision limiting/excluding the liability under Section 41(1).

11. Section 59 of the I.T. Act.

Section 59 of the I.T.Act,1961 provides for charging of any profits with respect to Section 56 as under:

"The provisions of sub-section (1) of Section 41 shall apply, so far as may be, in computing the income of an assessee under Section 56, as they apply in computing the income of an assessee under the head 'Profits and gains of business or profession' "

12. Action points for Assessing Officer:

- Assessing officer should look into the Profit & Loss A/c. and see whether any itemized losses/ expenditure/trading liability are credited back to the P&L A/c.
- Assessing Officer will compare the Profit & Loss A/c. with the computation statements and find out whether assessee has offered the same for taxation. If not, explanation may be called for from the assessee.
- Assessing Officer will closely scrutinize the balance sheet for any such items eligible for addition under Section 41(1) of the I.T. Act hidden in the balance sheet as liabilities and not offered for taxation.

- Assessing Officer will ensure before making any addition under this section that any such loss/ expenditure/trading liability had been claimed and allowed in the earlier years.
- Burden of proving that the liability is still subsisting lies on the assessee.
- In BIFR cases provisions of Section 41(1) will not be applicable, only if the CBDT has consented to give relief.
- If the assessee does not show the amount taxable under Section 41(1) in its return of income, penalty would be leviable under Section 271(1)(c) of the I.T. Act for concealment.

9 Unfolding The Income From Capital Gain

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Preface

The issue of short term capital gains (STCG) vs long term capital gains (LTCG) is an ongoing issue. In many of the cases, it is also intertwined with treating such gains as business income. Further, in some of the cases where claims of LTCG have been made, the AOs have treated them as sham transactions and taxed them under Section 69 of the Act, particularly with respect to dealings in penny stocks. The focus of this concept paper has been kept on few critical issues covering over 90% of the cases handled by the AOs. Towards this end, the following principal issues have been discussed:

a. STCG vs LTCG vs business income in shares and securities
b. Conversion of capital asset into stock and vice-versa
c. Bogus LTCG in penny stocks
d. Claiming of deduction under Section 54F etc.
e. Sale of depreciable assets
f. Treatment of slump sale
g. Reference to DVO
h. Insertion of Section 50D

Besides, as the target audience is the Assessing Officers of the Department, the language and content has been oriented accordingly.

2. Basics in brief

Section 2(14) defines "capital asset", and Section 2(47) defines "transfer" in relation to a capital asset. Section 2(42A) and

Section 2(42B) define "short-term capital asset" and "short-term capital gain" respectively, while Section 2(29A) and Section 2(29B) define "long-term capital asset" and "long-term capital gain".

The period of holding determines as to whether a transaction is in the nature of STCG or LTCG. If the holding period is 36 months or more, the gains on transfer of such assets are taxed as LTCG. However, exception has been provided for shares in a company, any other security listed in a recognised Stock Exchange in India, Units of UTI/any Mutual Fund specified in Section 10 (23D), zero coupon bonds, in which case, the cut-off holding period is 12 months.

The distinction between STCG and LTCG is important, as LTCG is taxed at a concessional rate (Zero tax in case of certain share transactions), while STCG is taxed at normal rates (concessional tax in case of certain share transactions). Further, LTCG is entitled to indexation while STCG is not. The CBDT prescribes the cost inflation index for each year. Section 111A and Section 112 deal with taxation of capital gains. It is to be noted that deductions under Chapter VI-A are not available in respect of LTCG by virtue of Section 112(2). Similarly, long-term capital losses can be set-off only against long-term capital gains (unlike STCL on which no such restrictions apply), as per Section 70 (3) and Section 74 (1)(b) of the Act. Further ST capital loss cannot be set off against any other income.

Unlike business income where various expenditure is allowed, in respect of capital gains, only two deductions namely, (i) expenditure incurred wholly and exclusively in connection with such transfer and (ii) cost of acquisition and cost of improvement, if any, are allowed as deductions.

3. Capital Gains vs Business Income

In G Venkatswami Naidu and Co vs CIT, 35 ITR 594, the Hon'ble SC has held that even an isolated and single transaction may be of an adventure in nature of trade if some of essential features of trade are present in such a transaction. The Hon'ble Court further held that decision about character of a transaction as to whether it is in nature of trade cannot be based solely on application of any abstract rule, principle or test and must in every case depend upon all relevant facts and circumstances.

Thus, in all the cases involving such controversies, it is essential that the AO bring on record, full facts and particulars of the case.

3.1 Decisions of Hon'ble Gujarat High Court:

In the case of CIT vs Rewashanker A Kothari, 283 ITR 338 (DoJ: 16.12.2006), the Hon'ble Gujarat HC laid down the following tests:

"11. In the case of *Pari Mangaldas Girdhardas* v. *CIT* 1977 CTR (Guj.) 647, after analyzing various decisions of the Apex Court, this Court has formulated certain tests to determine as to whether an assessee can be said to be carrying on business.

(*a*) The first test is whether the initial acquisition of the subject-matter of transaction was with the intention of dealing in the item, or with a view to finding an investment. If the transaction, since the inception, appears to be impressed with the character of a commercial transaction entered into with a view to earn profit, it would furnish a valuable guideline.

(*b*) The second test that is often applied is as to why

and how and for what purpose the sale was effected subsequently.

(*c*) The third test, which is frequently applied, is as to how the assessee dealt with the subject-matter of transaction during the time the asset was with the assessee. Has it been treated as stock-in-trade, or has it been shown in the books of account and balance sheet as an investment. This inquiry, though relevant, is not conclusive.

(*d*) The fourth test is as to how the assessee himself has returned the income from such activities and how the Department has dealt with the same in the course of preceding and succeeding assessments. This factor, though not conclusive, can afford good and cogent evidence to judge the nature of transaction and would be a relevant circumstance to be considered in the absence of any satisfactory explanation.

(*e*) The fifth test, normally applied in cases of partnership firms and companies, is whether the deed of partnership or the memorandum of association, as the case may be, authorises such an activity.

(*f*) The last but not the least, rather the most important test, is as to the volume, frequency, continuity and regularity of transactions of purchase and sale of the goods concerned. In a case where there is repetition and continuity, coupled with the magnitude of the transaction, bearing reasonable proportion to the strength of holding, then an

inference can readily be drawn that the activity is in the nature of business."

3.2 In a very recent case of Vaibhav J Shah (HUF), Tax Appeal Nos. 77 of 2010 and 78 of 2010 (DoJ: 27.06.2012), the Hon'ble Gujarat HC has reiterated the tests laid down by it in the Rewashanker A Kothari case. Besides, the Hon'ble HC has held that "*In view of the aforesaid decisions of the Apex Court as well as of this Court, it is clear that where number of transactions of sale and purchase of shares takes place, the most important test is* ***the volume, frequency, continuity and regularity of transactions of purchase and sale of the shares. However, where there is repetition and continuity, coupled with magnitude of the transaction, bearing reasonable proportion to the strength of holding, then an inference can be drawn that activity is in the nature of business****. Learned counsel for the revenue from the records could not demonstrate that there were large number of transactions which had* ***frequency, volume, continuity and regularity*** *and fell within the tests laid down by the Division Bench of this Court*."

3.3 **Other Recent Decisions:**

In the case of PVS Raju vs Addl CIT, 340 ITR 75 (DoJ: 27.07.2011), the Hon'ble AP High Court held as under:

The factors which weighed with the assessing authority, the CIT(A), and the ITAT in coming to the conclusion that the shares in question constituted "stock in trade", and not "investment", were that:-

(*a*) The frequency of buying and selling of shares by the appellants were high;

(*b*) the period of holding was less;

(*c*) the high turnover was on account of frequency of transactions, and not because of huge investment;

(*d*) the assessees had dealt in delivery trading purely with the intention of making quick profits on a huge turnover;

(*e*) the period of holding of a majority of the stock was between one to seven days;

(*f*) in most of the transactions, the assessees did not even hold on to at least some part of the huge purchases, and had engaged in the same scrips frequently;

(*g*) the intention of the assessees in buying shares was not to derive income by way of dividend on such shares, but to earn profits on the sale of the shares;

(*h*) the assessees had indulged in multiple transactions of large quantities with very high periodicity. These periodic transactions, selecting the time of entry and exit in each scrip, called for regular direction and management which would indicate that it was in the nature of trade;

(*i*) repeated transactions, coupled with the subsequent conduct of the assessees to re-enter the same scrip or some other scrip, in order to take advantage of market fluctuations lent the flavour of trade to such transactions;

(*j*) the assessees were purchasing and selling the same scrips repeatedly, and were switching from one scrip to another;

(*k*) the dominant impression left on the mind was that the assessees had not invested in shares;

(*l*) mere classification of these share transactions as investment in the assessee's books of accounts was not conclusive;

(*m*) the intention of the assessees at the time of purchase was only to sell the shares immediately after purchase;

(*n*) frequency of purchase and sale of shares showed that the assessees never intended to keep these shares as investment; and

(*o*) it is only for the purpose of claiming benefit of lower rate of tax, under Section 111A of the Act, that they had claimed certain shares to be investment, though these transactions were only in the nature of trade.

While examining any case, the AOs should examine whether the transactions of the assessee fit within the above framework.

3.4 In the case of *Sarnath Infrastructure (P.) Ltd.* v. *Asst. CIT* [2009] 124 ITD 71 (Lucknow) ; 120 TTJ 216, the Lucknow Bench of the Income-tax Appellate Tribunal has laid various principles which may be applied to determine whether the transaction of purchase and sale of share is in the nature of trade or investment. The relevant findings of the Income-tax Appellate Tribunal read as under :

'The following principles can be applied on the facts of a case to find out whether transaction(s) in question are in the nature of trade or are merely for investment purposes :

(1) What is the intention of the assessee at the time of purchase of the shares. This can be found out from the treatment it gives to such purchase in its books of account-whether it is treated as stock-in-

trade or investment; whether shown in opening/ closing stock or shown separately as investment or non-trading asset.

(2) Whether the assessee has borrowed money to purchase and paid interest thereon. Normally, money is borrowed to purchase goods for the purposes of trade and not for investing in an asset for retaining.

(3) What is the frequency of such purchases and disposal in that particular item ? If purchases and sales are frequent, or there are substantial transactions in that item, it would indicate trade. Habitual dealing in that particular item is indicative of intention of trade. Similarly, ratio between the purchases and sales and the holdings may show whether the assessee is trading or investing (high transactions and low holdings indicate trade whereas low transactions and high holdings indicate investment).

(4) Whether purchase and sale are for realising profit or purchases are made for retention and appreciation in its value? Former will indicate intention of trade and latter, an investment. In the case of shares whether intention was to enjoy dividend and not merely earn profit on sale and purchase of shares. A commercial motive is an essential ingredient of trade.

(5) How the value of the items has been taken in the balance sheet? If the items in question are valued at cost, it would indicate that they are investments or where they are valued at cost or market value or net realisable value (whichever is less), it will indicate that items in question are treated as stock-in-trade.

(6) How the company (assessee) is authorised in memorandum of association/articles of association ? Whether for trade or for investment ? If authorised only for trade, then whether there are separate resolutions of the board of directors to carry out investments in that commodity ? And vice versa.

(7) It is for the assessee to adduce evidence to show that his holding is for investment or for trading and what distinction he has kept to the records or otherwise, between two types of holdings : if the assessee is able to discharge the primary onus and could prima facie show that particular item is held as investment (or say, stock-in-trade) then onus would shift to the Revenue to prove that apparent is not real.

(8) The mere fact of credit of sale proceeds of shares (or for that matter any other item in question) in a particular account or much frequency of sale and purchase will alone will not be sufficient to say that the assessee was holding the shares (or the items in question) for investment.

(9) One has to find out what are the legal requisites for dealing as a trader in the items in question and whether the assessee is complying with them. Whether it is the argument of the assessee that it is violating those legal requirements, if it is claimed that it is dealing as a trader in that item ? Whether it had such an intention (to carry on illegal business in that item) since beginning or when purchases were made ?

(10) It is permissible as per the Central Board of Direct Taxes Circular No. 4 of 2007 of June 15, 2007

([2007] 291 ITR (ST.) 384) that an assessee can have both portfolios, one for trading and other for investment provided it is maintaining separate account for each type, there are distinctive features for both and there is no intermingling of holdings in the two portfolios.

(11) Not one or two factors out of the above alone will be sufficient to come to a definite conclusion but the cumulative effect of several factors has to be seen. The assessee-company was dealing in shares and it had dealt in shares both as stock-in-trade as well as investment. It sold shares from the investment portfolio and claimed that the profit arising therefrom was capital gain. The Assessing Officer held that the main business of the assessee was purchase and sale in shares. It was neither a share dealer nor a share broker. The details for purchases and sales affected by the assessee company revealed that sales and purchases were quite substantial and would not be made by a person who invested in shares. Further, the assessee did not have sufficient funds to make such investments and the assessee was claiming to have made investment out of borrowed capital. He, therefore, held that the profit in question was assessable as business income. Held that the undisputed fact was that the assessee was dealing in shares both as business as well as investment. It had kept separate accounts in respect of two portfolios. No material was brought on record to show that demarcation line between business and investment was hazy or

that the assessee had not maintained an investment portfolio and it was dealing in shares only like a trader. Thus, on appreciation of cumulative effect of several factors present it was to be held that the surplus was chargeable to capital gains only and the assessee was not to be treated as trader in respect of sale and purchase of shares in the investment portfolio.'

3.5 The following recent Tribunal decisions have been rendered in favour of Revenue:

a. Mafatlal Fabrics P Ltd vs DCIT, 49 SOT 303 (Mumbai ITAT), 02.11.2011

b. Swarnim Multiventures P Ltd vs DCIT, 54 SOT 347 (Hyderabad ITAT), 21.09.2012

c. ACIT vs Manoj Kumar Samdaria, 54 SOT 331 (Delhi ITAT), 25.10.2012

The decision of ITAT, Ahmedabad in the case of Sugham Chand Jain in which holding period was held to be decisive in treating transactions as business or capital gain is not very relevant now in view of Gujarat high court decisions mentioned earlier. Unless there is specific provision in the Act in the line of section 94(7), holding period cannot determine nature of transaction as business or capital gain.

Crucially, what is important is to examine the claim of the assessee in the light of the above decisions. Merely reproducing the citations will not suffice and AOs will need to bring out the factual aspects on each of the criteria in the order.

4. Enquiries by the AO

4.1 Records of previous years:

Go through the records of the earlier years and see if there is consistent pattern in trading and any other useful information.

4.2 Board Resolution and Minutes of Board meetings:

The AO can call for the Board Resolution and Minutes of Board Meetings in original. Section 193 of the Companies Act lays down the specific method of maintaining the minute's book. The minutes are to be maintained in book form and pasting of individual sheets is not permitted. This can be an effective course of enquiry, even in cases where assessee claims that he holds two separate portfolios, namely trading and investment. In the case of Sathappa Textilers (P.) Ltd. v. CIT [2003] 126 Taxman 491, the Madras High Court considered a similar issue regarding validity of Minutes of Proceedings and rejected the loose sheets filed by the assessee.

When the originals are produced before the AO, they should also be examined from the viewpoint of whether they are appearing as brand new, freshly typed, and having the same ink etc.

The language used in the Board Resolution and Minutes are also very important. For instance, in one particular case, it was observed that the reasoning was given as "*the strategy of making investments*

in the equity market is paying off and should over a period of time improve the financials of the company". This can be interpreted that the activities of the assessee have been undertaken with an intention of making profits.

4.3 Memorandum of Association and Articles of Association:

If the investment in shares and debentures is mentioned in the objectives, the same should be brought out clearly.

In the case of Sarder Indra Singh & sons Ltd. Vs. CIT (1953) 24 ITR 415, the Supreme Court had considered the objects of Memorandum of Association, among others, which read as follows:

"To carry on and undertake any business, transaction, operation or work commonly carried on or undertaken by bankers, capitalists, promoters, financiers, concessionaires, contractors, merchants, managers, managing agents, secretaries and treasurers.

To purchase or otherwise acquire, and to sell..... stock, share ....business concerns and undertakings.

To invest and deal with the moneys of the company not immediately required for the company's business upon such securities and in such manner as may from time to time be determined."

After a careful consideration, the court ruled that the assessee was engaged in business activity of sale of shares and securities.

4.4 Notes to Accounts and Significant Accounting Policies:

The AO can check in these pages, as to whether any significant information is available regarding the intention of the assessee and how they are classified in the books. Also, if there is any change in the method of accounting during the year, it should be brought out.

4.5 Director's Report:

Any claims made by the directors in this report placed before the shareholders can give a major clue towards the real intention of the assessee.

4.6 Separate Demat Accounts:

In all cases where the assessee claims that he has separate trading and investment account, it should be examined whether separate demat accounts are maintained for trading and investment portfolio. If not, it is to be brought out that the assessee has not followed the FIFO method strictly in terms of Section 45(2A). More importantly, the usage of a singular demat account for multiple uses, could fairly indicate that the classification adopted by the assessee as capital gains / business income, is merely a post-mortem exercise undertaken by the assessee to reduce the tax rates in his income.

4.7 Frequency of trading:

The factual aspects such as volume, frequency, continuity and regularity of transactions should be brought out in the assessment order. Besides, if the same scrip has been dealt with more than once, (say, purchase and sale in a repeated fashion of same scrip),

the details should be brought out in the assessment order, which would prove the real intention of the assessee that he is a trader and not an investor.

4.8 Holding Period:

The holding period of few select securities can also be worked out and placed in the assessment order, particularly in cases where the holding period is a matter of few days only. Besides, the Ratio of turnover to average stock can be worked out. In one case, it was seen that the total sales during the year was Rs.189.20 crores while the average of opening and closing stock was Rs.22.78 crores. Thus, when an AO presented in his assessment order as "the sales of Rs.189.20 crores turnover has been achieved despite the average stock being only Rs.22.78 crores. This shows an average sales turnover ratio of 8.31 (189.20/22.78). This effectively means that the average period of all share holdings including the claims made by the assessee as long term capital gains is just 44 days.", it makes for an impressive finding before the appellate authorities.

4.9 The time devoted to the activity and the extent to which it is the means of livelihood:

The P&L A/c can be analysed towards this end. Also, if the majority of Board meetings end up in reviewing the investments in shares and securities only, then a safe conclusion can be drawn that it is indeed the major activity. Needless to say, the factual aspects should be brought out in the assessment order.

4.10 Source of funds:

The AO can examine the sources of funds, whether

they are from internal accrual or borrowings. Even in cases where the assessee is having own sufficient funds, the bank statements can be examined to find out the immediate source of such investment.

4.11 Investment Policy:

The assessee can be asked to produce its Investment Policy.

4.12 Investment Team:

The AO can also make enquiries regarding the investment team, reporting structure, decision making authority, etc. In one particular case, in the initial questionnaire, the AO had asked for "Details of employees (other than directors): Name, salary, area of work; whether employed fully during the year." Subsequently, when the issue of taxing the income arose, the reply to this query could be used to prove that majority of employees were actually employed to take care of investments which constituted an organized business activity.

4.13 Internal Audit Report:

Where the assessee has been subjected to internal audit, the AO can call for copies of internal audit reports during the year. In one such case, it was seen that the Internal Audit Report for all the quarters contained reference only to trading activities without a single reference to the investment portfolio of the assessee. This can be crucial evidence.

5. CBDT Circulars

Circular No.768 dated 24.06.1998: Lays down the "date of

transfer" and 'period of holding of securities' in respect of shares acquired in physical form and subsequently converted into demat. An example of application of FIFO as per Section 45(2A) is also given.

Instruction No.1827 dated 21.08.1989: Lays down the tests for distinction between shares held as stock-in-trade and shares held as investment. Has been subsequently supplemented with circular no.4 of 2007.

Circular No.4 dated 15.06.2007: Lays down the tests for distinction between shares held as stock-in-trade and shares held as investments. This circular also accepts the possibility that a person may have two portfolios under (i) investment and (ii) trading portfolio.

6. Conversion of Capital Asset into Stock

Section 45(2) of the Act lays down the taxability of a capital asset, which is converted into stock-in-trade. The effect of this provision is two-fold:

a. The fair market value on the date of conversion shall be treated as the full value of consideration, and taxed in the year in which the asset is actually sold.

b. The excess of the sales price over the full value of consideration shall be taxed as business income in the year in which sale takes place.

For the purposes of ascertaining the fair market value, the provisions of Section 55A apply, along with provisions of Rule 111AA.

The provisions of Section 45(2) have been found to be misused in some cases. Examples are as follows:

a. In one case, it was seen that the assessee had sold listed equity shares acquired in January 2011 in February 2012. The said

assets were claimed to have been converted into stock-in-trade on 01.04.2011. On verification of the details, the following was seen:

Date	Cost / FMV	Remark
01.01.2011	180	1 lac listed equity shares Purchased in investment portfolio for Rs.1.80 crores.
01.04.2011	140 (as per stock exchange)	Assessee claims to have converted these capital assets into stock-in-trade @ Rs.1.40 crores. Thus, capital loss of Rs.0.40 crore was claimed.
01.02.2012	50	The shares were sold off and Rs.0.90 crore was claimed as business loss.

Had the capital assets not been converted into stock-in-trade, the assessee would have suffered long-term capital loss of Rs.1.30 crores, which could not have been claimed by virtue of provisions of Section 10(38). However, by adopting the above method, the assessee was cleverly claiming the losses in its return of income.

In the instant case, the AO has to examine the genuiness of conversion. The AO has to be innovative in calling the details, as he has to establish that such conversion was merely a sham and not genuine. Some of the details which can be examined by the AO are (i) Minutes of the Board, (ii) minutes of Investment Committee, (iii) copy of proposal mooted by the Investment Department, (iv) details of such conversion in the immediately preceding 4 years and succeeding years till date, (v) Minutes of original acquisition, (vi) remarks in Notes to Accounts, Auditor Report, Significant Accounting Policies. Other pointers could be the advance tax payments made by the assessee on quarterly basis (to know whether such conversion is an after-thought to reduce tax liability), quarterly financial statements submitted to banks / lenders

(to know whether the change in classification was reflected therein). Also, if need be, the CEO / Chief Investment Officer can be summoned for recording the statement.

b. An assessee had acquired a plot of land and treated it as capital asset. However, it subsequently started sub-plotting the piece of land and selling it. Although the assessee stated the entire activity to be capital gains, the AO can examine when the significant activities of conversion of agricultural land into non-agricultural land took place, sub-plotting activities began.

Rajendra Kumar Dwivedi vs CIT, 349 ITR 432 (Allahabad HC) 24.08.2012: Where no agricultural operations were carried on and the land was sub-divided and sold in plots, even though the assets were acquired over 30 years ago, the HC has upheld the Department action in treating the asset having been converted into stock-in-trade when the sub-plotting activity commenced.

In the case of conversion, the date of conversion is important as the period of holding till that date will determine whether the transaction is one of STCG or LTCG.

7. Bogus LTCG/ STCG in penny stock

Certain share transactions, [in common parlance, known as 'Penny stocks'] are fabricated with a view to launder the unaccounted money in the form of long-term capital gains at nil/concessional tax rates. The purchases are usually accompanied by a backdated contract Note showing the purchase of shares by the assessee at less than a rupee or just a few rupees per share, as they were quoted earlier (about a year or so). The purchase consideration could have been paid

either in cash or by cheque. The shares are usually stated to have been purchased in physical format and then converted into electronic form. After a year or so, the assessee sells such dematerialized shares on secondary market at the prevalent price and receives the cheque payment thereby converting black money into white. Depending upon how far the contract note for purchase of such shares was backdated, the assessee launders the money by either paying zero or 15% capital gain tax (depending on the rates of taxation of capital gains for the relevant A.Y.)

The general modus operandi adopted by the assessees is as follows:-

1. With the collusion of broker, shares of an unknown company with dubious background are purchased for miniscule consideration. The broker usually issues a fake contract note.
2. The counterparty is/are usually not traceable or is related to the broker and the broker undertakes off-market transactions to accommodate the assessee.
3. After a year, the shares are sold back by the assessee through the same broker. In the meantime, the share prices are rigged by the concerned broker to an abnormally high level.
4. The shares are now sold by the assessee and sale consideration is received. The sale consideration is in fact first paid by the assessee in cash to a trusted confidante of the broker. This cash consideration which is introduced in a banking channel by routing through a number of accounts, finally reaches the accounts of the broker. With this amount, the broker pays the consideration to the assessee.

5. Thus the assessee's own cash is introduced and comes back in the form of long term capital gain thereby claiming concessional tax rate.

6. For arranging these transactions, the broker typically charges commission. The typical characteristic of such transactions are as follows :-

   a. The scrip invested is an obscure one in most cases. It is merely Shell Company with no activities whatsoever.

   b. The assessee himself will be unaware of the financial performance of the company in which he is invested.

   c. The shares are purchased at lower levels and sold at higher rates through the series of off-market transactions created by the broker with vested interest. The share prices are artificially rigged through the off-market transactions.

   d. The assessee uses the services of the broker only for these particular transactions. Also, the assessee otherwise is passive investor or does not invest in other scrips.

   e. The assessee has never met the broker and usually claims that the transactions are arranged through a different person. The assessee himself would have never met the broker.

7.1 Unfortunately, most of the assessment orders in respect of bogus LTCG have been knocked off at appellate stage. One such example is the case of Acchyalal Shaw vs ITO, 30 SOT 44 (Kol) (URO) dated 16.01.2009. Even if the transactions are found by the AO to have taken place

on off-market basis, the appellate authorities have held that the assessee cannot be punished for the fault of the broker. The appellate authorities place reliance on the fact that the demat accounts show the delivery of shares and then rule in favour of the assessee.

7.2 To counter such tactics of the assessee, it is important to do further enquiries apart from conducting enquiries under Section 133(6) with the stock broker and the stock exchange.

a. First and foremost, the payment of purchase consideration has to be enquired from the bank account. Towards this end, the necessary information may be obtained from the bank as to who the ultimate beneficiary is, and in whose account the said funds were credited. If the funds are transferred to any other person other than the person from whom the shares are shown to have been purchased, this should be confronted with the assessee. Also, in many cases, substantial time lag is seen between the date of purchase and actual payment for purchase. In all such cases, the reasons for the same should be thoroughly investigated.

b. In many of the cases, it is seen that the receipt of shares in the demat account is much later, i.e. after 3-6 months of alleged purchases. In these cases, the assessee usually claims that the shares were received in physical form and then dematted. This claim of the assessee should be examined in greater detail. The assessee should be asked to furnish the relevant supporting evidences and then enquiry be

made with the share transfer agent of the company as to the actual date of purchase and from whose account these shares were transferred. Such an enquiry is possible with the "folio number" of the shares. The seller of these shares to the assessee can be found out, and if possible, enquiries be made with the concerned AO as to whether such a seller has shown these transactions and the actual date of sale reflected by him. If the counterparty has shown a sale date much later than the alleged purchase date of the assessee, it has to be confronted and brought as an evidence.

c. While treating the transactions as sham, the entire receipt is added by the AO as income. Where the assessee is shown to have purchased the shares in an earlier year, one of the arguments frequently taken by the assessee is that the investment in shares in earlier year has been accepted by the Dept. The Tribunals, in such cases, give relief to the assessee. Hence, it is suggested that the case of the preceding year when investments are made, is reopened under the Act and necessary action be taken in respect of the investment claimed to be made in that year and outstanding as at year-end, particularly when the broker has not confirmed the purchase transactions and the records do not indicate receipt of shares either in demat or physical form before the year-end. The remedial action should invariably be adopted where the purchase consideration is stated to have been paid in cash.

d. In many of the cases, assessees rely on Board's Circular No. 704, dated 28-4-1995, which reads as follows: "2. When the securities are transacted through stock exchanges, it is the established procedure that the brokers first enter into contracts for purchase/sale of securities and thereafter, follow it up with delivery of shares, accompanied by transfer deeds duly signed by the registered holders. The seller is entitled to receive the consideration agreed to as on the date of contract. The Board is of the opinion that it is the date of broker's note that should be treated as the date of transfer in cases of sale transactions of securities provided such transactions are followed up by delivery of shares and also the transfer deeds. Similarly, in respect of the purchasers of the securities, the holding period shall be reckoned from the date of the broker's note for purchase on behalf of the investors. In case the transactions take place directly between the parties and not through stock exchanges, the date of contract of sale as declared by the parties shall be treated as the date of transfer provided it is followed up by actual delivery of shares and the transfer deeds.". The crucial words here are "In case the transactions take place directly". So, the AO should examine the records of counter-party as stated above. It is also pertinent to note that SEBI had vide Circular No.SMDRP/POLICY/CIT-32/99 dated September 14, 1999 banned all negotiated deals including cross deals and all such deals are required to be executed only on the

screens of the exchanges in the price and order matching mechanism of the exchange just like any other normal trade. Thus, off-market deals are not in confirmation with regulatory guidelines.

e. The assessee can be summoned, his statement recorded and various evidences gathered to fortify the circumstantial evidences. Some of such evidences could be:

a. Why did he decide to buy shares of this company?

b. Name and address of the person who recommended the purchase alongwith relationship with him/her.

c. Did assessee analyze the financial performance of M/s. Jay Kay Dee Industries Ltd., before purchase of the shares?

d. Did assessee know at what price multiples (P/E ratio) the shares purchased was trading

e. Was assessee keeping track of share price movement? If yes, how, and the source of information. Also, the frequency of getting such updation.

f. On what basis did assessee decide to sell the shares?

g. What business is the company invested in engaged in? What are the products they are dealing in?

h. Knowledge of assessee regarding the financial performance of the company invested in

i. Details of share transactions (other than impugned purchases) during last (say) 5 years:

j. How did assessee get introduced to broker? Who introduced to this broker?

k. Did assessee fill the client introduction form / KYC forms? Copies thereof.

l. Have assessee ever been to the office of broker? If yes, whom did he meet?

m. How did assessee receive the contract notes from broker?

n. How did assessee place the purchase orders with broker? To whom did he speak / instruct for placing the orders?

o. How was the payment made/received to/from broker?

p. Did assessee know before-hand that share transactions were off-market transactions? When did he know?

q. When was the demat account opened? How were the instructions given to demat participant for transfer of shares?

r. What is the status of that demat account now?

s. In most of the penny stock cases, it is seen that the purchase transactions are claimed to be made on off-market basis, after the enquiries are commenced by the AO. In such cases, where the scrip is received in the demat account with much delay; the AO can consider making an alternative addition by treating such transactions as STCG.

8. Claiming of deduction under Section 54F etc.

Section 54F provides for deduction to any assessee being an individual or HUF, who transfers any long-term capital asset other than a residential house. To avail the benefit, the new residential house has to be purchased within a period of 1 year before or 2 years after the date of transfer. Alternatively, the residential house has to be constructed within 3 years. The scheme also provides for deposit in Capital Gains Account Scheme, to be utilized in a specified manner and the manner of taxability if not fully utilized. Also, there are restrictions in terms of sale of such new asset within 3 years.

There are several Sections such as Sections 54, 54EC, 54F, etc., which are modeled on similar lines and the AO may go through the nature of asset and terms and conditions specified in each section. However, some of the issues are recurring in nature, and the case laws relating to such issues are given below:

8.1 Purchase of multiple houses:

As per Section 54 and Section 54F, a person the deduction is eligible only in respect of one residential house.

237 CTR 210, Pawan Arya vs CIT, (Punjab & Haryana HC), DoJ - 13.12.2010: The Hon'ble Court held that exemption under Section 54 is not admissible against acquisition of two houses.

107 ITD 327, ITO vs Ms Sushila M Jhaveri, ITAT Mumbai Special Bench, DoJ – 17.04.2007: In para 11, it has been held as follows: "it is held that exemption under Sections 54 and 54F of the Act would be allowable in respect of one residential house only. If the assessee has purchased more than one residential house, then the choice would

be with assessee to avail the exemption in respect of either of the houses provided the other conditions are fulfilled. However, where more than one unit are purchased which are adjacent to each other and are converted into one house for the purpose of residence by having common passage, common kitchen, etc., then, it would be a case of investment in one residential house and consequently, the assessee would be entitled to exemption". Later decisions including (i) 45 SOT 111, Neville J Pereira vs ITO, ITAT Mumbai, DoJ – 20.10.2010; (ii) 53 SOT 236, Myrtle D'Souza vs ITO, ITAT Mumbai, DoJ – 20.06.2012, are on the same lines as the Special Bench decision in the case of Sushila M Jhaveri.

As per the ratio of the above judgments, it is imperative that the AO examine the factual aspects and bring them in the assessment order. Thus, a case where the assessee acquires 2 houses but converts them into 1, having a common kitchen, electricity meter etc. would be treated as 1 house only. Hence, it is important that the AO obtain the floor plans of the house(s) and critically examine as to whether they would qualify as one house only.

In the case of Krishnagopal Nagpal vs DCIT, DoJ: 07.03.2003, 82 TTJ 481, the ITAT Pune, had the occasion to examine the assessee's claim of 7 row houses being "a residential house". The ITAT held that "each row house is a separate and distinct residential house" (para 34).

8.2 Purchase in different name:

330 ITR 309, Vipin Malik HUF vs CIT, Delhi HC, DoJ – 07.08.2009: In this case, the Court upheld the contention that property has to be purchased in the name of seller only. Thus, where the asset sold belonged to the HUF of

the assessee but the property was purchased in the name of the assessee and his mother, Section 54F was held to be not applicable.

8.3 Letter of Allotment:

In the case of Rasiklal M Parikh vs ACIT, 28 taxmann.com 195, ITAT Mumbai, DoJ - 31.10.2012: It was held that letter of allotment issued by builder could not be considered as investment in residential house for the purpose of Section 54F. In this case, the ITAT had also examined the deduction claimed in respect of multiple houses and held as under: "we fail to understand how the assessee can substantiate his claim that three flats which are adjacent to each other are nothing but one residential unit, when the construction is not completed even after a lapse of more than 7 years. By merely filing of the design in the form of an internal map, would not suffice. It is only by physical verification, the contention of the assessee could be established that three flats are one residential unit having one common passage, one electricity meter and one municipal corporation number.".

8.4 Purchase of tenancy rights is not sufficient:

In Yogesh Sunderlal Shah vs ACIT, 139 ITD 214, DoJ – 21.09.2012, it was held that purchase of tenancy rights was not akin to purchase of a residential house, and the deduction under Section 54 was denied to the assessee.

8.5 House with no amenities and without approval is not qualified:

In Ashok Syal vs CIT, 209 Taxman 376, DoJ: 04.05.2012, the Punjab & Haryana HC has held that construction of a room on a plot with bricks and mud and absence of

amenities like boundary wall, kitchen, toilet, electricity, water and sewerage connection, etc. could not be termed as "residential house". The Court further noted that as per bye-laws, construction could not be made without getting map and drawings approved from competent authority, which had not been done.

8.6 Failure to construct residential house within stipulated period:

In the case of Anu Agarwal vs ITO, 28 taxmann.com 286, DoJ – 27.11.2012, the ITAT Chandigarh, has held that assessee was not entitled to Section 54F deduction where the assessee sold a property but failed to construct new residential house within specified period on plot purchased by her out of sale proceeds of that property.

8.7 Non-utlilization of sales consideration:

In 135 ITD 116, V Kumuda vs DCIT, DoJ: 06.01.2012, the Hyderabad ITAT held that assessee was not entitled to deduction under Section 54F where the sales proceeds were used for a different purpose and the new asset was acquired by way of bank loan and loans from family members. A similar decision has been rendered by the Kerala HC in the case of CIT vs VR Desai, 197 Taxman 52 (DoJ: 26.11.2009), where the sales proceeds had not been deposited in the Capital Gains Account Scheme. Similar is the case in Ranjit Narang vs CIT, 317 ITR 332, DoJ – 20.07.2009, wherein the Allahabad HC has upheld denial of deduction under Section 54F where the capital gains have not been utilized within 3 years.

It is imperative that the AO bring on record, all the facts related to the case, in the assessment order. It is quite

possible that an assessee may not satisfy more than 1 condition laid down in the section. In all such cases, the AO has to reject the claim of the assessee on based on non-compliance of each condition, so that the order is self-sustaining.

It may be noted that in a recent decision of 340 ITR 1, DoJ: 11.10.2011, Suraj Lamp & Industries Ltd vs State of Haryana, the Apex Court has held that transactions of nature of General Power of Attorney Sales or Sale Agreement / General Power of Attorney / Will transfers do not convey title and do not amount to transfer, nor can they be recognized as valid mode of transfer of immovable property. This is a landmark decision which analyzes the provisions of Transfer of Property Act and implications of non-registration of property deed, and every AO is requested to go through this decision carefully.

In one live case which is presently being disputed before ITAT, Ahmedabad, the assessee claimed to have purchased houses from his own sons, and then claimed deduction under Section 54F on those houses. However, it was found that the agreement was not registered at all and was merely executed in a Rs.100 stamp paper. Hence, the case law of Suraj Lamp & Industries Ltd is being cited before the Tribunal. In the assessment order, the AO had also examined the returns of income of the sons and found that the capital gains in respect of the sales of houses to their father had not been offered in their respective returns. Thus, the AO had concluded that the so-called purchase was sham. It was also recorded by the AO on alternate ground that the houses were 3 separate houses and could not be termed as one house. Further,

the CIT(A) had made exhaustive enquiries from the banks from whom the sons had originally availed bank loans to prove that the effective transfer of ownership had not taken place at all, and that the sons could not have transferred the property in view of the restrictive covenants in loan agreement. Thus, if the AO makes endeavor to gather additional facts and brings them on record, the order gets considerable strength for sustenance.

9. Sale of depreciable assets

Section 50 lays down that the capital gains arising on sale of depreciable assets shall be deemed to be short-term capital gains.

The case of CIT vs Sakthi Metal Depot, 333 ITR 492, DoJ: 06.01.2010 by Kerala HC is an important decision. It was held that for purpose of assessment of profit on sale of a depreciable asset, assessee need not have claimed depreciation continuously for entire period up to date of sale of asset. The assessee stopped claiming depreciation on flat 2 years prior to sale. However, since depreciation had been claimed in the past, by applying the provisions of Section 50A, the Court held that such gains were assessable as short term capital gains.

A similar view has been taken by the ITAT, Delhi Bench, in the case of Raj Woolen Industries vs ACIT, 54 SOT 117, DoJ – 14.05.2010.

10. Treatment of slump sale

Section 2(42C) defines slump sale, while Section 50B lays down the computation of capital gains in such a case.

In the case of Mahinda Engineering & Chemical Products

Ltd., 51 SOT 496, (DoJ: 18.04.2012), the Mumbai ITAT has held that sales of trademarks, plant and machinery, technical know-how, copyrights, goodwill were part and parcel of same business and they were integral and indivisible components of a composite unit sold by assessee, actually being a part of single transaction, what was sold by assessee was business as a whole and not item wise sale of different assets. Hence, it was concluded that the transaction was a slump sale. The Tribunal had held that non-transferring of a plot of land was not deciding factor in such transaction. It is interesting to note that the Tribunal had examined various aspects including (i) non-compete agreement, (ii) Director's Report to shareholders, (iii) Auditor's Report etc. The ITAT has also reproduced several clauses of the agreement to arrive at this conclusion. Thus, it is very essential that the AO bring out all relevant portions of the agreement in the assessment order, to buttress his claim of slump sale. The Tribunal's order is worth reading before passing any order regarding slump sale. A similar ratio has also been laid down by Kerala High Court in the case of Accelerated Freeze Drying Co. Ltd. 337 ITR 440, (DoJ: 06.10.2010).

In the case of SREI Infrastructure Finance Ltd., 251 CTR 129, DoJ: 30.03.2012, the assessee contended that scheme of arrangement was sanctioned by High Court under Sections 391 to 394 of Companies Act, 1956 and was statutory in nature and character and in such a case, provisions of section 50B would not apply. However, the Delhi High Court held that provisions of Section 50B are applicable and the scheme of sanction cannot be used as a ground to escape tax on transfer of capital asset.

In the case of DCIT vs Summit Securities Ltd, 135 ITD 99, DoJ: 07.03.2012, the ITAT Special Bench, Mumbai, held that negative figure of net worth cannot be ignored for working out capital gains in case of a slump sale under Section 50B. In this case, the assessee transferred its entire power transmission business to another company and the sale sonsideration of said business was Rs.143 crores. The assessee had negative 'networth' of Rs. 157 crores as per section 50B (i.e. value of liabilities or Rs.1517 crores was in excess of aggregate value of assets of Rs.1360 crores). In such a scenario, the ITAT Special Bench held that negative figure of net worth of Rs. 157 crore could not be ignored and the capital gain chargeable to tax in case of slump sale would be Rs. 300 crore (i.e., Rs. 143 crore plus Rs. 157 core) and not Rs. 143 crore as offered by the assessee.

11. Reference to DVO

In the case of 43 SOT 347, Thakorlal Harkishandas Intwala vs ITO, DoJ: 17.09.2010, the Ahmedabad Tribunal has upheld the rejection of valuation report as on 01.04.1981 filed by the assessee, in view of the exhaustive enquiries done by the AO regarding comparable instances of prevailing prices.

In cases in which the asset was acquired prior to 01.04.1981, the assessee has the option of taking the cost of acquisition as either the cost price or the fair market value as on 01.04.1981. If the fair market value is adopted, the assessee is required to file the valuation report of the registered valuer. Section 55A provides for reference to Valuation Officer by the AO, for ascertaining the fair market value of a capital asset.

Earlier sub-clause (a) of Section 55 was worded as "in a case where the value of the asset as claimed by the assessee is in

accordance with the estimate made by a registered valuer, if the Assessing Officer is of opinion that the value so claimed is less than its fair market value". Thus, this section was practically unusable as the objective of the AO is to refer such matters only when the fair market value adopted by the assessee is opined to be higher. Now, amendment has been brought in Section 55A w.e.f.01.07.2012. Thus, the relevant portion stands amended as "in a case where the value of the asset as claimed by the assessee is in accordance with the estimate made by a registered valuer, if the Assessing Officer is of opinion that the value so claimed is at variance with its fair market value". Hence, in all cases where the AO is of the opinion that fair market value as on 01.04.1981 claimed by the assessee is on the higher side, the AO can make reference to the Valuation Officer.

Although section 55A does not talk of any reasons to be recorded in writing, considering the judicial interpretation in various other sections, it is recommended that the AO record his reasons in brief, before referring the valuation to the DVO.

12. Insertion of Section 50D

The Finance Bill, 2012 has inserted a new section 50D w.e.f. 01.04.2013, i.e. for AY 2013-14 onwards. The reasoning given is as under: "Capital gains are calculated on transfer of a capital asset, as sale consideration minus cost of acquisition. In some recent rulings, it has been held that where the consideration in respect of transfer of an asset is not determinable under the existing provisions of the Income-tax Act, then, as the machinery provision fails, the gains arising from the transfer of such assets is not taxable. It is, therefore, proposed that where in the case of a transfer, consideration for the transfer

of a capital asset(s) is not attributable or determinable then for purpose of computing income chargeable to tax as gains, the fair market value of the asset shall be taken to be the full market value of consideration."

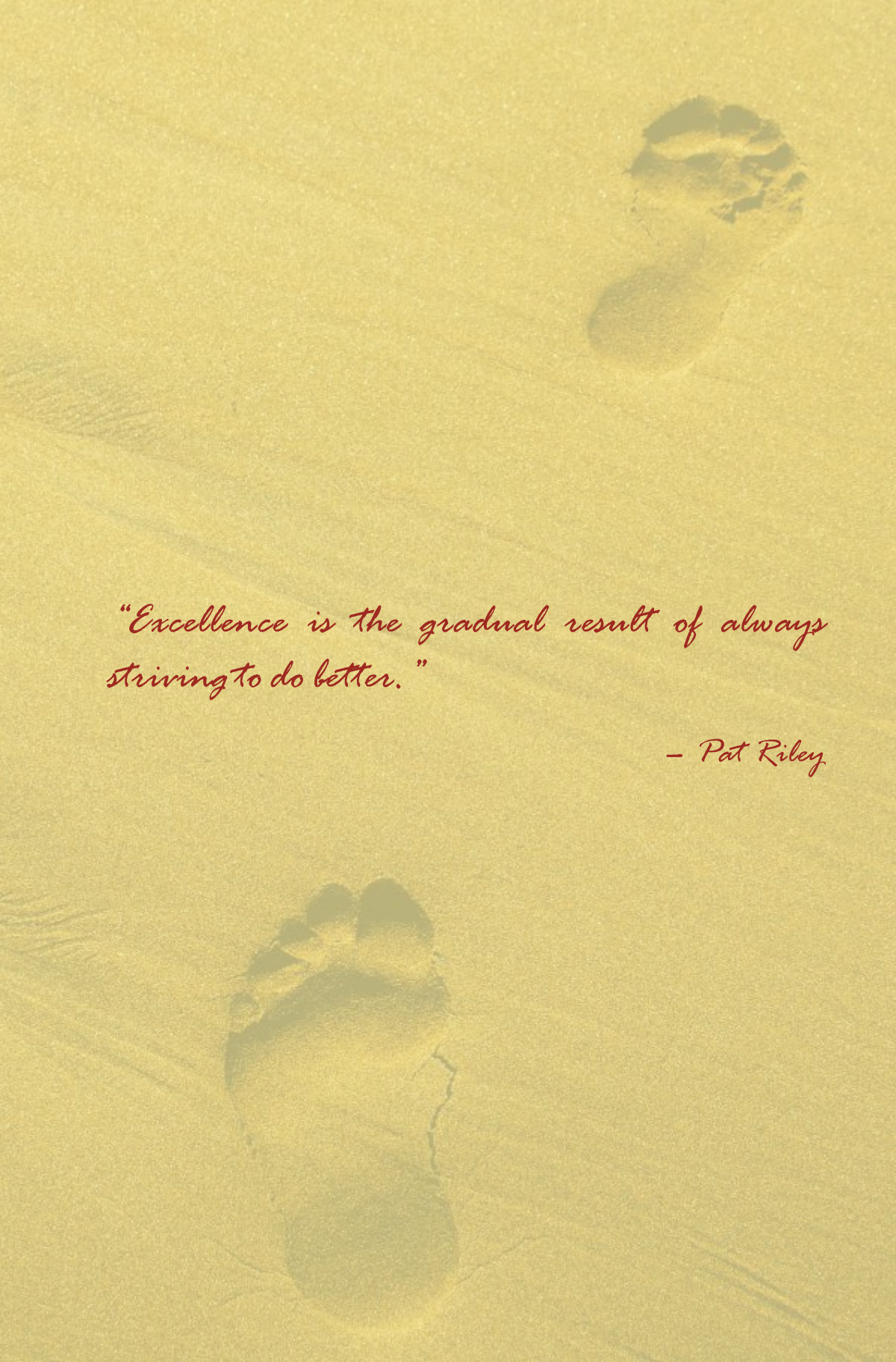
13. Other Recent Decisions in favour of Revenue

Premier Synthetic Industries vs ITO, 208 Taxman 195 (Madras HC)(Mag), DoJ: 04.06.2012: Purchase and sale of shares causing losses in a short span of time without ostensible reasons and therefore capital loss claim could not be allowed.

ACIT vs Jaimal K Shah, 137 ITD 376 (Mumbai ITAT), DoJ: 30.05.2012: 'Right of claim in flats' and 'flats' are distinct. Period of holding is to be determined from date of possession of flats, and the agreement date is not relevant when the flats are taken possession of. Gains are short term capital gains.

GK Properties P Ltd vs ITO, 25 taxmann.com 197 (Hyderabad ITAT), DoJ: 31.08.2012: Purchase of agricultural land with sole motive to sell same for earning profit is taxable as business income and not capital gain.

ACIT vs Faiz Murtaza Ali, 52 SOT 358, (Delhi ITAT), DoJ: 31.05.2012: Without evidence of personal use of household items, furniture or collector items inherited or received in gift, those items could not be held to be personal effects within meaning of provisions of section 2(14), and were liable to be taxed as capital gains.



"Excellence is the gradual result of always striving to do better."

– Pat Riley

10 Capital Gains on Income From Sale of Agricultural Land

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Sections relevant to the sale of lands

Section 2(14)	Definition of Capital Asset.
Section 10(37)	Exemption from Capital Gains on transfer of Agricultural Lands on acquisition.

Sections relating to business income if the land is held as stock-in-trade

Section 45	Charging section for Capital Gains.
Section 54B	Exemption from Capital Gains on transfer of Agricultural Lands in certain cases.
Section 194 LA	TDS on compensation payment for acquisition of Lands other than agricultural Lands.
Section 50C	Capital Gains in cases of understated consideration on sale/ transfer of lands

Sale of land can result in two kinds of incomes. If the land is held as stock in trade then the sale of such lands results in business income. Whereas if the land is held as investment then the income on the sale of the land results in Capital Gain.

2. Sale of land resulting in business income

The first and most important issue to be determined is whether the land is held as investment or stock in trade. If the agricultural land is held as stock in trade then the sale of such lands is taxable as business income and no exemption under the Act is provided in this regard.

2.1 In certain cases when the assessee claims that he is not a dealer in land but holding the same as investment then it is worth looking at the following:

i. The frequency of transactions
ii. Capacity of the person making the investment
iii. Period of holding of the assets
iv. treatment of the asset in the books of accounts etc.

These points become especially relevant in the areas which are notified for acquisition. Many speculators who are privy to the information before hand indulge in frequent buying and selling of land in the area to be acquired. In such cases it is worthwhile to determine whether the transaction is that of capital gains or is an adventure in the nature of trade. Reference in this regard is made to the decision of Hon'ble Supreme Court in the following cases to determine whether the sale is taxable as capital gains or business income.

(i) Raja Bahadur Kamakhya Narayan Singh vs. CIT 77 ITR 253 (SC)
(ii) CIT vs. Holck Larsen 160 ITR 67 (SC)

Once it is decided that the land is stock in trade, the sale of the same is business income whether the land is agricultural land or not.

3. Sale of Land held as investment

In case, the land is an investment and not stock in trade then it becomes necessary to establish after thorough investigation whether the lands sold are agricultural lands or not. This is most important because as per Section 2(14) of the I.T. Act, agricultural land which are not situated in specified areas are not Capital assets and sale of such land does not give rise to capital gains.

Section 2(14) which defines Capital Asset reads as under:

" Capital Asset" means property of any kind held by an assessee, whether or not connected with his business or profession, but does

not include agricultural land in India, not being land situate –

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

(b) in any area within such distance, not being more than eight kilometers, from the local limits of any municipality or cantonment board referred to in item (a), as the Central Government may, having regard to the extent of, and scope for, urbanization of that area and other relevant considerations, specify in this behalf by notification in the Official Gazette."

3.1 Further exemption from Capital gains is provided in Section 10(37) of the Act from sale of Agricultural lands arising to individual assesses or to HUF even if the lands are situated within the area specified in item (a) and (b) of sub-clause (iii) of clause (14) of Section 2.

3.2 Section 10(37) reads as under:

In case of an assessee, being an individual or a Hindu Undivided family, any income chargeable under the head "Capital Gain" arising from the transfer of agricultural land, where-

(i) such land is situate in any area referred to in item (a) and (b) of sub-clause (iii) of clause (14) of Section 2.

(ii) such land during the period of two years immediately preceding the date of transfer, was being used for agricultural purposes by such Hindu undivided family or

Individual or a parent of his;

(iii) Such transfer is by way of compulsory acquisition under any law, or a transfer the consideration for which is determined or approved by the Central Government or the Reserve Bank of India;

(iv) Such income has arisen from the compensation received by such assessee on or after the 1st day of April, 2004.

Explanation- For the purposes of this clause, the expression "compensation or consideration" includes the compensation enhanced or further enhanced by any court, Tribunal or other Authority;

4. Agricultural land

Agricultural land is a land on which agricultural activities are carried out. Agricultural activity has been held to be an activity where human effort has resulted in growing crops. The decision of the Supreme Court in the case of CIT vs. Raja Benoy Kumar Sahas Roy reported in 32 ITR 466 (SC) deals exhaustively with the issue as to what constitutes "agriculture". Spontaneous growth, such as wild growth of trees in a forest, do not constitute agricultural activity. The hon'ble Supreme Court in the case of Ramkrishna Deo reported in 35 ITR 312(SC) has upheld the above proposition. However, growing fruit trees does constitute agricultural activity as held in the case of Vajulal Chunilal (HUF) reported in 120 ITR 21.

Agricultural land may cease to be agricultural because it was lying fallow for some years and the land in the neighborhood was under development as non-agricultural land as was decided by the Supreme Court in the case of Sarifabibi Mohmed Ibrahim vs. CIT [1993] 204 ITR 631 (SC), where such land was held

to be non-agricultural because it was sold for non-agricultural purposes to a co-operative housing society with construction following the sale. In the case of Gemini Pictures Circuit Pvt. Ltd. reported in 220 ITR 43 (SC) the Supreme Court held that where certain lands were located in most important and busiest thoroughfare in city and the land was surrounded on all sides by industrial and commercial buildings and no agricultural operations were being carried on any land nearby, the mere fact that vegetables were being raised thereon at the time of sale or for some years prior thereto, could not change the nature and character of the land from non-agricultural to agricultural.

Where the land is agricultural and has been put to agricultural use, exemption cannot be denied merely because a hospital was coming up close to assessee's land. It would still continue to be treated as agricultural, notwithstanding such development. It was so held in CWT vs. E. Udaynarayan [2006] 284 ITR 511 (Mad.)

Where the price of land had escalated, the Assessing Officer inferred that it no longer retains the character of agricultural land. The High Court in CWT v. Shashiben [2007] 288 ITR 319 (Guj.) found, that though the land was uncultivated for some time with grass alone being raised, it does not cease to be agricultural merely with reference to the price of the land.

4.1 Once it is held that the land is agricultural then one of the major legal issue arising in the treatment of capital gain is whether the land is situate within the area specified in item (a) and (b) of sub-clause (iii) of clause (14) of Section 2. The distance of not more than 8 km. mentioned in the Section 2(14) of the I.T. Act whether it is the road distance

or distance as crow flies? Several judicial pronouncements have now established that distance of 8 km. is to be reckoned by the shortest motorable road which leads to the land and not the distance as the crow flies.

It is worth mentioning that the distance mentioned in the item (b) is not more than 8 kms. The AO should refer to Notification No. [SO 9447] (File No. 164/3/87ITA.I)], dated. 6-1-1994, wherein the exact distance in respect of every area is specified. It would also be worthwhile to see what is the nearest urban area because the land may be located in the vicinity of several areas mentioned in the notification. If the land falls within anyone of the areas then it becomes a "Capital Asset" within the meaning of the Act.

4.2 The AO has to be careful in determining the distance of 8 kms. In the case of CIT v. Lal Singh [2010] 325 ITR 588 (P&H) the Punjab and Haryana High Court held that the decision of the Tribunal could not be characterized as "perverse, illegal or contrary to the evidence available on the records." The physical location of a property could probably be ascertained precisely, since it is a matter of fact and not law. In that case the Assessing Officer had relied upon an inspector's report for the inference that it was within the notified periphery of eight kilometers of the Gurgaon municipal limits, while the assessee relied upon a certificate from the Tehsildar that it was outside the limit. The Tribunal had accepted the Tehsildar's certificate as having relevance and not that of the inspector. The High Court found that if the Assessing Officer had doubt about the correctness of the Tehsildar's certificate, further enquiry with reference to the records of the Public Works Department and the land

survey records should give a more satisfactory solution to such problems than merely going by the certificate of revenue authorities and much less of on an Inspector's report. Thus it was decided that between the certificate of revenue authorities and the Inspector's report without any objective facts, it is the former which should prevail. In view of this decision the AO must take effective steps to disprove any certificate of revenue authorities if he really doubts the certificate about the location of the lands.

Once it is established that the land in question is agricultural land and is not land situate in any area referred to in item (a) and (b) of sub-clause (iii) of clause (14) of Section 2, then no Capital Gain can arise out of the Transfer of such lands. However if the land is situated in any area referred to in item (a) and (b) of sub-clause (iii) of clause (14) of Section 2 then the following issues may be relevant.

5. Compensation received for the breach of agreement for sale

Another major issue arising out of the transfer of lands is the Compensation received for the breach of agreement for sale. The Gujarat High Court in CIT v. Hiralal Manilal Mody [1981] 131 ITR 421 (Guj) has held that the mere right to sue for specific performance is not a right which can be transferred under Section 6(e) of the Transfer of Property Act. It is also a proprietary personal right exempt under the definition of capital asset. At any rate, there is no transfer so as to justify liability for capital gains. The Calcutta High Court in the case of CIT v. Dhanraj Dugar [1982] 137 ITR 350 (Cal) held that the amount was neither revenue nor was

there liability for capital gains on such capital receipt. The High Court held that since there is no transfer and, hence, no liability to capital gains tax following the view taken earlier by the same High Court in CIT v. Ashoka Marketing Ltd. [1987] 164 ITR 664 (Cal).

However the other High Courts have taken a different view. Right to specific performance, which the assessee had under the agreement for sale was found to be a capital asset and since the amount received was for the surrender of such right, charging of capital gains on such receipt was upheld in the case of K.R. Srinath v. Asst. CIT [2004] 268 ITR 436 (Mad). In coming to the conclusion, the High Court followed the decision of the Bombay High Court in the case of CIT v. Vijay Flexible Containers [1990] 186 ITR 693 (Bom). A similar view had been taken by the Bombay High Court in the case of CIT v. Tata Services Ltd. [1980] 122 ITR 594 (Bom) and CIT v. Sterling Investment Corporation [1980] 123 ITR 441 (Bom).

The proposition that compensation for giving up the right to specific performance for such contractual right relating to capital asset would be liable for capital gains tax was accepted in the case of CIT v. Smt. Laxmidevi Ratani [2008] 296 ITR 363 (MP). The amount received as compensation for relinquishment of right under agreement of sale was held taxable in the case of J.K. Kashyap v. Asst. CIT [2008] 302 ITR 255 (Delhi).

The issue has not yet been finally settled as no decision of the Supreme Court is yet available on the issue. However for the state of Gujarat there being a decision of the Jurisdictional High Court the same is binding.

6. Compensation and interest received on Acquisition of agricultural lands

a. Year of taxability

Section 45(5) provides for taxation of both original and enhanced compensation only on the date of receipt from assessment year 1988-89 onwards. Hence as far as the accepted compensation is concerned, now there is no dispute. However, where disputed compensation is received by the claimant pending final decision, the question was whether the amount received would be taxable on receipt basis even in such a case is still a debatable issue.

The Supreme Court in CIT v. Ghanshyam (HUF) [2009] 315 ITR 1 accepted revenue's contention with reference to the provisions under Section 155(15) providing for refund of excess tax. After this provision, it found no reason for postponing the liability for the amount received by the assessee. The Supreme Court in Ghanshyam's case [2009] 315 ITR 1 did not make any distinction as regards liability in respect of compensation received before and after the insertion of sub-section (15) of Section 155 with effect from June 1, 2002, though the dispute decided by this common judgement related also to cases prior to the date of amendment.

The Supreme Court in this case also held that interest under Section 28 of the Land Acquisition Act will form part of the enhanced value of land, while interest under Section 34 of the I.T. Act will be construed as interest simpliciter for delay in payment, so that it would be governed by law relating to assessment of interest on such

delay being on accrual basis. However, by the Finance (No.2) Act, 2009 to Section 145A has been amended to make interest payable under Section 34 of the Land Acquisition Act on enhanced compensation taxable in the year of receipt.

The decision of the Supreme Court in the case of CIT v. Hindustan Housing and Land Development Trust Ltd. [1986] 161 ITR 524 (SC) which was followed in the case of Chief CIT v. Smt. Shantavva [2004] 267 ITR 67 (Karn) finding no difference even after Section 45(5) is no longer valid.

b. Treatment of Solatium

Many a times a person whose property is acquired under the Land Acquisition Act is not only awarded compensation with reference to the market value of the land but also damages on various counts apart from 15 per cent extra amount over and above the market value in view of the compulsory nature of the acquisition. Such extra amount is described as solatium though the statute itself does not use the word. The claim that this amount being consideration for the property acquired could not be treated as part of sale proceeds for purposes of capital gains has been rejected by the Gujarat High Court in the case of Vadilal Soda Ice Factory v. CIT [1971] 80 ITR 711.Similar view has been taken by the Punjab and Haryana High Court in the case of CIT v. K.C. Mahajan [1998] 234 ITR 235 (P&H) and the Kerala High Court in the case of Karvalves Ltd. v. CIT [1992] 197 ITR 95 and the Bombay High Court in R.R. Todiwalla v. CIT [1994] 208 ITR 65.

c. Treatment of extra Compensation

An additional compensation is provided for compulsory acquisition under the Land Acquisition Act, 1894, when part of a property is acquired, and such acquisition injuries the right to use of the remaining property. The Supreme Court in Smt. P. Mahalakshmi v. CIT [2002] 255 ITR 647 held that though the amount refers to the injury of the unacquired part of the property, it arises because of the acquisition of the acquired property, so that it has to be treated as part of the compensation liable to tax.

d. On compulsory requisition before acquisition

Where a property was requisitioned for some period, but later converted into acquisition, the dispute was whether the amount attributable to requisition could be treated as compensation liable for capital gains. Section 45(5), which requires compensation for transfer covered by compulsory acquisition under any law, may not cover requisition cases. Section 45(5) only determines years of taxation as the year in which the compensation is received.

The Supreme Court has decided in the case of P. Mariappa Gounder v. CIT [1998] 232 ITR 2 (SC) that mesne profits are table as profits enjoyed by the person in possession depriving the owner of possession. The Supreme Court has decided that it will be taxable only in the year in which it is quantified and not earlier to the same. In light of this decision it can be held that the income from loss of possession accrues on the date on which the compensation was quantified and paid in the same year, so as to be taxable in that year.

7. Application of Section 50C

The AO should gather the information about the jantri rates prevailing in the area while ascertaining the Capital Gains on sale of lands. In cases of sale consideration being less than the Jantri rates he should apply the Jantri rates to compute the Capital Gains by applying Section 50C of the IT Act.

8. Deduction under Section 54B from Capital Gains arising out of sale of agricultural land

The agricultural land is situate in the area specified in item (a) and (b) of sub-clause (iii) of clause (14) of Section 2 is a capital asset. However, deduction under Section 54B of the I.T. Act provided from the capital gains arising from sale of such agricultural land, provided agricultural operations are carried out on such land for two years preceding the year in which the land is sold and the cost of new agricultural land purchased within two years of sale of such land is more than the capital gain. Lesser deductions are provided if the cost of the agricultural land purchased within 2 years of sale of the original agricultural land is less than the capital gains arising to the assessee.

9. Some of the other debatable issues are:

1. Whether AOP would be eligible to claim exemption under Section 10(37)?
2. Status of the confirming parties in such transactions?
3. Does the inclusion of confirming parties result in making the individual's share indeterminate in the AOP?
4. Whether the onus lies on the agriculturist alone to prove that the agricultural activity was actually carried out on the land in question for claiming exemption under Section

10(37) or deduction under Section 54B

5. Whether notice under Section 148 can be issued for escapement of Capital Gains to the recipient of compensation only on the ground that agricultural land falls in the area referred to in item (a) and (b) of sub-clause (iii) of clause (14) of Section 2.

6. The status of land falling in the vicinity of several notified areas.

10. Levy of Tax and interest under Section 201/201(1A) in case of default under Section 194 LA

The important part is to determine whether the land acquired is agricultural land or not and whether agricultural operations were carried on the land or not? Once it is found that Capital Gains was chargable on the acquisition of such lands then orders should be passed levying Tax under Section 201 and interest under Section 201(1A)

The Department should continuously monitor Acquisition Notifications published in the Newspapers and Gazette etc.

Field Surveys may be carried out by visits to the lands proposed to be acquired in the current year to confirm the actual agricultural activities. Reports of the District Collector may be called for in order to ascertain the status of the lands.

11. Suggested information to be gathered by the AO

Most of the other issues in this regard, are factual issues in order to establish whether the land sold is agricultural land within the meaning of the Act or not.

The Assessing Officer may collect the following information in respect of the agricultural land which may be useful in

computing the capital gains and also to determine the true nature of land.

(i) Purchase deed and sale deed of the sale of the land.

(ii) 7/12 certificate issue showing the characterization of land.

(iii) The certificate of Talati regarding crops grown whether the land is irrigated or not and the income from the land as shown in the land revenue records.

(iv) Jantri rates prevailing in the area.

(v) Evidences of income arising from agricultural operations in the form of sale bills etc.

(vi) Evidences of expenditure having been incurred on agricultural operations by calculating bills of expenditure etc.

(vii) Distance of the land from the areas specified in Section 2(14)(iii)(a) & (b) of the I.T. Act.

(viii) Any permission has been obtained from the revenue authorities to convert the land use to non agriculture. Whether the permission has been obtained by the vendor or vendee.

(ix) Whether land itself was developed by plotting and provided with roads and other facilities.

(x) The land use in the surrounding area to indicate whether the land was agricultural or not?

(xi) Whether there were any previous sales of portions of the land for non-agricultural use?

11 Special provision for full value of Consideration – Section 50C

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CIT(Appeals)-XV, Ahmedabad

A. INTRODUCTION (WITH LEGISLATIVE INTENT)

Section 50C was introduced in the Income-tax Act, 1961 by the Finance Act, 2002 with effect from 1-4-2003 for substituting valuation done for Stamp Valuation purposes as full value of consideration in place of apparent consideration shown by the transferor of capital asset, being land or building and, accordingly, calculating capital gains under Section 48.

By the Explanatory notes to the amendment it was clarified that –

(1) Section 50C is a special provision for determining the full value of consideration in cases of transfer of immovable property, being land or building or both;

(2) Section 50C provides that where the consideration declared to be received or accruing as a result of transfer of land or building or both is less than the value adopted or assessed by the Stamp Valuation Authorities for the purpose of payment of stamp duty in respect of transfer, then value so adopted or assessed by them shall be deemed to be the full value of consideration;

(3) It is also provided that where the assessee claims that the value adopted or assessed for stamp duty purposes is more than the fair market value of the property as on the date of transfer and he has not disputed this value before the appellate authorities or the Court

under Stamp Duty Act then the Assessing Officer may refer the valuation of such property under transfer to the Valuation Officer in accordance with Section 55A of the Income-tax Act, 1961. If the fair market value so determined by the Valuation Officer is less than the value adopted for stamp duty purposes the Assessing Officer may take such fair market value to be the full value of consideration. On the other hand, if the fair market value determined by the Valuation Officer is more than the value adopted or assessed for stamp duty purposes the Assessing Officer shall adopt such fair market value determined by the Stamp Valuation Authorities as full value of consideration and he shall not adopt the valuation done by the Valuation Officer as full value consideration;

(4) The insertion of Section 50C is made effective from 1-4-2003 and, accordingly, would be applicable for the assessment year 2003-04 and the subsequent years.

Earlier there used to be a provision in Section 52 of the Income-tax Act, 1961 which enabled the Assessing Officer to refer the property under transfer to the Valuation Officer for determining market value. However, in K.P. Varghese v.ITO (1981) 131 ITR 597 (Supreme Court), it was held that Section 52(2) cannot be applied to genuine transaction unless there are evidences to show that consideration declared in the sale deed is understated. In other words unless the revenue was able to show that something over and above the sale consideration had passed hands between the transferee and the transferor, Section 52(2) could

not be invoked. It became almost a herculean task for the Assessing Officer to collect evidence to show the exchange of additional money for consideration was other than apparent sale consideration. Accordingly, it was considered to insert a deeming provision by way of Section 50C for substituting apparent sale consideration by valuation done by SVA subject to certain conditions.

B. SECTION 50C OF THE I.T. ACT

50C. Special provision for full value of consideration in certain cases :

(1) Where the consideration received or accruing as a result of the transfer by an assessee of a capital asset, being land or building or both is less than the value adopted or assessed or assessed or assessable by any authority of a State Government (hereafter in this section referred to as the stamp valuation authority') for the purpose of payment of stamp duty in respect of such transfer the value so adopted or assessed or assessed or assessable shall, for the purposes of Section 48, be deemed to be the full value of the consideration received or accruing as a result of such transfer.

(2) Without prejudice to the provisions of sub-section (1), where –

a) the assessee claims before any Assessing Officer that the value adopted or assessed or assessed or assessable by the stamp valuation authority under sub-section (1) exceeds the fair market value of the property as on the date of transfer;

b) the value so adopted or assessed or assessed

or assessable by the stamp valuation authority under sub-section (1) has not been disputed in any appeal or revision or no reference has been made before any other authority, Court or the High Court, the Assessing Officer may refer the valuation of the capital asset to a Valuation Officer and where any such reference is made, the provisions of sub-sections (2), (3), (4), (5) and (6) of Section 16A, clause (i) of sub-section (1) and sub-sections (6) and (7) of Section 23A, sub-section (5) of Section 24, Section 34AA, Section 35 and Section 37 of the Wealth-tax Act, 1957 (27 of 1957), shall, with necessary modifications apply in relation to such reference as they apply in relation to a reference made by the Assessing Officer under subsection (1) of Section 16A of that Act.

Explanation 1. – For the purposes of this section 'Valuation Officer' shall have the same meaning as in clause (r) of Section 2 of the Wealth-tax Act, 1957 (27 of 1957).

Explanation 2 – For the purposes of this section, the expression 'assessable' means the price which the stamp valuation authority would have, notwithstanding anything to the contrary contained in any other law for the time being in force, adopted or assessed if it were referred to such authority for the purposes of the payment of stamp duty.

(3) Subject to the provisions contained in sub-section (2), where the value ascertained under sub-section (2)

exceeds the value adopted or assessed by the stamp valuation authority referred to in sub-section (1), the value so adopted or assessed by such authority shall be taken as the full value of the consideration received or accruing as a result of the transfer.

C. BASIC INGREDIENTS OF THE PROVISIONS

i) There should be a transfer of capital asset, being land or building or both;

ii) There should be a transfer of such capital asset by way of registration with the Stamp Duty Authorities;

iii) Stamp duty is sought to be imposed by the Stamp Valuation Authorities at certain value of the capital asset which is different than the sale consideration shown in the documents of transfer sought to be registered;

iv) Where valuation done by the Stamp Valuation Authorities for levying Stamp duty is less than the sale consideration shown by the assessee in the sale deed Section 50C cannot be invoked;

v) Where valuation done by the Stamp Valuation Authorities for levying stamp duty is more than the sale consideration shown by the transferor in the sale deed then such higher valuation will be considered as full value of consideration and, accordingly, such full value of consideration being valuation done by the Stamp Valuation Authorities will be substituted for apparent consideration;

vi) The capital gains under Section 48 shall be computed accordingly on the basis of such higher full value of consideration and not on the basis of apparent consideration shown in the sale deed;

vii) If the assessee, being transferor, claims before the Assessing Officer that fair market value of the property under transfer is less than the valuation done by the Stamp Valuation Authorities then the Assessing Officer may refer the property to the Valuation Officer for determining its fair market value as on the date of the transfer;

viii) Such reference would be made in accordance with Section 55A;

ix) On receipt of valuation report from the Valuation Officer, the Assessing Officer has to compare the fair market value as determined by the Valuation Officer with the valuation done by the Stamp Valuation Authorities under the Stamp Duty Act and with the apparent sale consideration shown by the assessee in the sale deed;

x) Where valuation done by the Valuation Officer is more than the valuation done by the Stamp Valuation Authorities (SVA) then valuation done by the SVA would be taken as full value of consideration and capital gains will be calculated accordingly;

xi) If valuation done by the Valuation Officer is less than the valuation done by the SVA then valuation done by the Valuation Officer would be adopted as full value of consideration as against the apparent consideration shown by the assessee or the valuation done by the SVA and capital gains be calculated accordingly;

xii) lf valuation done by the Valuation Officer is less than the valuation done by the SVA as well as sale consideration shown by the assessee in the sale deed then apparent

consideration shown in the sale deed would alone be accepted as full value of consideration and capital gains be calculated accordingly, i.e. as shown by the assessee;

xiii) With effect from 1.10.2009, applicable for the assessment year 2010-11 the Finance Act, 2009 (No.2) has enabled the assessing officer to find out Stamp Duty Value assessable by the SVA in cases where agreements to sale were executed, consideration changed hands and possession of the property was handed over to the buyer but without getting the transfer registered with the SVA. In such situation the stamp duty valuation assessable would also be treated as full value of consideration;

xiv) Use of the word 'shall' in Section 50C makes it mandatory for the assessing Officer to adopt the valuation done by the SVA in place of apparent consideration, if necessary conditions under Section 50C are satisfied. The Assessing Officer has no discretion.

D. INTERPRETATION OF SECTION AS PER COURTS / TRIBUNAL

1. WHAT IS 'FULL VALUE' –

The phrase 'full value' has been explained by the Hon'ble Supreme Court in CIT v. George Anderson & Co. Ltd.(CIT v. George Anderson & Co. Ltd. [1967] 66 ITR 622 (SC)). It is held therein that full value of consideration is the full sale price actually paid. The expression 'full value' means the whole price without any reduction whatsoever and it cannot be referred to the adequacy or inadequacy of the price bargained. It also does not have the reference to the market value

of the capital asset which is the subject-matter of the transfer. However, Section 50C creates a fiction and, therefore, it is a departure from the established principles.

2. SUBMISSION OF INSTRUMENTS OF TRANSFER BEFORE STAMP VALUATION AUTHORITIES –

Under Section 53A of the Transfer of Property Act an immovable property can be taken as transferred if consideration is passed on between the parties and possession of the property is handed over, even though there is no registration of the instrument of transfer. However, for the purpose of invoking Section 50C it is necessary that transfer of property is registered with the SVA, meaning thereby that Section 50C cannot be invoked in respect of unregistered documents (Navneet Kumar Thakkar V. ITO [2008] 110 ITD 525 (SMC) (Jodh.)., ITO V. Ms. Kumudini Venugopal [2010] 5 ITR(Trib.) 145 (Chennai).).

3. SECTION 50C IS CONSTITUTIONALLY VALID

It has been held that classification for preventing evasion of tax and undervaluation of transaction by substituting apparent sale consideration are neither unreasonable nor discriminatory. Section 50C pertains to a class of capital asset being land or building and its object is to bring the income arising from the capital gains. The charge of income is levied by virtue of Sections 4 & 5 and not by Section SOC. Therefore, insertion of Section 50C is within the legislative competence and is not violative of Article 14 of the Constitution of India. (Bhatia Nagar Premises Co-

operative Society Ltd. v. Union of India [2011] 334 ITR 145/ 197 Taxman 249 / [2010] 6 taxmann.com 120 (Bom.), K.R. Palanisamy V. Union of India [2008] 306 ITR 61 /[2009] 180 Taxman 253 (Mad.).)

4. REFERENCE TO VALUATION OFFICER

Recourse to Section 55A can be taken only when conditions laid down under Section 50C are satisfied and not otherwise. There is no discretion available to the Assessing Officer to make reference under Section 55A at his own sweet will without showing that conditions for making reference are satisfied. (ITO v. Chandrakant R. Patel [2011] 11 taxmann.com 180/131 ITD 1 (Ahd.))

The conditions for making reference to the Valuation Officer under Section 55A are that (1) valuation done by the SVA is more than apparent sale consideration, (2) the assessee makes a claim before the Assessing Officer that fair market value of the property under transfer is less than the valuation done by the SVA. If these two conditions are satisfied the Assessing Officer is bound to make a reference to the Valuation Officer for determining fair market value of the property under transfer but where no such claim is made by the assessee before the Assessing Officer or he has not made any claim even before the SVA that valuation done by them is higher than fair market value of the property then the Assessing Officer is not bound at his own to make reference to the Valuation Officer. (Sharad Dinesh Photographer v. ITO[2011] 43 SOT 452 (Mum.)

The claim for reference to the Valuation Officer has to be justified by the assessee with prima facie material. Unless justified, the Assessing Officer may not make such reference. On the other hand, once a claim for reference is made, the Assessing Officer is statutorily required to refer the property to the DVO, unless he proves that materials submitted by the assessee in this regard are false or it cannot lead to the inference what the assessee wanted to him to draw.(Md. Shoib v. Dy. CIT [2010] 1 ITR (Trib.) 452 (Luck.).

In this regard it may be mentioned that provision of Section 50C(1) is mandatory whereby there is no option to the Assessing Officer but to adopt the valuation done by the SVA in place of apparent consideration shown by the assessee. It has been held that where there was material on record that valuation done by the SVA was more than apparent sale consideration and the Assessing Officer did not adopt the valuation done by the SVA as full value of consideration the order of the Assessing Officer would be erroneous and could be revised by the Commissioner under Section 263 (A.K.G. Consultants (P.).

Once reference is made to the DVO the Assessing Officer is duty bound to wait for report from the DVO before finalizing the assessment. Without waiting for report of the DVO if assessment is completed then he has to rectify the assessment by invoking Section 155(15). Otherwise order of the Assessing Officer would be invalid (N. Menakshi v. Asstt. CIT[2010] 326 ITR 229 (Mad.).

Where a claim is made by the assessee for a reference to the DVO and he does not accede to his request and completes the assessment by adopting the valuation done by the SVA as full value of consideration then the action of the Assessing Officer is not justified. B.N. Properties Holding (P.) Ltd. v. Asstt. CIT[2010] 6 ITR (Trib.) 1 (Chennai).

5. SECTION 50C CAN BE INVOKED ONLY IN THE CASE OF TRANSFEROR AND NOT IN THE CASE OF TRANSFEREE –

Since Section 50C modifies sale consideration and that too for the purpose of computation of capital gains, it cannot be extended to operate in respect of computation of income under other heads for other purposes. Therefore, difference between apparent consideration and valuation done by the SVA cannot be treated as undisclosed investment in the hands of transferee. Operation of legal fiction is confined to sale consideration only. The Assessing Officer has to independently show that transferee has paid something over and above the apparent purchase consideration in the sale deed. This has to be proved independent of application of Section 50C which cannot he resorted to for any assistance for presuming that something over and above has exchanged hands and, therefore, there would be an undisclosed investment taxable under Section 69 or under Section 69B (ITO v.Venu Proteins Industries (2010) 4 ITR (Trib)602/195 Taxman 14 (Ahd) (Mag) , CIT v.Chandni Bhuchar (2010) 323 ITR 510 / 191 Taxman 142 (Punj & Har.) , IO.V.Harle Street Pharmaceuticals Ltd. (2010) 38 SOT 486 (Ahd.).

6. SECTION 50C IS A LEGAL FICTION –

Since Section 50C is a legal fiction its area and scope are confined to what is stated in the provision. Therefore, this provision can be invoked only when there is a transfer of land or building or both. Its operation cannot be extended to the other assessees or to other properties or to other circumstances than what is stated therein. It has also been held that Section 50C can be invoked if development rights are transferred along with the transfer of the land. What is to be seen is that there is a registered transfer deed. The additional rights given would not make any difference. So long as condition laid down under Section 50C. i.e. instrument of transfer is registered in respect of the immovable property other events or additional transfer or rights or liabilities would be in consequential (Arif Akhatar Hussain v. ITO (2011) 45 SOY 257/9 Taxmann. com.90(Mum)

7. SECTION 50C CANNOT BE APPLIED TO OTHER ASSETS OR FOR OTHER PURPOSES –

Where a property is treated as stock-in-trade or business asset it would not be a capital asset and, therefore, provisions of Section 50C cannot be invoked (CIT v.Thiruvengadam Investments (P)Ltd. (2010) 320 ITR 345 (Mad.), Thiruvengadam Investments (P)Ltd. 's case . Where flats were sold as business assets and were held in the books as stock-in-trade then Section 50C could not be invoked for computing business income by substituting valuation done by the SVA as real sale consideration as against actual sale price received by

the assessee (Inderlok Hotels (P)Ltd. v.ITO(2009) 32 SOT 419 (Mum), Asst.CIT v.Excellent Land Develoeprs (P)Ltd. (2010) 1 ITR (Trib) 563 (Delhi). Similarly, it has been held that Section 50C cannot be made applicable to transfer of leasehold rights in land (Atul G Puranik v. ITO (2011) 11 Taxmann.com 92(Mum) or to ascertain FMV of the property as on 1-4-1981 which is, in fact, the cost of acquisition of the property at the discretion of the assessee (Shri Pyare Mohan Mathur HUF v. ITO (2011) 12 taxmann.com 170 (Agra).

8. ONUS AND ITS DISCHARGE –

Under Section 50C when stamp duty valuation of a property is higher than apparent sale consideration shown in the instrument of transfer then onus to prove that fair market value of the property is lower than such valuation by the SVA is on the assessee who can reasonably discharge this onus by submitting necessary material before the Assessing Officer, such as valuation by an approved valuer. Thereafter onus shifts to the Assessing Officer to show that material submitted by the assessee about fair market value of the property is false or not reliable.(Ravi Kant v.ITO(2007)110 TTJ Delhi 297).

9. EXEMPTION AND SECTION 50C –

When valuation done by the SVA is adopted as full valuation of consideration under Section 50C then such value adopted will result in larger capital gain for the assessee as compared to what is disclosed by him. For the purpose of getting benefit under Section 54F the assessee cannot be expected to invest more

than actual amount of capital gains accrued to him on the basis of sale consideration as per instrument of transfer. The legal fiction created by Section 50C in determining the capital gains cannot be extended to Section 54F or other provisions allowing exemption from capital gains as deeming Section can be applied only for the definite and limited purposes for which it is created. Therefore, capital gains and net consideration mentioned in exemption provisions such as Section 54F can be worked out on the basis of apparent sale consideration without imposing fiction created under Section 50C (Gouli Mahadevappa v. ITO (2011) 128 ITD 503/(2010) 8 taxmann.com 15 (Bang).

10. OTHER EXAMPLES –

Section 50C can be invoked in respect of transfer of depreciable asset also, Section 50 providing for cost of acquisition as stated in Section 48 and Section 49 in respect of depreciable assets does not affect other provisions. One fiction cannot be imposed on another fiction or one supposition of law on other supposition of law. There is nothing in these two provisions to prohibit the applicability of these two fictions independently and simultaneously for two independent purposes. (ITO v.Ms.Kumudini Venugopal (2010) 5 ITR (Trib) 145 (Chennai), ITO vs United Marine Academy (2011)138 TTJ129(Mum)(SB).

Where agreement to sell was entered prior to introduction of Section 50C but there was a delay in submission of instrument of transfer before the Stamp Valuation Authorities for genuine reason, it was held that Section 50C would not be applicable

Similarly. Section 50C cannot be used to ascertain undisclosed investment in the case of purchaser on the basis of valuation done by the Stamp Valuation Authorities (CIT v.Chandni Bhuchar (2010) 323 ITR 510/191 Taxman 142 (Punj. & Har.).

If apparent sale consideration by the assessee is accepted by the Stamp Valuation Officer then provisions of Section 50C will not be applicable .(Punjab Poly Jute Corpn. V.Asstt.CIT (2009) 120 ITD 233 (Asr.)

Where valuation done by the Valuation Officer is higher than valuation adopted by the Stamp Valuation Authorities then valuation done by the Stamp Valuation Officer has to be taken as full value of consideration .(Jitendra Mohan Saxena v. ITO 2008) 305 ITR (AT)62 ITAT (Luck).

E. IMPORTANT FACTUAL AREAS FOR COLLECTION & INVESTIGATION BY A.O.

(1) This being deeming provisions, these provisions cannot be extended beyond its objective for which the same is promulgated.

(2) In the case of co-owners, proceedings in all the co-owners be examined and consistent stand has to be taken.

(3) While making reference to DVO, the objective of reference be very clear. The appellant has to be provided an opportunity to rebut the valuation of DVO though as per this Section the same is mandatorily be adopted.

(4) The reference to DVO is invariably in the case of dispute of full value of consideration and stamp valuation authorities whether on the instance of A.O. or assessee.

(5) 'Cost of acquisition' is different than 'full value of sale consideration' hence reference for determination of cost of acquisition is separate than reference to DVO under section 50C.

F. PRECAUTION IN DRAFTING ASSESSMENT ORDER

(1) Clearly mention the facts to demonstrate that Section 50C is applicable.

(2) Discuss clearly with date and term of reference in assessment order as far as reference to DVO. The valuation report can be made part of order for ready reference.

(3) Discuss clearly the opportunity given to appellant after receipt of DVO's report, disposing technical objection if there.

(4) In the case of co-ownership of land or building, details of treatment by department in all such cases if available be mentioned and if required, necessary action for reopening or revision be initiated, if, required.

12 Accommodation entries from fake companies

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When we refer to an entry of loan transaction as 'fake loan' received from a 'paper company', it invariably means that such entry represents unaccounted money of the person in whose books of account the money has been credited as loan and the lender company is only a conduit for routing the money back to the books of account of that person. However, despite having knowledge of this fact and knowing the techniques and methods used by the assessees for this purpose, it remains a huge challenge for the tax authorities to bring all material facts and evidences on record so as to prove which in his opinion is a fact beyond doubt.

2. In an economy where unaccounted income is a big menace, there are always efforts made by the tax evaders to bring their unaccounted income back to their books of account without paying any tax on the same. Numerous methods and techniques are used for this purpose and there are lots of techniques that authorities know about and probably countless others that have yet to be uncovered. Routing the unaccounted income back to the books of account disguised as loan or share capital is one of such methods widely used by the tax evaders in our country. The method is most prevalent and perhaps also one of the most organized one to bring the unaccounted money back to the books of account and even the established business houses resort to this method to bring their unaccounted money back to their business without paying any tax on the same.

The process to bring the money back in this manner is commonly known in business parlance as *Jamakharchi entries* or *accommodation entries*. This is a well organized racket controlled and conducted by persons known as *entry providers*. Kolkata is undoubtedly the *Mecca* of such operations liberally providing entries to business concerns all over the country but other business hubs such as Mumbai and Delhi are also not far behind in having organized rackets for providing *accommodation entries* to the willing tax evaders. Although, there is no uniformity of methodology or approach, or certainty of estimation of unaccounted income being brought back in the books of accounts in this manner, the magnitude of the same, without any doubt, is significant and huge.

2.1 The method of providing *accommodation entry* entails breaking up large amounts of money into smaller, less-suspicious amounts. In India, this smaller amount has to be below Rs. 50,000/- as deposit of cash below this amount does not require providing PAN of the depositors. The money is then deposited into one or more bank accounts either by multiple people or by a single person over an extended period of time. Also, even larger amounts are deposited in the banks with PAN numbers of individuals who are mostly illiterate and work for these *entry operators* for small salary or commission. The money is then routed through *paper companies* controlled by these operators. These companies are incorporated by taking care of all formalities such as registering with ROC but having only postal addresses with no real office or employees. The directors of such companies are again individuals

who are mostly illiterate or semiliterate and work for the *entry operators* for small salaries or commission. At first sight, most of these companies would pass of as finance, investment or technology companies. But as the *entry operators* would secretly admit, these are only paper companies used to route the unaccounted income and, at the same time, clean hoards of unaccounted income for their clients. These companies used for routing the unaccounted money are basically *fake companies* that exist for no other reason than to 'layer' the entries or pass it on to the beneficiary as loan or share capital. They take in unaccounted money as "loan or share capital" and pass it on to either another such paper company for 'layering' of the transaction or directly to the beneficiary as loan or share capital. They simply create the appearance of legitimate transactions through fake entries of loans or share capital in their books of account. As has been exposed from time to time through search and seizure operations by the department, such *entry operators* controls hundreds of bank accounts for depositing cash and hundreds of companies for routing the *entries*. Limited resource and infrastructure of the Registrar of Companies (ROC) perhaps makes it easier for them to incorporate large number of such paper companies without any difficulty. The process, *prima facie*, may appear very simple but it is extremely difficult to expose the whole chain of money deposited and 'layers' through which it is routed back to the beneficiary. The biggest problem is that there is no effective deterrence to curb the activities of these *entry operators*. Even conducting search and

seizure operations against them have not really worked as a deterrence and such operations often ended up in disclosure of 'unaccounted commission income' of these *entry operators* which definitely could not be the purpose of conducting search and seizure operations against these operators.

2.2 In USA, in 1996, Harvard-educated economist Franklin Jurado went to prison for cleaning $36 million for Colombian drug lord Jose Santacruz-Londono. Even in India, people with a whole lot of unaccounted income typically hire such 'financial experts' to handle the process to bring the money back to books of account without paying tax on the same. It's complex by necessity. The whole idea is to make it impossible for Income-tax authorities to trace the unaccounted money and it's source during the process of bringing it back to the books of account of the assessee. However, we do not have such provisions in Income-tax Act 1961 to put such operators behind bars. Hence, the solution at the moment is to handle the individual cases of such *entries* routed back through paper companies at the time of assessment in the purview of available provisions of Income- tax Act and judicial pronouncements in respect of the same.

3. Recourse under Section 68 of the Income-tax Act 1961:

The recourse available for the assessing officers to tackle the individual cases of such fake loans brought back in the books of account as cash credit is within the meaning of Section 68 of the Income-tax Act 1961**.** The provision relating to

cash credit, as in Section 68, was provided for the first time in the Income Tax Act 1961 (Act No.43 of 1961) as there was no corresponding provision in the Income Tax Act, 1922. It would be pertinent to note that Section 68 is a new section in comparisons with the provision of the Income Tax Act, 1922 and it is a culmination of a series of judicial pronouncements under the provisions of the Income Tax Act, 1922.

3.1 For the purpose of better comprehension, the Section 68 may be divided as below:

(1) Where any sum is found credited in the books of an assessee;

(2) Maintained for any previous year; and

(3) Assessee offers no explanation about the nature and source thereof; or

(4) The explanation offered by him, is not, in the opinion of the Assessing Officer, satisfactory;

(5) The sum so credited may be charged to Income tax;

(6) As the income of the assessee, of that previous year.

The initial catchphrase of the section is " Where any sum is found credited in the books of account of the assessee" meaning thereby that Section 68 is attracted where an entry relating to a sum is found to have been credited in the books of the assessee, which thus implies, existence of books and recording of a sum which the Assessing Officer considers as doubtful. Perusal of Section 68 would show that in

relation to the expression 'books', the emphasis is on the word 'assessee'. In other words, such books have to be the books of the assessee himself and not of any other person and books of account of even a firm in which the assessee is a partner cannot be considered as the books of the assessee as held in the case of ***Smt. Shanta Devi v. CIT [1988] 171 ITR 532 (Punj. & Har.).***

On this issue, it would also be pertinent to refer to another recent decision by **Hon. Indore Bench of ITAT in case of *Agrawal Coal Corpn. (P.) Ltd. v. Asstt. CIT 63 DTR 201.*** In this case it was held by the Tribunal that merely because the companies were registered with ROC, were filling return of income, having PANs/bank accounts, share application forms were submitted but the same did not establish their identity as these companies might have been existing on papers or in real sense at the time of registration but were specifically found to be non-existent. Further, assessee even failed to produce the director or employees of these share applicants and, thus, addition under Section 68 made in the hands of assessee was sustainable.

In ***CIT vs. Frostair (P.) Ltd. [2012] 26 taxmann. com 11 (Delhi)***, it was held that the assessee was under a burden to explain nature and source of share application money received in a given case and he had to establish shareholder's identity; genuineness of transaction; and creditworthiness of shareholders. On being informed that assessee had accepted share

capital from some companies which were engaged in providing bogus entries, in form of loan and share application money, Assessing Officer asked for details under Section 142 of the Act. Assessee submitted a list of 18 shareholders from which Assessing Officer discerned that PAN/GIR No. of shareholders was not correct, they were not available at addresses given and they were not filing their ITRs with concerned officers. It was held by the Hon. High Court that since Assessing Officer had examined all facts in exhaustive manner, addition under Section 68 and, consequently initiation of penalty proceedings were justified.

Another recent decision by Hon. Allahabad High Court dated July 30, 2012 in the case of ***CIT vs.Hindon Forge (P.) Ltd. [2012] 25 taxmann.com 239 (All.),*** may also be referred to on this issue. In this case the Assessee-company had taken unsecured loans from eight different trusts. One 'R' was common managing trustee of all these trusts. He was also managing director of assessee-company and other directors were his close relatives. 'R' did not produce trust deeds, its objects, and beneficiaries of trusts to establish that there were beneficiaries other than him and his associates. Trusts were receiving cash donations, which were transferred on same day to assessee by way of cheques. Assessee did not prove that trusts had any other sources of fund or that they had given credits to any other person or company. In the given facts it was held that the method and manner adopted by assessee clearly established that he was playing a fraud with revenue and, since genuineness

of transactions were not established at all, there was no question of shifting burden under Section 68 on revenue and, therefore, addition of unsecured loans to income of assessee was justified. It is important to note that the decision of Hon. Gujarat High Court in the case of *Dy. CIT v. Rohini Builders (supra)* was also referred to in this decision.

There is another recent and significant decision dated 15th February 2012 in the case of *Commissioner of Income-tax vs. Nova Promoters & Finlease (P) Ltd. [2012] 18 taxmann.com 217 (Delhi)* which is of immense relevance, as in this case important observations have been made by the Hon. Delhi High Court as to the burden of proof and shifting of onus in the cases of cash credit under Section 68 of the Act. In this case, the assessee filed its return declaring loss for relevant assessment year which is Assessment Year 2000-01. Subsequently, Assessing Officer received information from the Investigation Wing that assessee had obtained accommodation entries in garb of share application monies. In order to examine genuineness and creditworthiness of companies which gave entries to the assessee, Assessing Officer issued summons to two persons namely, 'M' and 'R' who did not appear before him. Subsequently, assessee filed a letter with Assessing Officer along with affidavits of 'M' and 'R' in which both of them had stated that transactions with assessee were genuine and earlier statements recorded from them by the Investigation Wing were given under pressure. The Assessing Officer, however, did not accept those affidavits and made certain additions to the income of the assessee

under Section 68. But, Hon.Tribunal, taking a view that there was no dispute about identity of shareholders namely 'M' and 'R', deleted addition made by the Assessing Officer. On revenue's appeal, it was noted by the Hon. High Court that both 'M' and 'R' had admitted before Additional Director (Investigation) that they were acting as *accommodation entry* providers. They had also given a list of 22 companies in which they were operating accounts. It was also apparent that out of 22 companies whose names figured in information given by them to the Investigation Wing, 15 companies had provided so-called 'share subscription monies' to the assessee. It was held by the Hon. High Court that on facts, there was specific involvement of assessee-company in modus operandi followed by 'M' and 'R' and, therefore, impugned order passed by Tribunal deleting addition was to be set aside. It was held by the Hon. High Court that *"the ratio of a decision is to be understood and appreciated in the background of the facts of that case. So understood, it will be seen that where the complete particulars of the share applicants such as their names and addresses, income tax file numbers, their creditworthiness, share application forms and share holders' register, share transfer register etc. are furnished to the Assessing Officer and the Assessing Officer has not conducted any enquiry into the same or has no material in his possession to show that those particulars are false and cannot be acted upon, then no addition can be made in the hands of the company under Section 68 and the remedy open to the revenue is to go after the share applicants in accordance with law.* ***We are afraid that we cannot apply the ratio to***

a case, such as the present one, where the Assessing Officer is in possession of material that discredits and impeaches the particulars furnished by the assessee and also establishes the link between self-confessed "accommodation entry providers", whose business it is to help assessees bring into their books of account their unaccounted monies through the medium of share subscription, and the assessee. The ratio is inapplicable to a case, again such as the present one, where the involvement of the assessee in such modus operandi is clearly indicated by valid material made available to the Assessing Officer as a result of investigations carried out by the revenue authorities into the activities of such "entry providers". T***he existence with the Assessing Officer of material showing that the share subscriptions were collected as part of a pre-meditated plan – a smokescreen – conceived and executed with the connivance or involvement of the assessee excludes the applicability of the ratio***. *In our understanding, the ratio is attracted to a case where it is a simple question of whether the assessee has discharged the burden placed upon him under Section 68 to prove and establish the identity and creditworthiness of the share applicant and the genuineness of the transaction. In such a case, the Assessing Officer cannot sit back with folded hands till the assessee exhausts all the evidence or material in his possession and then come forward to merely reject the same, without carrying out any verification or enquiry into the material placed before him. The case before us does not fall under this category and it would be a travesty of truth and justice to express a view to the contrary.*

Reference was also made on behalf of the assessee to the recent judgment of a Division Bench of this court in ***CIT v. Oasis Hospitalities Private Limited****, (2011) 333 ITR 119. We have given utmost consideration to the judgment. It disposes of several appeals in the case of different assessees. These quoted observations clearly distinguish the present case from CIT v Oasis Hospitalities P Ltd. (supra). Except for discussing the modus operandi of the entry operators generally, the Assessing Officer in that case had not shown whether any link between them and the assessee existed. No enquiry had been made in this regard. Further, the assessee had not been confronted with the material collected by the investigation wing or was given an opportunity to cross examine the persons whose statements were recorded by the investigation wing.*

In the case before us, not only did the material before the Assessing Officer show the link between the entry providers and the assessee-company, but the Assessing Officer had also provided the statements of Mukesh Gupta and Rajan Jassal to the assessee in compliance with the rules of natural justice. Out of the 22 companies whose names figured in the information given by them to the investigation wing, 15 companies had provided the so-called "share subscription monies" to the assessee.

In the light of the above discussion, we are unable to uphold the order of the Tribunal confirming the

deletion of the addition of Rs.1,18,50,000 made under Section 68 of the Act as well as the consequential addition of Rs.2,96,250."

Another decision of Hon. Delhi High Court, which is most recent dated 21st December 2012 in the case of ***CIT vs. N R Portfolios Pvt. Ltd. in ITA Nos. 134/2012*** could be of utmost help for the assessing officers dealing with the challenges of exposing *accommodation entries* and bringing it to tax under Section 68 of the Act. In this case, the assessee, a company, received Rs. 35 lakhs towards share allotment. As the shareholders did not respond to summons, the AO assessed the said sum as an unexplained credit under Section 68. On appeal, the CIT(A) and Tribunal relied on ***Lovely Exports 216 CTR 195 (Del) & Divine Leasing 299 ITR 268 (SC),*** held that as the assessee had furnished the PAN, bank details and other particulars of the share applicants, it had discharged the onus of proving the identity and credit-worthiness of the investors and that the transactions were not bogus. It was also held that the AO ought to have made enquiries to establish that the investors had given accommodation entries to the assessee and that the money received from them was the assessee's own undisclosed income. On appeal by the department the Hon. High Court, held reversing the decision of Ld.CIT(A) & Hon. Tribunal that:

Though in previous decisions (Lovely Exports) it was held that the assessee cannot be faulted if the share applicants do not respond to summons and that the Revenue authorities have the wherewithal to compel anyone to attend legal proceedings, this is merely one

aspect. An assessee's duty to establish the source of the funds does not cease by merely furnishing the names, addresses and PAN particulars, or relying on entries in the Registrar of Companies website. The company is usually a private one and the share applicants are known to it since the shares are issued on private placement basis. If the assessee has access to the share applicant's PAN or bank account statement, the relationship is closer than arm's length. Its request to such concerns to participate in income tax proceedings, would, from a pragmatic perspective, be quite strong. Also, the concept of "shifting onus" does not mean that once certain facts are provided, the assessee's duties are over. If on verification, the AO cannot contact the share applicants, or the information becomes unverifiable, the onus shifts back to the assessee. At that stage, if it falters, the consequence may well be an addition under Section 68 (A. Govindarajulu Mudaliar *34 ITR 807 followed).*

Another decision of utmost relevance is of Hon. ITAT Indore Bench in the case of ***Vaibhav Cotton (P.) Ltd. vs. Income-tax Officer, 4(4) Indore, [2012] 26 taxmann.com 352 (Indore.)*** In this case the assessee company had shown in its balance sheet certain amount representing share capital received from a Kolkata based company and some other individual investors. Face value of shares was Rs. 10 and those shares were issued at a premium of Rs. 90 per share. Next year, promoters/directors of assessee-company purchased those shares back at a discount of 90 per cent. In order to ascertain

genuineness of share transactions, Assessing Officer issued notices to Kolkata based company and other alleged shareholders which were returned by postal authorities with a remark 'left'. He also visited respective banks through which money was routed by these investors and found that cash was deposited immediately prior to issue of cheque to assessee and accounts of those companies were closed immediately after transfer of funds. Assessing Officer thus taking a view that share transactions were not genuine, added amount in question to assessee's taxable which was upheld by the Hon. Tribunal.

4. It is not necessary to establish that the money came back to the books of the assessee as 'entry' actually emanated from his coffers :

While dealing with doubtful cash credits, is it necessary for the assessing officer to establish that the money came back to the books of the assessee as 'entry' actually emanated from the coffers of the assessee? This issue has been decided by the Hon'ble Delhi High Court in a recent decision dated 20.07.2012 in the case of *Commissioner of Income-tax vs Independent Media (P.) Ltd.210 TAXMANN 14(Delhi)(2012),* which is significant as the observation made by the Hon. Court in this decision would be a great help in establishing the cases where '*entries*' have been taken from paper companies. In this case it was alleged by the Investigation wing that the assessee-company received share capital from those persons who had given statements before Investigation wing that they were entry providers giving accommodation entries after receiving

cash and after charging their commission. Assessee furnished PAN of subscriber-companies, share application forms, board resolutions, copy of bank statement, pay orders, confirmation from subscribers, their income-tax returns, copies of their balance sheets, etc. However it was held by the Hon. Court that if explanation adduced by assessee with regard to identity and creditworthiness of subscriber-companies and genuineness of transactions was not acceptable for valid reasons, Assessing Officer could make addition under Section 68 and for that purpose he would not be under any duty to further show or establish that monies emanated from coffers of assessee-company. The Hon. Court further observed that *"We are unable to uphold the view of the Tribunal that it is incumbent upon the Assessing Officer, on the facts and circumstances of the case, to establish with the help of material on record that the share monies had come or emanated from the assessee's coffers. Section 68 of the Act casts no such burden upon the Assessing Officer. This aspect has been considered more than 50 years back by the Supreme Court in the case of A Govindarajulu Mudaliar v.CIT [1958] 34 ITR 807 where precisely the same argument was advanced before the Supreme Court on behalf of assessee. The argument was rejected by the Court."*

4.1 The Hon'ble Court further referred that in the above case, Shri Venkatarama Iyer, J. speaking for the Court observed as under: -

"Now the contention of the appellant is that assuming that he had failed to establish the case put forward

by him, it does not follow as a matter of law that the amounts in question were income received or accrued during the previous year, that it was the duty of the Department to adduce evidence to show from what source the income was derived and why it should be treated as concealed income. In the absence of such evidence, it is argued, the finding is erroneous. We are unable to agree. Whether a receipt is to be treated as income or not, must depend very largely on the facts and circumstances of each case. In the present case the receipts are shown in the account books of a firm of which the appellant and Govindaswamy Mudaliar were partners. When he was called upon to give explanation he put forward two explanations, one being a gift of Rs. 80,000/- and the other being receipt of Rs. 42,000/- from business of which he claimed to be the real owner. When both these explanations were rejected, as they have been it was clearly upon to the Income-tax Officer to hold that the income must be concealed income. There is ample authority for the position that where an assessee fails to prove satisfactorily the source and nature of certain amount of cash received during the accounting year, the Income-tax Officer is entitled to draw the inference that the receipt are of an assessable nature. The conclusion to which the Appellate Tribunal came appears to us to be amply warranted by the facts of the case. There is no ground for interfering with that finding, and these appeals are accordingly dismissed with costs."

5. Responsibility towards source of source :

In ordinary circumstances, assessee's burden is confined to prove creditworthiness of creditor with reference to transaction between assessee and creditor. It was so held in ***Nemi Chand Kothari v. CIT [2004] 136 Taxman 213 (Gau.)***,*that a* harmonious construction of Section 106 of the Evidence Act and Section 68 of the Income-tax Act will be that though apart from establishing the identity of the creditor, the assessee must establish the genuineness of the transaction as well as the creditworthiness of his creditor, the burden of the assessee to prove the genuineness of the transactions as well as the creditworthiness of the creditor must remain confined to the transactions, which have taken place between the assessee and the creditor. What follows, as a corollary, is that it is not the burden of the assessee to prove the genuineness of the transactions between his creditor and sub-creditors nor is it the burden of the assessee to prove that the sub-creditor had the creditworthiness to advance the cash credit to the creditor from whom the cash credit has been, eventually, received by the assessee. It is not the business of the assessee to find out the source of money of his creditor or of the genuineness of the transaction, which took place between the creditor and sub-creditor and/or creditworthiness of the sub-creditors, since, these aspects may not be within the special knowledge of the assessee.

5.1 However, on this issue, it is important to keep in mind that it may not be the responsibility of the assessee to prove source of source but nothing precludes the assessing officer to make enquiry in respect of the

source of the source as well to establish that both the source and it's source are part of a larger chain of 'paper companies' engaged in the business of providing *accommodation entries to the willing tax evaders*. Once a valid presumption is raised by way of an enquiry about the genuineness of transaction between the source and it's source the same could be used as an evidence to doubt the integrity of the source of the assessee and to raise a valid presumption about the transaction between the assessee and it's source being not genuine.

6. Test of human probability :

As has been discussed earlier, the issue of shifting of onus in the cases of cash credit is a complex one and each case has to be examined in it's own facts and circumstances. Hence, in the cases of 'fake loan' from 'paper companies' the theory of preponderance of human probability as pronounced by the Hon. Apex Court in the cases of ***CIT v. Durga Prasad More [1971] 82 ITR 540*** and ***Sumati Dayal v. CIT [1995] 80 Taxman 89/214 ITR 801 (SC)*** is of utmost importance. In the cases where it has been established that the source company is a mere 'paper company' solely engaged in the activity of providing accommodation entries, the presumption on the basis of human probability may be referred to by the assessing officers to fortify their findings.

6.1 Hon. Supreme Court in ***CIT v. Durga Prasad More [1971] 82 ITR 540 ,*** at pages 545-547 made a reference to the test of human probabilities in the following fact situation : –

"...Now we shall proceed to examine the validity of those grounds that appealed to the learned judges. It is true that an apparent must be considered real until it is shown that there are reasons to believe that the apparent is not the real. In a case of the present kind a party who relies on a recital in a deed has to establish the truth of those recitals, otherwise it will be very easy to make self-serving statements in documents either executed or taken by a party and rely on those recitals. If all that an assessee who wants to evade tax is to have some recitals made in a document either executed by him or executed in his favour then the door will be left wide-open to evade tax. A little probing was sufficient in the present case to show that the apparent was not the real. The taxing authorities were not required to put on blinkers while looking at the documents produced before them. They were entitled to look into the surrounding circumstances to find out the reality of the recitals made in those documents.

Now, coming to the question of onus, the law does not prescribe any quantitative test to find out whether the onus in a particular case has been discharged or not. It all depends on the facts and circumstances of each case. In some cases, the onus may be heavy whereas, in others, it may be nominal. There is nothing rigid about it. Herein the assessee was receiving some income. He says that it is not his income but his wife's income. His wife is supposed to have had two lakhs of rupees neither deposited in banks nor advanced to others but safely kept in her

father's safe. Assessee is unable to say from what source she built-up that amount. Two lakhs before the year 1940 was undoubtedly a big sum. It was said that the said amount was just left in the hands of the father-in-law of the assessee. The Tribunal disbelieved the story, which is, prima facie, a fantastic story. It is a story that does not accord with human probabilities. It is strange that the High Court found fault with the Tribunal for not swallowing that story. If that story is found to be unbelievable as the Tribunal has found, and in our opinion rightly, then the position remains that the consideration for the sale proceeded from the assessee and, therefore, it must be assumed to be his money.

It is surprising that the High Court has found fault with the Income-tax Officer for not examining the wife and the father-in-law of the assessee for proving the department's case. All that we can say is that the High Court has ignored the facts of life. It is unfortunate that the High Court has taken a superficial view of the onus that lay on the department.

'...Science has not yet invented any instrument to test the reliability of the evidence placed before a Court or Tribunal. Therefore, the Courts and Tribunals have to judge the evidence before them by applying the test of human probabilities. Human minds may differ as to the reliability of a piece of evidence. But, in that sphere, the decision of the final fact-finding authority is made conclusive by law." (p. 545)

6.2 The test of human probabilities has been emphasized

in yet another decision of the Hon. Supreme Court in the case of ***Sumati Dayal v. CIT [1995] 80 Taxman 89/214 ITR 801 (SC)***. It was held in this case that in view of Section 68, where any sum is found credited in the books of the assessee for any previous year, the same may be charged to income-tax as the income of the assessee of the previous year if the explanation offered by the assessee about the nature and source thereof, is, in the opinion of the Assessing Officer, not satisfactory. In such case there is *prima facie* evidence against the assessee, viz., the receipt of money, and if he fails to rebut the same, the said evidence being unrebutted can be used against him by holding that it is a receipt of an income nature. While considering the explanation of the assessee, the department cannot, however, act unreasonable.

6.3 Why this decision is so important while dealing with cases of 'fake loan' from 'paper companies', because it acknowledges that what is apparent may not be real and test of human probabilities has to be applied to understand if the apparent is real and if the transaction fails to withstand the test of human probabilities it has to be taken as an in-genuine transaction even if documentary evidences suggest otherwise. In this case, the assessee, a dealer in art pieces, had shown income from horse-race winnings in two consecutive accounting years. The assessing officer did not accept this and made addition under Section 68 which was confirmed by the Appellate Assistant Commissioner. Thereafter the assessee approached the Settlement

Commission. The Settlement Commission also took the view that the claim of winnings in races was false and what were passed off as such winnings really represented the appellants taxable income from some undisclosed sources. Hon. Supreme Court also agreed with the Settlement Commission saying that after considering the surrounding circumstances and applying the test of human probabilities the Commission had rightly concluded that the assessee's claim about the amount being her winnings from races was not genuine.

6.4 The test of human probability often comes to the help of the revenue to track unaccounted income. This could be a great help in exposing the 'fake loans' from 'paper companies' as well. In one of its special kinds, the test of human probability made an assessee pay huge amount of tax in ***Som Nath Maini v. CIT [2008] 306 ITR 414 (Punj. & Har.).*** In this case, the assessee in his return declared loss from sale of gold jewellery and also declared a short-term capital gain from sale of shares so that the two almost match each other. This simple tax planning became ineffective after the Assessing Officer disbelieved the astronomical share price increase applying the test of human probability. The Assessing Officer observed that short-term capital gains were not genuine in as much as the assessee had purchased 45000 shares of *Ankur International Ltd.* at varying rates from Rs. 2.06 to Rs. 3.1 per share and sold them within a short span of six-seven months at the rate varying from Rs. 47.75 paisa to Rs. 55. Even though the

two respective transactions for purchase and sale of shares were routed through two different brokers, yet the Assessing Officer did not believe the astronomical rise in share price of a company from Rs. 3 to Rs. 55 in a short-term.The assessee lost its case before the Tribunal. Confirming the order of the Tribunal, the Punjab and Haryana High Court held that the burden of proving that income is subject to tax is on the revenue but, on the facts, to show that the transaction is genuine, burden is primarily on the assessee. As per the Court, the Assessing Officer is to apply the test of human probabilities for deciding genuineness or otherwise of a particular transaction. Mere leading of the evidence that the transaction was genuine, cannot be conclusive. Any such evidence is required to be assessed by the Assessing Officer in a reasonable way. Genuineness of the transaction can be rejected in case the assessee leads evidence which is not trustworthy, and the department does not lead any evidence on such an issue.

7. Responsibility of the Assessing Officer :

There is no denying to the fact that in the case of cash credit the primary onus is on the assessee and where the assessee fails to discharge such onus the Assessing Officer is well within his jurisdiction to treat the cash credit as income of the assessee within the meaning of Section 68 of the Act. However, the balance of burden in the case of cash credits is delicate and complex and unless and until the Assessing Officer shows his intention to make enquiry to examine the truth, the additions made under Section

68 in the cases of 'fake loan' from 'paper companies' would not get affirmation of the appellate authorities. In the cases of loans from 'paper companies', additions are often made by the Assessing Officers by highlighting the defects in the submission of the assessee without making further enquiries which does not help the case of revenue as merely highlighting defects in the submission of the assessee without making any further enquiry would in most cases be not accepted as sufficient to reach a conclusion that entry of such loan represents income of the assessee.

Some example of the same is given below for illustration:

1. The assessee has provided name, address and PAN of the creditor but did not provide confirmations from him.
2. Confirmatory letters from the creditors were filed but the creditors were not produced for examination.
3. Summons issued under Section 131 to the creditors but they did not respond to the summons.
4. The letters sent to the creditors at the given address returned unserved with comment "not found" or "inadequate address".
5. The confirmation of the creditor was filed but his bank statement was not produced or his credit worthiness have not been established.

7.1 It must be kept in mind that such instances could be the circumstances to have a valid doubt as to the genuineness of the loan but these alone would not be sufficient to have a valid presumption as to the fact that the cash credit represents income of the

assessee. Under Section 68 of the Act, the Assessing Officer has jurisdiction to make enquiries with regard to the nature and source of the sums credited in the books of account of the assessee and it is immaterial as to whether the amount so credited is given the colour of a loan or share application money or sale proceeds. The use of the words "any sum credited in the books" in Section 68 indicates that the section is very widely worded and the Assessing Officer is not precluded from making an enquiry as to the true nature and source of the sum credited in the accounts even if it is credited as loan from another company. The Assessing Officer would be entitled, and it would indeed be his duty to enquire whether the alleged creditors do in fact exist or not and whether the loan shown in the garb of a credit from a company is nothing but an *accommodation entry* routed through a *paper company* solely existing for the purpose of providing such *accommodation entries*. Although, given in the context of share application money, the decision of Hon. Delhi High Court in the case of ***CIT vs. Sofia Finance Ltd. 205 ITR 98 (full bench)*** is extremely significant where explaining and rather over ruling some observations of the division bench in *Steller Investment* case which has been confirmed by the Hon. Supreme Court in 164 CTR 287 in a one line decision stating that no question of law arose in such a case. The full bench observed as under :

"*what is clear, however, is that Section 68 clearly permits an ITO to make enquires with regard to the*

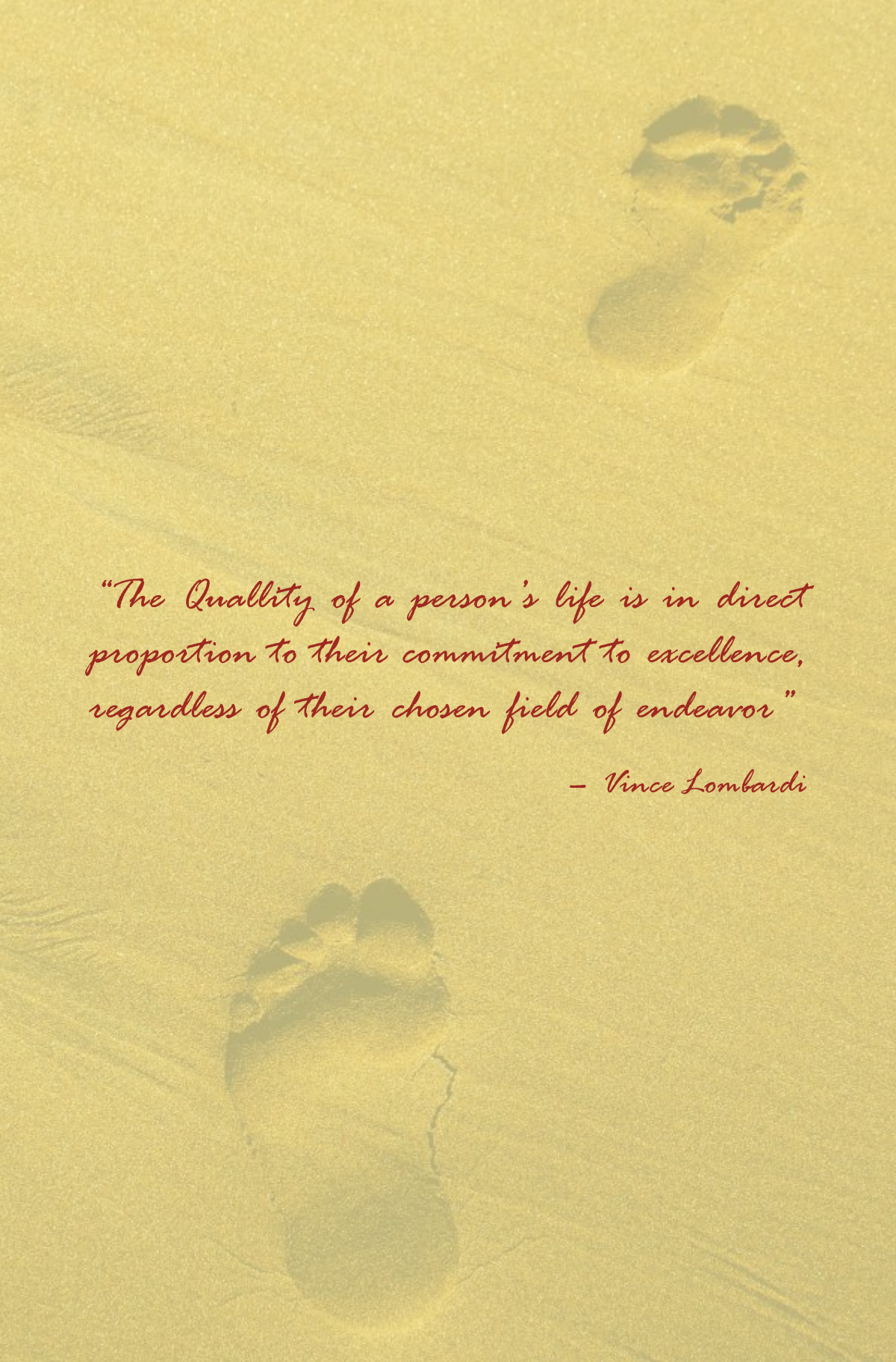
nature and source of any of all the sums credited in the books of account of the company irrespective of the name and cloture or the source indicated by the assessee. In other words, the truthfulness of the assertion of the assessee regarding the nature and the source of the credit in his books of account can be gone into by the ITO. In the case of Steller Investments Ltd., the ITO had accepted the entries subscribed share capital. Section 68 of the Act was not referred to and the observations in the said judgement cannot mean that the ITO cannot or should not go into the position as to whether the alleged share holder actually existed or not. If share holders are identified and it is established that they have invested money in the purchase of shares then the amount received by the company would be regard as capital receipts and to that extent the observations in the case of Steller Investment Ltd. are correct, but if, on the other hand, the assessee offers new explanation at all or explanation offered is not satisfactory then, the provision of Section 68 may be invoked."

7.2 It is, therefore, imperative on the part of the Assessing Officer to make enquires as to the nature and source of cash credits and bring evidence on record to expose the fact that the loan is a fake one representing an *accommodation entry from a paper company*. Although, the nature and extent of enquiry has to be case- specific so as to raise a valid presumption to treat the loan as income of the assessee. However, in the case of accommodation entries received through

paper companies the Assessing Officer can easily bring certain facts on record to highlight that the loan received actually represents an *accommodation entry*. It could be proved that the company providing loan exists only on paper, it has no employees, the address given is only a postal address and the company does not have any physical set up at the given address, the same address is used as postal address for multiple companies indulging in to the same activity of providing *accommodation entries*. It could also possibly be proved that the directors of the companies are non- existent or even if they exist, they are illiterate or semi illiterate individuals who do not have competence or credibility to operate any investment company. Examining the directors on oath under Section 131 could also be a way to carry the enquiry further so as to prove that they may be acting on behalf of some other person for petty amounts received as salary or commission. It could also be proved that the company is receiving huge amount as loan and giving the same to other concerns without any apparent motive of conducting any actual business and the directors of the company are not even aware of such huge transactions made by the company for, considering the doctrine of business purposes, the company should have a reason, other than avoidance of taxes, for undertaking such transactions. Necessary enquiries may also be made from the bank to examine the bank account of the creditor and also to examine the person who has introduced such bank accounts. In some of the cases, It may have been held that

the assessee do not have responsibilities to prove the source of the source, but nothing precludes the Assessing Officer to examine even the source of the source as a process of enquiry to bring the truth on record that these companies work in a chain as conduit to provide *accommodation entries* which does not represent any genuine transactions.

7.3 As discussed earlier, in number of decisions the efforts of the Assessing Officers have been acknowledged and applauded by the appellate authorities where enquires have been made and additional information and evidences have been brought on record to raise a valid presumption as to the cash credit being income of the assessee. It is, therefore, required that the Assessing Officers properly analyse the individual cases before them and, instead of solely depending on the submissions of the assessee and highlighting the deficiency of the same, conduct independent enquiry and bring additional facts and evidences on record to raise a valid presumption, in favour of *accommodation entry representing income of the assessee,* which could sustain the test of appeal.



"The Quallity of a person's life is in direct proportion to their commitment to excellence, regardless of their chosen field of endeavor"

– Vince Lombardi

13 Handling of cash credits - Section 68

Vimalendu Verma
CIT(Appeals)-XXI, Ahmedabad

Sunil Kumar Jha
Addl CIT, Central Range, Baroda

INTRODUCTION

Section 68 of the I T Act is one of the most powerful yet debated provision of the I T Act. This provision has given plethora of judgments, sometimes conflicting, both in favour of Revenue and the assessee. In light of those judgements an attempt is made to analyse Section 68 with the following sub headings:

1. Section 68 with latest amendment
2. The Proviso
3. General discussion
4. Important case laws in favour of departments

Section 68 of the Income tax Act reads as under:

1. Cash credits.

68. Where any sum is found credited in the book of an assessee maintained for any previous year, and the assessee offers no explanation about the nature and source thereof or the explanation offered by him is not, in the opinion of the [Assessing] Officer, satisfactory, the sum so credited may be charged to income-tax as the income of the assessee of that previous year :

The following provisos shall be inserted in Section 68 by the Finance Act, 2012, w.e.f. 1-4-2013 :

Provided *that where the assessee is a company, (not being a company in which the public are substantially interested)*

and the sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called, any explanation offered by such assessee-company shall be deemed to be not satisfactory, unless –

(a) the person, being a resident in whose name such credit is recorded in the books of such company also offers an explanation about the nature and source of such sum so credited; and

(b) such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory:

Provided further *that nothing contained in the first proviso shall apply if the person, in whose name the sum referred to therein is recorded, is a venture capital fund or a venture capital company as referred to in clause (*23FB*) of Section 10.*

The Proviso- amendment

Finance Act, 2012 inserts two provisos to Section 68, with effect from 1-4-2013 (assessment year 2013-14). First proviso to enlarge the onus of a closely held company and provides that if a closely held company receives any share application money or share capital or share premium or the like, it should also establish the source of source (that is, the resident from whom such money is received). Second proviso provides that the first proviso will not apply if the receipt of sum (representing share application money or share capital or share premium etc.) is from a VCC or VCF [referred in Section 10(23FB)].

Objective of the amendment – As explained in the Memorandum:

"Certain judicial pronouncements have created doubts about the onus of proof and the requirements of this section, particularly,

in cases where the sum which is credited as share capital, share premium etc.

Judicial pronouncements, while recognizing that the pernicious practice of conversion of unaccounted money through masquerade of investment in the share capital of a company needs to be prevented, have advised a balance to be maintained regarding onus of proof to be placed on the company. The Courts have drawn a distinction and emphasized that in case of private placement of shares the legal regime should be different from that which is followed in case of a company seeking share capital from the public at large.

In the case of closely held companies, investments are made by known persons. Therefore, a higher onus is required to be placed on such companies besides the general onus to establish identity and creditworthiness of creditor and genuineness of transaction. This additional onus needs to be placed on such companies to also prove the source of money in the hands of such shareholder or persons making payment towards issue of shares before such sum is accepted as genuine credit. If the company fails to discharge the additional onus, the sum shall be treated as income of the company and added to its income".

Thus in case of private limited companies higher onus is cast upon them to explain even source of source of the share application money/ share premium etc.

General discussion

1. According to Section 68 of Income Tax Act 1961, where any sum is found credited in the books of an assessee maintained for any previous year, and the assessee offers no explanation about the nature and source of the same or the explanation

offered by him is not satisfactory in the opinion of A.O., the sum so credited may be charged to income tax as the income of the assessee of that previous year.

The basic precondition for the Section 68 is that the assessee should file a valid confirmation. Valid confirmation has no specific format but it must contain name, complete address of the lender. It is better if PAN of the lender is also obtained as, if no PAN given then ambit of doubt is far more for the AO. With the confirmation the AO must insist on some identity proof like copy of driving license, copy of passport, copy of ration card or election ID card etc.

The confirmation so filed must indicate complete details of transactions (like mode- cash or cheque, with number date of cheque with bank details). The AO have right to demand the copy of bank account of the lender evidencing such transactions and the same needs to be filed. In case transaction is in cash then AO must demand cash flow statement of the lender, preferably containing details of opening balance and its source thereof.

As far as the creditworthiness or financial strength of the creditor/subscriber is concerned, that can be proved by producing the bank statement of the creditors/subscribers showing that it had sufficient balance in its accounts to enable it to subscribe to the share capital. Once these documents are produced, the assessee would have satisfactorily discharged the onus cast upon him. Thereafter, it is for the Assessing Officer to scrutinize the same and in case he nurtures any doubt about the veracity of these documents, to probe the matter further. However, to discredit the documents produced by the assessee on the aforesaid aspects, there has to be some cogent reasons and materials for the Assessing Officer and he

cannot go into the realm of suspicion. Thus element of credit worthiness and satisfaction of AO thereafter is subjective and requires more efforts/inquiry on the part of the AO to give a finding in the order that lender is not credit worthy.

If AO observe some cash deposit before issue of cheque then some 'nexus' must be established between the cash deposit and the lendee. A mere observation that cheque is issued after few days of cash deposit and additions made on this count will not sustain in the appellate stage. Hon'ble Gujarat HC has even held in 208 Taxman 35 that even if there is cash deposit before the cheque is issued same cannot be held has income of lendee if lender is income tax assessee.

If cash credit is disallowed for the reason of creditworthiness then some discussion must be there in the assessment order. Such discussion should reveal that some inquiries were conducted which help the AO to conclude that lender is not creditworthy. It may be pointed out that such inquiries must be confronted to the assessee and replies obtained in interest of natural justice.

2. There **must exist books of accounts** before making addition under Section 68: The addition under Section 68 can be made on the basis of unexplained cash credit found in the books of the asseessee, hence existence of books of an assessee is a condition precedent before an addition under Section 68 can be made.

3. Now the question is what may be termed as books of the assessee. As per **Section 2(12A)** of Income Tax Act books includes ledgers, day books, cash books, whether kept in the written form or as print outs of data stored in floppy, disc, tape or any other electro-magnetic data storage device.

4. In Central Bureau of Investigation v. V.C. Shukla [1998] 3

SCC 410, the Supreme Court has held that 'Book" ordinarily means a collection of sheets of paper or other material, blank, written or printed, fastened or bound together so as to form a material whole. Loose sheets or scraps of paper cannot be termed as book for they can be easily detached and replaced.

5. **Books of accounts must be of assessee himself** and not of any other assessee. In Smt Shanta Devi v. CIT [1998] 171 ITR 532 (P&H), it was held that a perusal of Section 68 would show that the expression books has been used with reference to the word assessee. In other words, such books of account have to be books of the assessee himself and not of any other assessee. Thus books of account of a partnership firm cannot be considered to be the books of account of the partner. Any cash credit shown therein cannot be brought to tax as income under Section 68 in the hands of the partners.

6. **Bank Pass book is not books of account for the purpose of Section 68**. In CIT, Poona v. Bhaichand H. Gandhi 141 ITR 67 (Bom.) it was held that the pass book supplied by the bank to the assessee cannot be regarded as the book of the assessee, that is, a book maintained by the assessee or under his instructions. Therefore a cash credit for the previous year shown in the assessee's bank pass book but not shown in the cash book maintained by the assessee for that year, does not fall within the ambit of Section 68 of Income Tax Act, 1961,thus if AO finds any unexplained transaction in the bank passbook of the assessee then same can be taxed as unexplained money under Section 69A of the act

8. It is not necessary that books of account must be rejected before making any addition under Section 68. In Devinder Singh v. ACIT [2006] 101 TTJ 505 (ITAT-Asr) it has been

held that there is nothing in Section 68 that books of account must be rejected before making an addition under Section 68. This is an independent and deeming provision and will apply if the assessee fails to offer an explanation of the source of particular receipt/credit appearing in the books of account or if the explanation given by the assessee is found to be not satisfactory by the A.O.

9. Additions in the Partner's capital account-whether firm is liable to explain and whether addition can be made to firm's income in such case under Section 68. In CIT v. Metachem Industries [2000] 245 ITR 160(MP), it has been held that where the assessee-firm had satisfactorily explained the credits standing in the name of its partners, the responsibility of the assessee stands discharged.

10. Once it is established that the amount has been invested, by a particular person, be he a partner or an individual then the responsibility of the assessee firm is over. The assessee firm cannot ask the person who makes investment, whether the money invested is properly taxed or not. If that person owns the entry then the burden of the assessee firm is discharged. It is open to the A.O to undertake further investigation with regard to that individual who has deposited the amount.

11. In India Rice Mills v. CIT 218 ITR 508, 511 (All.) it was held that where the capital contributions are made by the partners prior to the commencement of the business by the assessee-firm, it is for the partners to explain the source of such capital contributions and if they fail to discharge such onus then such capital contributions, although entered in the books of accounts of the assessee-firm, cannot be regarded as income of the assessee-firm.

12. Proper enquiry must be made by A.O before making any addition under Section 68: The A.O must make proper enquiry before making any addition under Section 68. In Khandelwal Constructions v. CIT 227 ITR 900 (Gau.) it has been held that Section 68 of Income Tax Act, 1961, empowers the Assessing officer to make enquiry regarding cash credit. If he is satisfied that these entries are not genuine he has every right to add these as income from other sources. But before rejecting the assessee's explanation A.O. must make proper enquiries and in the absence of proper enquiries, addition cannot be sustained.

13. The **assessee is also entitled to cross-examine** any person whose statement has been recorded by the A.O and such statement is proposed to be used by the A.O.-CIT v Eastern Commercial Enterprises 210 ITR 103 (Cal.).

14. If some depositor or any other person with whose evidence cash credit in question can be proved, does not cooperate in the assessment proceedings with the assessee concerned then assessee can also take assistance of Section 131 of the Act wherein ample powers have been given to the A.O for compelling the attendance of witnesses.

15. Provision applies to all credit entries :

In the cases where credit entry has been made in the books of the assessee, the ambit of Section 68 is wide and inclusive. Provision applies to all credit entries. The language of Section 68 shows that it is general in nature and applies to all credit entries in whomsoever name they may stand, that is, whether in the name of the assessee or a third party as held in the case of ***Gumani Ram Siri Ram v. CIT [1975] 98 ITR 337 (Punj. & Har.).***

The section has applicability even in the cases of search as

Section 68 is a provision of general application and there is nothing either in Section 132 or Section 68 or elsewhere to exclude the application of this general provision to a case where the business premises or the residence of a person has been searched and the documents and other things seized under Section 132 of the Act. The presumption under Section 132(4A) does not override or exclude Section 68, that is, it does not obviate the necessity to establish by independent evidence the genuineness of the cash credits under Section 68, nor does it do away with the burden which is on the assessee to establish the requisites of cash credits as held in the cases of ***Pushkar Narain Sarraf v.CIT [1990] 183 ITR 388 (All.)*** and ***Daya Chand v. CIT [2001] 250 ITR 327 (Delhi).***

It is obvious by the above that the provision applies to non-commercial loans as well and it was precisely the same as held by the Hon. Calcutta High Court in the case of ***C. Kant & Co. v.CIT [1980] 126 ITR 63 (Cal.),*** observing that Section 68 does not make any distinction between commercial and non-commercial loans.

16. Burden of Proof :

The Assessing Officer when starts enquiry, specifically to satisfy himself of the source of such credit, and if during the enquiry, he is satisfied that the entries are not genuine, then he has every right to add the said sum represented by such credit entry as income of the assessee. The satisfaction of the assessing officer is the basis of invocation of provisions of Section 68. However, such satisfaction must not be illusory or imaginary but must have been derived from relevant facts and evidences, and on the basis of proper enquiry of all material before him.

The enquiry envisaged under Section 68 is an enquiry which is reasonable and just. The amount of cash credits could not be included in the total income of the assessee if the Assessing Officer has not made proper enquiry. Under Section 68, the onus is on the assessee to offer explanation where any sum is found credited in the books of account and where the assessee fails to prove to the satisfaction of the Assessing Officer, the source and nature of the amount of cash credits, he is entitled to draw an inference that the credit entries represent income taxable in the hands of the assessee. It is not the duty of the Assessing Officer to locate the exact source of the cash credits. The burden to identify the source lies upon the assessee and he is required to explain the genuineness of the credit entry.

The issue of cash credit has always been a matter of vexed litigation. Section 68 enacts a golden rule of evidence which is not in dispute, i.e., if any sum is found credited in the books of account of an assessee, the onus is on him to explain the said entry. The principle embodied in Section 68 is only a statutory recognition of what was always understood to be the law based upon the rule that the burden of proof is on the taxpayer to prove the genuineness of borrowings since the relevant facts are exclusively within his knowledge. Even before the enactment of Section 68, this rule of evidence was applicable vide ***Kale Khan Mohammed Hanif v. CIT [1963] 50 ITR 1 (SC).*** Section 68 does not absolve the responsibility of the Assessing Officer to prove that the cash credits constitute the income of the assessee. In ***Orient Trading Co. Ltd. v. Commissioner of Income-tax (1963) 49 ITR 723 (Bom.)***, one of the questions referred to the Bombay High Court was whether there was any material before the Tribunal to hold that a sum standing in the books of the assessee to the

credit of a third party belonged to the assessee. The Bombay High Court discussed the nature and significance of cash credits in such cases and observed as follows:

"When cash credits appear in the accounts of an assessee, whether in his own name or in the name of third parties, the Income-tax Officer is entitled to satisfy himself as to the true nature and source of the amounts entered therein, and if after investigation or inquiry he is satisfied that there is no satisfactory explanation as to the said entries, he would be entitled to regard them as representing the undisclosed income of the assessee. When these credit entries stand in the name of the assessee himself, the burden is undoubtedly on him to prove satisfactorily the nature and source of these entries and to show that they do not constitute a part of his business income liable to tax. When, however, entries stand, not in the assessee's own name, but in the name of third parties, there has been some divergence of opinion expressed as to the question of the burden of proof. The Income-tax Officer's rejection not of the explanation of the assessee, but of the explanation regarding the source of income of the depositors, cannot by itself lead to any inference regarding the non-genuine or fictitious character of the entries in the assessee's books of account."

The expression "nature and source" in Section 68 has to be understood together as a requirement of identification of the source and the nature of the source, so that the genuineness or otherwise could be inferred. The Law on the subject has been illustrated in a number of decisions prior to 1968. Hon. Supreme Court, in *Kale Khan Mohd. Hanif Vs. CIT (supra),* pointed out that the onus on the assessee has to be understood

with reference to the facts of each case and proper inference drawn from the facts. The law after Section 68 is not different. If the *prima facie* inference on the fact is that the assessee's explanation is probable, the onus will shift to the Revenue. Though the Assessing Officers, often, acts on confirmatory letters as evidence, the onus does not get discharged merely by such confirmatory letters as found in ***CIT Vs. United Commercial and Industrial Co. (Pvt.) Ltd. (1991) 187 ITR 596 (Cal),*** nor is the fact that the amount is received by account payee cheques is sacrosanct as was pointed out in ***CIT vs. Precision Finance Pvt. Ltd. (1994) 208 ITR 465 (Cal).*** This view was further held in the case of ***Nemi Chand Kothari v. CIT [2003] 264 ITR 254 (Gau.)*** where in it was held that it cannot be said that a transaction, which takes place by way of cheque, is invariably sacrosanct. Once the assessee has proved the identity of his creditors the genuineness of the transactions, and the creditworthiness of his creditors vis-à-vis the transactions which he had with the creditors, his burden stands discharged and the burden then shifts to the revenue to show that though covered by cheques, the amounts in question, actually belonged to, or was owned by the assessee himself. Even the particulars from assessment records, where the creditor is assessed, may not be sufficient as observed in ***CIT vs. Korlay Trading Co.,. Ltd. (1998) 238 ITR 820 (Cal).***

Further, in the case of ***Kamal Motors v. CIT [2003] 131 Taxman 155 (Raj.).*** It was held that the responsibility is on the assessee to discharge the onus that the cash creditor is a man of means to allow the cash credit. The burden to prove the source of receipt is in respect of each entry as held in the case of ***CIT v. R.S. Rathore [1995] 212***

ITR 390 (Raj.), that while explaining the various credits and investments, it is possible that the assessee may be successful in explaining some of them, but that does not by itself mean that the entire investments has to be considered as explained. It is each and individual entry on which the mind has to be applied by the taxing authority when an explanation is offered by the assessee.

On the issue of burden of proof a very specific and illustrious decision was from the Hon. Calcutta High Court in *CIT vs. Precision Finance Pvt. Ltd. (1994) 208 ITR 465 (Cal)* where in it was laid down that the assessee is expected to establish:-

1. Identity of his creditors;
2. Capacity of creditors to advance money; and
3. Genuineness of transaction.

As to the issue of genuineness of transaction, it was further held in the above decision that the transaction is not genuine, simply because some, out of many, of the transactions are by cheque. Conversely, it is not open for the Assessing officer to add token amount merely for the purpose of making the returned income into a round figure. Where certain sum of money claimed by the assessee to have been borrowed from certain persons, it is for the assessee to prove, by cogent and proper evidence, that they are the genuine borrowings for the reason that the facts are exclusively within the assessee´s knowledge.

But at the same time, the law does not expect the impossible on the part of the tax payer as was pointed out in ***Life Insurance Corporation of India vs. CIT (1996) 219 ITR 410 (SC),*** although pronounced in a different context. All that matter is that the explanation is *prima facie* reasonable. If it

is so, it cannot be rejected on mere surmises. It was so held in ***CIT vs. Bedi & Co. Pvt. Ltd. (198) 230 ITR 580 (SC).*** The affidavits filed cannot be rejected outright without cross examination as was found by the Hon. Supreme Court in ***Mehta Parikh & Co. vs. CIT (1956) 30 ITR 181(SC).*** It was pointed out that where the assessee's account were accepted as genuine, it is ordinarily not possible to show that the credits therein do not come from the sources attributed for them. These and other decisions would indicate that the ultimate inference in such cases is to draw from the facts and the preponderant probability of such explanation and difficulty in proving an explanation is a fact which cannot be ignored as observed in ***S. Hastimal vs. CIT (1963) 49 ITR 273 (Mad.).*** To say that the borrowing has not come from the accounted source of the lender may not be sufficient in itself to reach a presumption as it was held in the case of *CIT vs.* ***Metachem Industries (2000) 245 ITR 160 (MP)*** that there is no further responsibility to show, that it has come from the accounted source of the lender. In the case of ***Jalan Timbers v. CIT [1997] 223 ITR 11 (Gauhati)***, it was held that where, in respect of certain cash credits, the assessee had not only disclosed them in his return of income but also produced confirmatory letters from the creditors, and the creditors had also declared the amounts in their income-tax returns which were accepted by the ITO, addition made as cash credits by ignoring the aforesaid facts would not be justified. It was also held in the case of ***CIT v. U.M. Shah, Proprietor, Shrenik Trading Co. [1973] 90 ITR 396 (Bom.)*** that If the parties had received the summons but did not appear, the assessee could not be blamed. However, where the summons was returned with the postal remark

'not known' (and 'not found'), the said is an endorsement of the presupposed that at the specific address furnished by the assessee the addressee could not be traced. In such cases, the question of issuing a second summons would arise only if the address given earlier was erroneous, and not when it was almost identical as held in the case of ***Ram Kumar Jalan v. CIT [1976] 105 ITR 331 (Bom.).***

A decision often referred to by the assessee and tax practitioners on the issue of burden of proof in respect of cash credit is from Hon. Gujarat High Court in the case of *DCIT vs. Rohini Builders (2002) 256 ITR 360 (Guj).* It was held in this case that mere identification of the source of the creditors even without evidence as to the nature of the income could justify acceptance, where the assessee has given PAN of the creditor and also shows that the amounts were received by account payee cheques. Hon. High Court, in this case, endorsed the findings of the Tribunal that it is not necessary that there should be explanation as to the source of the money on the part of the creditors in every case.

It may, however, be understood that the above view was expressed by the Hon. High Court in a given facts and circumstances and it does not necessarily mean that in each and every case the onus on the part of the assessee is discharged by merely providing the PAN of the creditors. In fact, there are enough judicial pronouncements favouring Revenue where it has been acknowledged that the burden does not shift merely by providing PAN of the creditors or by simply identifying the source of cash credit. More so, in the cases where efforts have been made by the Assessing Officers to gather evidences by conducting enquiry to examine the truth in respect of the

cash credit. ***In CIT vs. Bhan & Sons (2005) 273 ITR 206 (P & H),*** it was found that the credits were received by account payee cheques and the creditors were income tax assessees. But the contention of the Assessing Officer was that the assessee did not respond to the requirements of the production of creditors before him for verification. The first appellate authority and the High Court felt that it was possible for the Assessing Officer to have accepted the same or make further enquiries with reference to the files of the creditors, since they were assessees. Even so, the High Court reversing the finding of the Tribunal observed as under :

"*the appellate authorities have failed to appreciate that in the present case the assessee had totally failed to respond to the notice of the Assessing Officer. Further, even if they were of the view that the Assessing Officer should have made cross verification with the records of the creditors available with him, they ought to have directed the Assessing Officer to do so instead of straight way accepting the assessee's version without affording any opportunity to the Assessing Officer to make the verification. In the alternative, the appellant authorities could have themselves verified the material placed before them with the records of the creditors. This has not been done. Accordingly, we are satisfied that the appellate authorities have not dealt with the matter properly.*"

The principle, as envisaged by the Hon. High Court in the above case, is one of absolutely liability, in which case the burden does not shift. Further, mere mention of income-tax file number of creditor will not suffice to discharge the onus as held in the case of ***CIT v. Korlay Trading Co.***

Ltd. [1998] 232 ITR 820 (Cal.), where in it was held that where, without filing confirmation letter from the creditor, the assessee merely mentioned the income-tax file number of the creditor (which was also not supported by any affidavit from the creditor), the genuineness of the cash credit cannot be said to have been proved by the assessee.

In fact, the principle of onus, that the assessee is required to establish the identity, prove the genuineness of the transaction and establish the creditworthiness of the donor, has been reiterated even in a recent decision of Hon. Delhi High Court in the case of *CIT vs. Oasis Hospitalities Pvt. Ltd., 333 ITR 119 (Delhi)(2011)*. In this case it was held by the Hon. Court that *"The initial onus is upon the assessee to establish three things necessary to obviate the mischief of Section 68. Those are: (i) identity of the investors; (ii) their creditworthiness/investments; and (iii) genuineness of the transaction. Only when these three ingredients are established prima facie, the department is required to undertake further exercise."*

17. **Onus of proof**: **Prima facie onus is always on the assessee to prove the cash credit entry found in the books of account of the assessee**. In land mark cases like Kale Khan Mohammad Hanif v CIT[1963] 50 ITR 1 (SC), Roshan Di Hatti v CIT [1977] 107 ITR (SC) it has been held that the law is well settled that the onus of proving the source of a sum of money found to have been received by an assessee, is on him. Where the nature and source thereof cannot be explained satisfactorily, it is open to the revenue to hold that it is the income of the assessee and no further burden is on

the revenue to show that the income is from any particular source. It may also be pointed out that the burden of proof is fluid for the purposes of Section 68. Once assessee has submitted basic documents relating to identity, genuineness of transaction and creditworthiness then AO must do some inquiry to call for more details to invoke Section 68.

18. If the partner is source, is it income of firm or partner :

One argument taken by the assessee in the cases of firm that where the money has come from partner and genuineness of the same is not proved, addition if any, has to be made in the case of partner and not in the case of firm. On this issue it is most important to refer to the decision in the case of ***CIT v. Kishorilal Santoshilal [1995] 216 ITR 9 (Raj.)***, where in it was held that In the case of cash credits in accounts of firm, the following points need be noted:

(i) there is no distinction between the cash credit existing in the books of the firm, whether it is of a partner or of a third party;

(ii) the burden to prove the identity, capacity and genuineness has to be on the assessee;

(iii) if the cash credit is not satisfactorily explained, the ITO will be justified to treat it as income from undisclosed sources;

(iv) the firm has to establish that the amount was actually given by the lender;

(v) the genuineness and regularity in the maintenance of the account has to be taken into consideration by the taxing authorities;

(vi) if the explanation is not supported by any documentary or other evidence, then the deeming fiction created by Section 68 can be invoked;

(vii) simply because the amount is credited in the books of the firm in the partner's capital account, it cannot be said that it is not the undisclosed income of the firm and that in all cases it has to be assessed as an undisclosed income of the partner alone.

19. An assessee can discharge his onus of proof by proving three things: Identity of the creditor, capacity of the creditor and the genuineness of the transaction in question. Once the assessee proves all three things his onus is discharged. It is also to be noted that there are many case laws wherein it has been held that the assessee only needs to prove the source of an entry he need not to prove the source of the source or the creditor's creditor(position changed w.e.f AY 2013-14 for private limited companies where they have to prove source of source as discussed earlier).

20. In ITO v Suresh Kalmadi [1988] 32 TTJ (Pune) TM 300 it was held that where identity of creditor is established and entry shown to be not fictitious, the burden shifts on to the department to show as to why the entry still represented the suppressed income of the assessee. The assessee cannot be called upon to prove the worth of his creditor's creditor. The fact that in the books of the creditors exactly the same amounts had been credited in the name of other parties and that immediately after repayment, the creditors withdrew the money could not lead to any adverse inference when this was their modus operandi and assessee's case was not the solitary transaction.

A decision of Hon. ITAT Agra Bench in the case of ***Smt. Suman Gupta vs.Income-tax Officer, Ward 1, Aligarh [2012] 25 taxmann.com 220 (Agra)*** may

also be referred to on this issue. In this case the assessee was found to have received Rs. 13 lakh as loans from six persons. Assessing Officer noted that immediately before amounts were lent to assessee, identical amounts were deposited in bank accounts of said persons. Assessee could produce only one lender for examination. Assessing Officer found that lenders had no creditworthiness to give loan as they had very small bank balances and were earning small income. In the given facts, it was held by the Tribunal that it was money of assessee which was routed through bank accounts of lenders for purpose of giving credits to assessee and entries were only *accommodation entries* and as such, could not be considered as genuine transactions.

21. Merely proving the identity of the creditor does not discharge the onus of the assessee if the capacity or creditworthiness of the creditors is not proved. The assessee also has to prove the capacity to give credit of the creditor. For example in Shankar Ghosh v ITO [1985] 23 TTJ (Cal.) 20 the assessee failed to prove the capacity of the person from whom he had allegedly taken loan. Further the assessee could not explain the need for the loan and the manner in which the loan amount was spent. The creditor issued two letters demanding repayment but did nothing on non compliance therewith, such letters did not therefore carry any conviction about the explanation of the assessee. Loan amount was rightly held as assessee's own undisclosed income.

22. Assessee also have to prove the genuineness of the transaction in question in addition to the identity and capacity of the creditors. In CIT v Sahibganj Electric cables (p) Ltd. [1978] 115 ITR 408 (Cal.) where the amounts of loan

received by cheques and repayments also made by cheques through asessee's bankers, the creditors gave confirmation letters mentioning therein their income tax file numbers. ITO without making any further enquiry, disbelieving the evidence of the assessee made addition. ITAT held the additions not justified as the assessee discharged the onus. High Court held that Tribunal is justified in deleting the addition.

23. Some case laws in favour of AO which could be used to draw conclusions. The AOs may read the judgement before applying it to the facts of his case. (Source: Case laws in favour of department by Shivaji P Jacob)

    1. Onus of proving the source of a sum of money found to have been received by an assessee is on him. When the nature and source of a receipt, whether it be of money or other property, cannot be satisfactorily explained by the assessee, it is open to the revenue to hold that it is the income of the assessee and no further burden lies on the revenue to show that the income is from any particular source.

       Roshan Di Hatti Vs CIT (SC) 107 ITR 938

       Kale Khan Mohammad Hanif Vs CIT (SC) 50 ITR 1

    2. Credits in the name of third parties – Assessee must prove identity of credits, capacity of creditor to advance money and genuineness of transaction – Then only burden shifts to the Department.

       Shankar Industries Vs CIT (Cal) 114 ITR 689

       Hari Chand Virender Paul Vs CIT (P&H) 140 ITR 148

       CIT Vs Biju Patnaik (SC) 160 ITR 674

CIT Vs Precision Finance P. Ltd. (Cal) 208 ITR 465

Dhanalakshmi Steel Re-rolling Mills Vs CIT (AP) 228 ITR 780

Sanil K.M.P. Vs CIT (Ker) 177 Taxman 481

3. Assessee failed to prove the genuineness of credit-mere proof of identity of creditor or that transaction was by cheque, is not sufficient – Addition under Section 68 upheld

   Mangilal Jain Vs ITO (Mad) 315 ITR 105

   CIT Vs Precision Finance P. Ltd. (Cal) 208 ITR 465

4. Rejection of opening capital on the ground that assessee failed to prove source and how it got accumulated over the years Justified

   C. Packirisamy Vs ACIT (Mad) 315 ITR 293

5. Cash credit in books of account of HUF – Assessable under Section 68 in the hands of HUF in whose books the credit appears and not in the hands of members of HUF in whose name the credit stands.

   Munshi Ram Vs CIT (P&H) 126 ITR 663

6. Firm's books showing cash credit in names of partners – No satisfactory explanation – Will be deemed to be income of firm.

   CIT Vs Shiv Shakthi Timbers (M.P) 229 ITR 505

   Anand Ram Raitani Vs CIT (Gau) 223 ITR 544

   Shanta Devi Vs CIT (P&H) 171 ITR 532

   CIT Vs Kishorilal Sontishilal (Raj) 216 ITR 9

   Hardwarmal Onkarmal Vs CIT (Pat) 102 ITR 779

   CIT Vs Deepak Iron and Steel Rolling Mills (P&H) 336 ITR 307

7. Cash credit can be assessed even when business income is estimated – There is nothing in law which prevents ITO in taxing both unexplained cash credit and business income estimated after rejecting books being unreliable – It is for the assessee to prove that even if the cash credit represents income, it is from a source which has already been taxed

   CIT Vs Devi Prasad Viswanath Prasad (SC) 72 ITR 194

   Kale Khan Mohammed Hanif Vs CIT (SC) 50 ITR 1

   Ratanchand Dipchand Vs CIT (MP) 38 ITR 188

   CIT Vs Maduri Rajaiahgari Kistaiah (AP) 120 ITR 294

   D.C. Auddy & Bros. Vs CIT (Cal) 28 ITR 713

8. Where any sum is found credited in the books of the assessee for any previous year it may be charged to Income Tax as the income of the assessee for that previous year if the explanation offered by assessee about the nature and source thereof is, in the opinion of the Assessing Officer, not satisfactory.

   Sumati Dayal Vs CIT (SC) 214 ITR 801

   Vasantibai N. Shah Vs CIT (Bom) 213 ITR 805

   Sreelekha Banerjee & Ors. Vs CIT (SC) 49 ITR 112

9 Mere filing of Income Tax file number is not enough to prove genuineness of cash credit.

   CIT Vs Korlay Trading Co.Ltd. (Cal) 232 ITR 820

10 Cash credit can be assessed even if transaction is through cheques.

   CIT Vs Precision Finance P. Ltd. (Cal) 208 ITR 465

   K.C.N. Chandrasekhar Vs ACIT (ITAT, Bang) 66 TTJ 355

CIT Vs United Commercial & Industrial Co.(P) Ld. (Cal) 187 ITR 596

11 Sec. 68 applicable even to share application money – Use of the words "any sum found credited in the books" indicates that the section is widely worded and ITO is not precluded from making enquiry as to the true nature and source thereof even if the sum is credited as share application money.

CIT Vs Sophia Finance Limited (Del-FB) 205 ITR 98

CIT Vs Nivedan Vanijyya Niyojan Ltd. (Cal) 263 ITR 623

CIT Vs Rathi Finlease Ltd. (MP) 215 CTR 429] explained

Dhingra Global Credence P. Ltd. Vs ITO (ITAT, Del) 1 ITR (Trib) 529] decision

Agarwal Coal Corporation (P) Ltd. Vs Addl. CIT (ITAT, Indore) 135 ITD 270] of

SC in CIT Vs Lovely Exports P. Ltd. [319 ITR (ST) 5] and distinguished

12 No evidence on record to show that cash credit was covered by intangible additions made for earlier year – Addition upheld.

CIT Vs Manick Sons (SC) 74 ITR 1

13 Assessee must establish nexus between credits and amount disclosed under VDIS

Radio Instruments Associates (P) Ltd. Vs CIT (AP) 166 ITR 718

CIT Vs Assam Cold Storage Co. (Gau) 204 ITR 540

Jamnaprasad Kanhaiyalal Vs CIT (SC) 130 ITR 244

Radhey Shyam Tibrewal Vs CIT & Ors.(SC) 145 ITR 186

ITO Vs Ratanlal (SC) 145 ITR 183

14 Mere filing of gift deeds, PAN cards, I.T. returns etc. did not by itself discharge assessee from preliminary burden to establish genuineness of gifts where donors were not found at the address given in the returns or PAN card – In such circumstances, it is the duty of the assessee to produce donors / creditors before the Assessing Officer as otherwise addition under Section 68 has to be made.

Prakashchandra Singhvi (HUF) Vs ITO (ITAT, Ahd) 134 ITD 283

15 Sec. 68 does not confine to cash entries in books – If the liability shown in the account is found to be bogus and there is no plausible and reasonable explanation of the assessee, the amount can certainly be added towards the income of the assessee

V.I.S.P (P) Ltd. Vs CIT (MP) 265 ITR 202

16 Cash credit in books of accounts seized under Section 132 – Presumption under Section 132 (4A) does not absolve assessee of explaining source of cash credit

Daya Chand v. CIT (Del) 250 ITR 327

17 Cash receipts entered in note book / rough cash book found during the course of survey – Section 68 applies.

Haji Nazir Hussain & Co. Vs ITO (ITAT, Del-TM) 91 ITD 42

18 Mere entries of sale in books of accounts of assessee were not enough to justify cash credit – Some evidence of sale generating extra-ordinary income, was required to be placed by assessee – Sales amount treated as cash introduced from undisclosed sources.

Addl. CIT Vs Gurshant Rotary Compressors Ltd. (ITAT, Del-TM) 116 ITD 131

19 Credits in accounts claimed as advance received towards sale of shops and affidavit filed from such creditors – But none of them were produced before the Assessing Officer for authenticating their signature and explaining the contents of the affidavit – Possession of shops not handed over or money was not returned even after lapse of considerable time Addition under Section 68 upheld.

Krishan Kumar Jhamb Vs ITO & Anr (P&H) 17 DTR 249

20. Transaction of purchase and sale of shares – Allegedly made through a broker who is not registered with Stock Exchange Concerned company and broker denied transaction – Income from undisclosed sources – Addition under Section 68 upheld.

CIT Vs Hakumat Rai (P&H) 49 DTR 266

21 Assessing Officer has the power to examine the genuineness of brought forward creditors – Assessee failed to establish the unclaimed balance in the name of clients – Letters from creditors show discrepancy in balance – Addition on account of discrepancy upheld

Suresh Kumar T. Jain Vs ITO 2010-TIOL-354-ITAT-BANG

22 Unexplained credit and debit entries of like amount in the 'Haste Khate' – Explanation offered by assessee was found untrue – Theory of peak credit could not be applied – Addition of all credits sustained

Jhamatmal Takhatmal Kiranan Merchants Vs CIT (MP) 152 CTR 311

14 Deduction in respect of profits and gains from certain industrial undertakings - Sections 80IA/80IB

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1. ISSUE: MEANING OF PHRASE 'DERIVED FROM'

The phrase "Derived from" has been a very contentious issue while applying the provisions of Sections 80IA and 80IB of the Act and other similar provisions contain same phrase. The issue revolves around the contention whether deduction is applicable for all receipts/income of the assessee or is it restricted to profits and gains "derived from".

The phrase derived from used in the Sections 80IA(1) and 80IB(1) of the Act is highlighted for reference below:-

*"**80-IA.**(1) Where the gross total income of an assessee includes any profits and gains derived by an undertaking or an enterprise…….. …….. a deduction of an amount equal to hundred per cent of the profits and gains **derived from** such business for ten consecutive assessment years.*

***80-IB.** (1) Where the gross total income of an assessee includes any profits and gains **derived from** any business ……..., a deduction from such profits and gains of an amount equal to such percentage and for such number of assessment years as specified in this section."*

1.1 The issue has been discussed in detail in various judgments, which clearly brings about the concept of "income derived from" in contrast to other related concept like "income attributable to". The decision of the Apex Court in the case of ***Cambay Electrical Supply Co. Ltd. 113 ITR 84*** highlights the distinction between the two expressions. According to the Hon'ble Apex Court, the expression 'attributable to' has a much wider import than the expression 'derived from' thereby intending to cover receipts from sources other than the actual conduct of the business of the industrial undertaking. In other words, it can be understood to mean that there can be receipts which are incidental to the actual conduct of the business of industrial undertaking yet the same may not fall within the expression of 'derived from' so as to be eligible for the benefits envisaged under Section 80-IA of the Act.

1.2 Another notable judgment on the issue is in the case of ***Sterling Foods 237 ITR 53 (SC).*** Herein also, the Apex Court opined that where the nexus between the income and the industrial undertaking was not direct but was only incidental, it would not fall within the expression 'profits derived from industrial undertaking'. Similar is the decision of the Hon'ble Apex Court in the case of ***Pandian Chemicals Ltd. 262 ITR 278(SC)***. Their Lordships, in the aforesaid case, were dealing with the question as to whether the interest derived from the deposit made with the Electricity Board could be construed as a profit derived from the industrial undertaking of the assessee for the purposes of deduction under Section 80HH. According to the

Hon'ble Apex Court, the said income was not eligible for the purposes of the claim under Section 80HH. Therefore, certain income falling within the parameters of being incidental to business, can fall within the scope of the business of the assessee, yet it cannot be said to have been derived from the eligible industrial undertaking of the assessee, so as to be eligible for deduction under Section 80-IA of the Act.

1.3 The Hon'ble Supreme Court while deciding upon the case of ***Liberty India Ltd. Vs CIT [2009] 183 Taxman 349 (SC)*** brought out fine distinction between "profit linked incentives" and "investment linked incentives" and the concept of "first degree source", "derived from" as against "attributable to". The relevant portion of the order is as under:

"13.Before analyzing Section 80-IB, as a prefatory note, it needs to be mentioned that the 1961 Act broadly provides for two types of tax incentives, namely, ***investment linked incentives*** *and* ***profit linked incentives****. Chapter VI-A which provides for incentives in the form of tax deductions essentially belong to the category of "profit linked incentives".*

Therefore, when Section 80-IA/80-IB refers to profits derived from eligible business, it is not the ownership of that business which attracts the incentives. What attracts the incentives under Section 80-IA/80-IB is the generation of profits (operational profits). For example, an assessee company located in Mumbai may have a business of building housing projects or a ship in Nava Sheva. Ownership of a ship per se will

not attract Section 80-IB (6). It is the profits arising from the business of a ship which attracts sub-section (6). In other words, deduction under sub-section (6) at the specified rate has linkage to the profits derived from the shipping operations. This is what we mean in drawing the distinction between profit linked tax incentives and investment linked tax incentives. It is for this reason that Parliament has confined deduction to profits derived from eligible businesses mentioned in sub-sections (3) to (11A) [as they stood at the relevant time].

14. Analyzing Chapter VI-A, we find that Section 80-IB/80-IA are the Code by themselves as they contain both substantive as well as procedural provisions. Therefore, we need to examine what these provisions prescribe for "computation of profits of the eligible business". It is evident that Section 80-IB provides for allowing of deduction in respect of profits and gains derived from the eligible business. The words ***"derived from"*** *is narrower in connotation as compared to the words* ***"attributable to".*** *In other words, by using the expression "derived from", Parliament intended to cover sources not beyond the first degree. In the present batch of cases, the controversy which arises for determination is:whether the DEPB credit/Duty drawback receipt comes within the first degree sources?*

According to the assessee(s), DEPB credit/duty drawback receipt reduces the value of purchases (cost neutralization), hence, it comes within first degree

source as it increases the net profit proportionately. On the other hand, according to the Department, DEPB credit/duty drawback receipt do not come within first degree source as the said incentives flow from Incentive Schemes enacted by the Government of India or from Section 75 of the Customs Act, 1962. Hence, according to the Department, in the present cases, the ***first degree source*** *is the incentive scheme/provisions of the Customs Act. In this connection, Department places heavy reliance on the judgment of this Court in Sterling Food's case (supra). Therefore, in the present cases, in which we are required to examine the eligible business of an industrial undertaking, we need to trace the source of the profits to manufacture. (see CIT v. Kirloskar Oil Engines Ltd. [1986] 157 ITR 762 (Bom.)."*

1.4 In the case of ***Vellore Electric Corpn. Ltd. v. CIT [1997] 93 Taxman 401/227 ITR 557 (SC)*** where assessee-electricity distributing company had to deposit contingency reserve as stipulated in the Electricity (Supply) Act in securities authorised under the Indian Trusts Act, the Hon'ble Supreme Court held that the assessee was entitled to deduction in respect of interest earned from investment in securities there being direct and proximate connection between carrying on business as licensee under the Electricity (Supply) Act and income derived by way of interest from investment in securities. However, in the case of ***CIT v. Kothari Products Ltd. [2007] 295 ITR 223/[2008] 168 Taxman 236 (All.)*** it was held that Section 80-I should not be stretched to the limit where income

derived from the industrial undertaking is reinvested by the assessee in a non-industrial undertaking for the purpose of earning income from the non-industrial undertaking. Therefore, the interest income accruing to assessee-industrial undertaking from investment in banks could not be treated as 'income derived from an industrial undertaking' and would not entitled to deduction under Section 80-I merely because original nucleus funds, which had yielded interest, came from an industrial undertaking.

1.5 In view of the above judicial pronouncements, the Assessing Officer should collect the facts to clearly establish that the profits and gains claimed by the assessee to be eligible for deduction doesn't fall under the purview of the concept of "derived from". The following **fact-finding** may be helpful to the Assessing Officer in this regard:

- Examine carefully the income claimed under Section 80IA or under Section 80IB and check whether it contains income embedded therein which can be brought out of the realm of "derived from". For example, Modvat/Duty Drawback/ DEPB income etc. cannot be credited against the cost of manufacture of goods debited in the Profit & Loss account for purposes of Section 80-IA/80-IB as such credits would constitute independent source of income beyond the first degree nexus between profits and the industrial undertaking.
- Check whether the assessee has claimed deduction

in respect of passive income like interest income, interest from margin money, compensation from sundry debtors for delayed payments etc. that are not in the nature of operational profits. Also in the case of interest subsidy, the source of the subsidy is not the business of the assessee but the scheme of the State Government. Therefore, it is not eligible for deduction.

- Ask the assessee to produce the books of account with documents like raw material purchase, sale book, stock register etc. in respect of the income claimed for deduction as it is necessary for the assessee to maintain the books properly and separately in order the avail the deduction. In case, the assessee neither produces records of raw material purchased nor explains process of manufacturing nor submits proof of sale, benefit of deduction under Section 80-IA could be denied. This issue was highlighted by the Hon'ble Supreme Court in the case of ***Arisudana Spinning Mills Ltd vs. CIT***. Further, reference may be had to the judicial findings in the case of *Regal Industries Ltd. V. CIT [2010] 328 ITR 175 (PUNJ. & HAR.)* wherein it has been held that deduction under Section 80IA cannot be claimed by the assessee because of non-maintenance of records of purchase of raw material, proof of sale etc.
- Check whether the income claimed for deduction contains any income from trading activities, from

service or in the nature of commission. Business of Trading of products is not entitled to deduction under Section 80IA as the same can't be held to be profits and gains derived from Industrial Undertaking as narrated in *Liberty Shoes Ltd. V. CIT, Central Circle, Ludhiana [2007] 158 Taxman 340 (Punj. & Har.)*

1.6 While drafting the Assessment Order the Assessing Officer, in addition to above fact-finding, should clearly highlight the relevant case laws depending upon the facts and circumstances of the case. The **critical areas** that need to be highlighted in the Assessment Order while disallowing the deduction under Section 80IA and 80IB of the Act are:-

- The profits and gains claimed for deduction doesn't fall under the purview of "derived from"
- The case of the assessee at best falls under the category of "attributable to" and not "derived from"
- The receipt do not come within first degree source from the eligible business
- The nexus between the income and the industrial undertaking is not direct but was only incidental

The Assessing Officer may take clues from the case laws discussed below, in respect of certain types of receipts/income, which prima-face doesn't fall within the concept of "derived from".

Nature of receipt	Case Name / Citation
Modvat Credit or Duty Drawback or DEPB	Liberty India V. CIT [2009] 183 Taxman 349 (SC) CIT – III, Rajkot V. Orchev Pharma (P) Ltd. [2012] 25 taxmann.com 518 (SC) Eastman Exports Global Clothing (P) Ltd. [2011] 11 taxmann.com 175 (Mad.) CIT, Karnal V. Accent of Living [2010] 191 TAXMAN 88 (PUNJ. & HAR.)
Export Incentives	Assistant Commissioner of Income-tax, Indore V. Neo Sack (P) Ltd. [2010] 186 TAXMAN 294 (SC). M.M. Forgings Ltd. V. Additional Commissioner of Income-tax, Range-IV [2011] 11 Taxmann.com367 (Mad.)
Service commission income	Indian Additives Ltd. V. Deputy Commissioner of Income-tax [2010] 25 taxmann 412 (SC)
Transport or Freight subsidy	CIT Vs Kiran Enterprises [2010] 189 TAXMAN 457 (HP) Janak Raj Bansal V. CIT [2010] 228 CTR 167 (HP) Ms Supriya Gill V. CIT [2010] 193 TAXMAN 12 (HP) CIT V. Maharani Packaging (P) Ltd. [2012] 24 taxmann.com 204 (HP.) CIT Vs. Maharani Packaging (P) Ltd. 55 DTR 340 (HP)
Interest on margin money deposits	Avanti Feeds Limited Vs DCIT, ITA Nos 1170& 53/Hyd/04 dated 23-01-09
Interest subsidy	CIT V. Gheria Oil Gramudyog Workers Welfare Association [2010] 228 CTR 94 (HP)
Commission Income from supply of goods	Sharavathy Steel Products (P) Ltd. V. ITO Ward 12(2), Bangalore [2011] 15 taxmann.com 71 (Kar.)

2. ISSUE: "DEPRECIATION"

The basic issue involving depreciation is that whether the assessee has an option not to claim current depreciation and if so, whether the same would have any bearing in computing the deduction allowable under Section 80-IA/80-IB of the Act.

Presently, the majority opinion of the Courts suggests

towards mandatorily deduction of allowable depreciation before allowing deduction under Chapter VI-A of the I.T.Act. Even if the assessee choose to disclaim the depreciation expense, the deduction under Chapter VI-A is allowable only after taking into account the allowable depreciation.

2.1 One of the important case law related to this issue is ***Plastibends India Limited Vs Add CIT (2010) 31 (I) ITCL 401 (Bom-HC)*** wherein it was held that the quantum of deduction under Section 80 IA is not dependent upon the assessee claiming or not claiming depreciation, because under Section 80 IA the quantum of deduction has to be determined by computing total income from business after deducting allowable expenses under Section 30 to 43D. Thus for the purpose of deduction under Chapter VI-A, the gross total income has to be computed, inter alia, including depreciation allowable under Section 32 of the Act, even though the assessee has computed the Total Income under Chapter IV by disclaiming the current depreciation.

2.2 Another important judicial pronouncement on this issue is ***Dabur India Ltd. v CIT ITA No. 579/2007.*** In this case, it was held that the assessee who has claimed special deduction under Ch VI-A, the claim of depreciation is mandatory. Profits and gains of an undertaking are to be computed as per the provisions of Section 29 to Section 43A and if the assessee claims relief under Chapter VI-A of the Act, then it is not open to the assessee not to claim depreciation allowance. This is because Chapter VI-A

is an independent code by itself for computing these special types of deductions. In other words, one must first calculate the gross total income from which one must deduct a percentage of incomes contemplated by Chapter VI-A. That such special incomes were required to be computed as per the provisions of the Act, viz., Section 29 to Section 43A, which included Section 32(2). Therefore, one cannot exclude depreciation allowance while computing profits derived from a newly established undertaking for computing deductions under Chapter VI-A.

2.3 In view of the principles set out by the above judicial pronouncements, the Assessing Officer may collect the facts regarding claim/disclaim of depreciation for the purpose of deduction. The following **fact-finding** may be helpful to the Assessing Officer in this regard:

- Examine whether the allowable depreciation has been properly deducted before allowing deduction under Section 80-IA or 80-IB of the Act. If the assessee has not claimed the depreciation, the deduction under Section 80-IA or 80-IB should be recomputed after considering the allowable depreciation.

- In view of the specific provisions of Section 80-IA(5) of the Income-tax Act, 1961, the profit from the eligible business for the purpose of determination of the quantum of deduction under Section 80-IA of the Act has to be computed after deduction of the notional brought forward losses and depreciation of eligible business even

though they have been allowed set off against other income in earlier years.

2.4 While drafting the assessment order the Assessing Officer may keep in mind the above judicial pronouncements. The **critical areas** that need to be highlighted in the assessment order while allowing depreciation before deduction are:-

- It should be emphasised that Chapter VI-A is an independent code by itself for computing these special types of deductions. That such deductions were required to be computed after considering the provisions of the Act, viz., Section 29 to Section 43A, which included Section 32(2).
- It can be argued that the assessee is trying to reduce deduction under Section 80IA by adopting a device by deferring the claim of depreciation to subsequent years by keeping the WDV intact and bring forward that WDV in subsequent years as per his choice. By not claiming depreciation the assessee seeks to inflate the profits and therefore, claiming higher amount of deduction under Section 80IA.
- The Assessing Officer may quote the finding of the Hon. Supreme Court in Liberty India vs. CIT (2009) 317 ITR 218 (SC) wherein it has clearly laid down that any attempt to inflate or reduce available deduction under Section 80IA or 80IB under Chapter VIA should be discouraged and rejected.

- The Assessing Officer may also place reference on the judicial findings in the case of *CIT vs Loonkar Tools Pvt. Limited 213 ITR 721 (Raj)* and recent judgement of Hon'ble ITAT, Ahmedabad in the case of *Radha Madhav Industries, Daman vs ITO to on 15 October, 2010.*

3. ISSUE : "FILING OF RETURN UNDER SECTION 139(1)"

The basic issue involving filing of return is whether the condition for filing return of income under Section 139(1) on or before the due date is 'mandatory' or 'directory' in nature. In connection to this reference may be had to Section 80AC of the Act.

80AC. *Where in computing the total income of an assessee of the previous year relevant to the assessment year commencing on the 1st day of April, 2006 or any subsequent assessment year, any deduction is admissible under Section 80-IA or Section 80-IAB or Section 80-IB or Section 80-IC [or Section 80-ID or Section 80-IE], no such deduction shall be allowed to him unless he furnishes a return of his income for such assessment year on or before the due date specified under sub-section (1) of Section 139.]*

3.1 This Section was probably inserted to counter the effect of the decision of ITAT Pune Bench in the case of Dy. CIT v. Lab India Instruments (P.) India Ltd. [2005] 93 ITD 120 wherein it was held that deduction/exemption are allowable even if they are made in a revised return filed under Section 139(5) but before completion of the assessment. Further, it was held that the provisions of Section 139 are procedural in nature which could not

affect the rights and liabilities of an assessee in absence of any specific provision to do so. The reliance was placed on a decision of Apex Court in *Anchor Pressings (P) Ltd.* v. *CIT*[1986] 27 Taxman 295 according to which if all the material are placed on record, then claim of deduction can be made even through an application under Section 154. To overcome the above view, a new Section 80AC was inserted by the Finance Act, 2006 making it effective from April 1, 2006. It provided that deductions under Section 80-IA/ 80-IB/ 80-IAB etc. cannot be allowed unless the assessee furnishes a return of his income on/ or before due date of filing of return under Section 139(1). The explanatory notes to the Circular No. 14/2006 dated 28-12-2006 expresses the intention of the Section 80AC as under:-

"Circular No. 14/2006, Dated 28-12-2006

10. Benefits of certain deductions not to be allowed in cases where return is not filed within the specified time limit.

10.1 Section 139(1) casts an obligation on every assessee to furnish the return of income by the due date. With a view to enforce the compliance in this regard by the assessees who are entitled for deduction under Section 10B from their income, a proviso (fourth proviso) to sub-section (1) of Section 10B has been inserted so as to provide that no deduction under Section 10B shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified in sub-section (1) of Section 139. Similarly, with a view to enforce the compliance for furnishing

the return of income by the due date by the assessees who are entitled for deductions under Section 80-IA or Section 80-IAB or Section 80-IB or Section 80-IC from their income, a new Section 80AC has been inserted so as to provide that no deduction under Section 80-IA or Section 80-IAB or Section 80-IB or Section 80-IC shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified in sub-section (1) of Section 139.

10.2 This amendment takes effect retrospectively from 1-4-2006 and applies in relation to the assessment year 2006-07 and subsequent years.

3.2 One of the favourable case law related to this issue is that of the ITAT Amritsar Bench in the case of ***BalKishan Dhawan HUF v. ITO [2012] 18 taxmann.com 234/ 50 SOT 49 (URO)*** wherein it was held that Section 80AC not only contains the time-limit for claiming deduction under Section 80-IB but also indicates the consequences that would follow if the return of income containing claim for deduction is not furnished before the due date specified in Section 139(1). The Bench held that **provisions under Section 80AC are mandatory**. If the assessee wants to avail deduction under Section 80-IB, he has to necessarily furnish his return of income containing such claim within the time permissible under Section 139(1) since language of the Section 80AC is negatively worded and it provides in clear terms that deduction under Section 80-IB shall not be allowed if the return of income containing such claim

is not furnished by the due date specified under Section 139(1).

3.3 In a related issue recently, ***ITAT Special Bench at Rajkot in Saffire Garments [TS-865-ITAT-2012(Rjt)],*** had denied deduction under Section 10A as the assessee had filed the return belatedly. ITAT SB held that the proviso to Section 10A(1A) [laying down that deduction will not be available if return is filed beyond due date under Section 139(1)] was 'mandatory' and not merely directory. The Proviso to Section 10A(1A) provides that "*no deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under Section 139(1)*". The assessee's argument that the said Proviso is merely directory and not mandatory was not accepted by the ITAT and held that the Proviso is one of the several consequences (such as interest under Section 234A) that befall an assessee if he fails to file a Return of Income on the due date. As the other consequences for not filing the Return of Income on the due date are mandatory the consequence in the Proviso cannot be held to be directory (Shivanand Electronics 209 ITR 63 (Bom) & other judgements distinguished). Thus, denial of deduction under Section 10A was a necessary consequence of failure to file return within the specified date.

3.4 There is another decision of Ahemdabad Bench taking a slightly different view in ***Parmeshwar Cold Storage (P.) Ltd. v. Asstt. CIT [2011] 49 SOT 67 (URO)/ 16 taxmann.com 88.*** In that case, deduction was

not claimed in the original return filed within the time allowed under Section 139(1). It was held that claim could be made in the revised return because Section 80AC does not so clearly mandate that return which should be filed within the time allowable under Section 139(1) must contain the claim of deduction under Section 80-IB or 80-IC. It is held therein that if the original return is filed in time, then claim under Section 80-IB/ 80-IC can be made through a revised return. Even where revised return is invalid, the claim could be made before appellate authorities in view of decision of the Apex Court in *Goetze (India) Ltd.* v. *CIT [2006] 157 Taxman 1.* In its view, section does not require that claim under Section 80-IB should be made only through the original return filed in time. Almost on similar line, ITAT Chandigarh Bench in *Elecon Packpet v. ITO [2011] 15 taxmann.com 351/[2012] 49 SOT 402* held that where assessee had e-filed its original return of income within time allowable under Section 139(1) but could not make the claim of deduction under Section 80-IC due to system error, the claim could be made subsequently.

3.5 In few cases, the Courts have taken a view point that the provisions are directory and not mandatory in nature. Bangalore bench of ITAT in the case of *Vanshee Builders & Developers P. Ltd vs. ITO, ITA No.386/ Bang/2012* held that provisions of Section 80AC were only 'directory' and not mandatory, provided there was reasonable cause for filing of return of income belatedly. The ITAT, Chennai in the case of *Gemini Communications Ltd vs ACIT I.T.A.No. 1252/ Mds/2012* held the Assessee's claim for deduction under

Section 80IC is acceptable on basis of manual return filed by "TAPAL" and held that the Electronic filing of returns is not mandatory as per IT Act or Rules.

3.6 In view of the specific Section 80AC of the Act and a few favorable judicial pronouncements, the Assessing Officer may collect facts regarding date of filing of return by the assessee for the purpose of deduction. The following **fact-finding** may be helpful to the Assessing Officer in this regard:

- Examine whether the return was filed within due date specified under Section 139(1) of the Act or is it a case of belated/No return.
- Whether claim of deduction was made in the original return/belated return.
- Whether assessee has filed any revised return(s). Whether it is a case, where deduction was not claimed in the original return but claimed for the first time in the revised return.
- In case of belated return, what were the factual causes that prevented the assessee to file return within due date as per Section 139(1) of the Act.

3.7 While drafting the assessment order the Assessing Officer, may highlight the following **critical areas** in the assessment order:-

- The provisions of the Section 80AC may be highlighted along with the explanatory note on the section in Circular No. 14/2006 dated 28-12-2006 stated above. Further, case laws and judicial precedents may be discussed stressing the

overriding effect of the specific section stating mandatory conditions.

- The Assessing Officer may place reference on the judicial findings in the case of *ITAT Special Bench at Rajkot in Saffire Garments [TS-865-ITAT-2012(Rjt)]* and judicial stand in the case of *Parmeshwar Cold Storage (P.) Ltd.* v. *Asstt. CIT [2011] 49 SOT 67 (URO)/ 16 taxmann.com 88*.

4. ISSUE: "FILING OF FORM 10CCB"

Similar to the issue of filing of return, is the issue whether filing of Form 10CCB is mandatory or not. In connection to this reference may be had to Rule 18BBB as stipulated in Section 80IB(13) r.w.s 80IA(7) of the Act. The statutory requirement, both under the Act and the Rule, is that the audit report must be furnished 'along with the return of income'. Strictly interpreted, this will mean that the audit report must be a necessary enclosure to the return of income. The report cannot be furnished either before or after filing the return of income. It may be noted that now rule 12(2) provides that the return of income required to be furnished in Form No. ITR-1 or Form No. ITR-2 or Form No. ITR-3 or Form No. ITR-4 or Form No. ITR-5 or Form No. ITR-6 or Form No. ITR-8 shall not be accompanied with report of audit required to be attached with the return of income under any of the provisions of the Act.

In this regard, reference may be had in the case of ***CIT v. Jaideep Industries [1989] 180 ITR 81 (Punj. & Har.)*** wherein it was held that there can be no escape from the conclusion that the requirement of audit report being filed along with the return of income is mandatory.

4.1 There are several cases, however, which take stand that filing of statutory form is only procedural and directive in nature as discussed below.

In the case of **CIT v. Medicaps Ltd. [2010] 323 ITR 554 (MP)** *it was held that filing of audit report is procedural and directory in nature and the same can be filed at the appellate stage. In the case of* **CIT v. Panama Chemical Works [2007] 165 Taxman 135/292 ITR 147 (MP)** *it was held that the requirement of filing the report is mandatory and failure to file it is fatal. But that is not so insofar as the requirement of filing it along with the return is concerned. If, in a given case the assessee fails to file such report along with the return and files it subsequently, but before completion of the assessment, it will not be fatal to the claim of the assessee and the ITO will have the power to accept the same if he is satisfied that the delay in filing the same was for good and sufficient reasons. In the case of* **CIT v. Shivanand Electronics [1994] 209 ITR 63 (Bom.)** *it was held that for purpose of claiming relief under Section 80J(6A), filing of audit report before ITO is mandatory, but filing of audit report along with the return is not mandatory. Further, it was held that no duty is cast on the ITO to ask an assessee who has failed to file the audit report, to do so before rejecting his claim for relief.*

The ITAT, Kolkata in the case of ***DCIT v. Tide Water Oil Co.(I) Ltd, ITA No. 20151/Kol/10 dated 20-1-2012.BCAJ Pg. 27, Vol. 43 B Part 5***, allowed deduction under Section 80IB though the form no. 10CCB was filed in the course of reassessment

proceedings only and was not filed with the return of income nor during the course of assessment proceedings. The ITAT held that the assessee is not making any fresh claim for deduction under Section 80IB but merely furnishing the documents to substantiate its claim made during the course of assessment and even reassessment proceedings and hence deduction to be allowed.

In the case of ***Eagle Synthetics (P.) Ltd. v. ITO [2011] 16 taxmann.com 255 (Ahd. - Trib.)*** it was held that where assessee did not claim deduction under Section 80-IB as it was not having sufficient profit as per return of income but during assessment Assessing Officer enhanced profit by making addition/ disallowance, assessee should be granted an opportunity to file audit report in respect of its claim under Section 80-IB. In *CIT* v. *Sitaram Bhagwandas* [1976] 102 ITR 560 (Pat.) and *CIT* v. *Universal Trading Co.* [1978] 114 ITR 412 (Cal.), it was held that report can be filed with revised return if not filed with original return.

In the case of ***CIT-I, Chennai Vs M/s AKS Alloys (P) Ltd.*** one of the question of law was whether filing of Form 10CCB is mandatory or not. It was held that it is well settled by a number of judicial precedents that before the assessment is completed, the declaration could be filed. In fact, the said issue came to be decided by the Karnataka High Court in the case in *CIT vs. ACE Multitaxes Systems (P) LTD. (2009) 317 ITR 207(Karnataka)*, wherein it was held that when a relief is sought for under Section 80IB of the Act, there is no obligation on the part of the assessee to file return accompanied by the audit report, thereby, holding that

the same is not mandatory. Therefore, it is clear that before the assessment is completed if such report is filed, no fault could be found against the assessee. That was also the view of the Delhi High Court in the case in CIT v. Contimeters Electiricals (P) LTD -(2009) 317 ITR 249(Delhi), wherein the Delhi High Court, by following the judgements of the Madras High Court in CIT V. Arunachalam (A.N.)-(1994) 208 ITR 481 and in CIT v. JAYANT PATEL (2001) 248 ITR 199 (Mad) held that the filing of audit report along with the return was not mandatory but directory and that if the audit report was filed at any time before the framing of the assessment, the requirement of the provisions of the Act should be held to have been met.

In the recent case of the ***ITAT Ahmedabad in the case of Zest Aromas (P) Ltd. Vs CIT-II,*** it was held that as per the requirements of Section 80-IA(7), read with Section 80-IB(13) and Rule 18BBB, no deduction under Section 80-IB will be admissible unless the accounts of the undertaking for the previous year relevant to the assessment year for which the deduction is claimed, have been audited by an accountant and the report of such audit in prescribed form duly signed and verified by such accountant is furnished. Since in instant case, deduction under Section 80-IB has been allowed by the Assessing Officer admittedly without such report, the Commissioner was justified in holding the order of the Assessing Officer as erroneous insofar as it was prejudicial to the interests of revenue. Therefore, invocation of provisions of Section 263 by the Commissioner, cancelling the assessment order

and directing the Assessing Officer to make a fresh assessment was upheld. It was, however, made clear that since the audit report has been filed by the assessee before the Commissioner during revisional proceedings, the Assessing Officer while framing the fresh assessment, will examine the admissibility of the claim of deduction under Section 80-IB taking into consideration the audit report filed before the Commissioner.

4.2 As seen from the above, most of the judicial findings support the view that filing of Form 10CCB is directory in nature and can be filed before the completion of the assessment proceedings. The Assessing Officer may check the correctness of the claim keeping in view the details filled in the Forms.

5. ISSUE: "DEDUCTION ON ENHANCED INCOME"

The issue here is that whether income enhanced by the Assessing Officer on account of disallowances, excess stock found and surrendered etc. is eligible for deduction under Section 80IA/80IB of the Act. In this regard, a few of the case laws are discussed below.

In the case ***Home Tex V. CIT [2012] 20 taxmann. com 729 (Punj. & Har.)*** it was held that excess stock voluntarily surrendered by the assessee at the time of Survey can't be considered for calculating deduction under Section 80IB as the assessee had failed to show that the amount which was invested in the excess stock and was surrendered at the time of survey was derived from industrial undertaking. In this case, the assessee-firm was exclusively engaged in manufacturing and export of textile goods. A survey was carried out at the premises of the assessee-firm wherein

excess stock was found on physical verification. In course of survey, the assessee surrendered Rs. 40,00,000 on account of excess stock as per physical verification voluntarily. The surrender of additional income was over and above the regular income as per books of account. Later on, the assessee submitted that the undisclosed income was on account of surrender of additional stock found during the course of survey and, therefore, the same was to be considered for calculating deduction under Section 80-IB. The claim was rejected by Assessing Officer as well as the Tribunal. **The Hon'ble High Court *held* that the assessee had failed to show that the amount, which was invested in the excess stock and was surrendered at the time of survey was derived from industrial undertaking.** In the absence of any such finding or nexus established by the assessee, the Tribunal had rightly declined the claim of deduction under Section 80-IB in respect of excess income surrendered during survey on account of excess stock which was not reflected in the regular books of account

In the case of ***Commissioner of Income-tax v Harshwardhan Chemicals [2003] 131 Taxman 813 (RAJ.) High Court of Rajasthan, Jaipur*** denied deduction on the enhanced income, which was not derived from industrial activities by the assessee. The assessee was engaged in the business of manufacturing and selling of Single Super Phosphate (SSP) fertiliser. The Assessing Officer disallowed deduction under Sections 80HH and 80-I on enhanced income by way of excessive subsidy showing bogus purchases and sales in its books of account, as it was not earned out of the industrial activities carried out by the assessee. On appeal, the Commissioner (Appeals) affirmed

the order of the Assessing Officer. On second appeal, however, the Tribunal held that if an assessee is found to have involved itself in earning unaccounted money, it cannot be held disentitled from claiming the other statutory benefits which are available to it at that time for its carrying on the business in the backward area. The Hon'ble High Court held that for deduction under Section 80HH, there should be profit and gains from newly established industrial undertaking and profit should be from the industrial activities carried out by the industry. Same requirement is for deduction under Section 80-I. When there was no dispute that the part of the income, on which the deduction under Sections 80HH and 80-I had been denied, related to the income other than the income from industrial activities of the assessee, the Tribunal had committed error in allowing deduction on the subsidy amount, which had been claimed on showing bogus enhanced purchases and sales by the assessee. The Assessing Officer as well as the Commissioner (Appeals) were justified in **denying deduction under Sections 80HH and 80-I on such additional income which had nothing to do with the industrial activities.**

In the case ***CIT vs. Allied Industries, 229 CTR 462 (HP) [BCAJ]*** it was held that additional income surrendered by the assessee firm having been added to the income of the business itself, it is to be considered while working the deduction under Section 80IB. The assessee was in the business of manufacturing tractors and automobile components. The assessee was entitled to deduction under Section 80-IB of the I. T. Act, 1961. In the course of the assessment proceedings for the A.Y. 2001-02, the assessee offered a sum of Rs.2,50,000 for taxation to cover up all

discrepancies. The Assessing Officer added the amount but disallowed the claim for deduction under Section 80-IB in respect of this amount. The Tribunal allowed the assessee's claim and held that the amount offered by the assessee as addition for the purposes of taxation would amount to profits and gains of business and were entitled for deduction under Section 80-IB. On appeal filed by the Revenue, the Himachal Pradesh High Court upheld the decision of the Tribunal and held: "Additional income surrendered by the assessee firm having been added to the income of the business itself, is to be considered while working out deduction under Section 80-IB, in the absence of any finding of any authority that the said income was derived from any undisclosed source."

In the case of ***M/s Datta Constructions Ltd. Vs. ACIT July 2012 2 ITA NO. 2077/Hyd/2011*** the Assessing Officer had made an addition of Rs. 1,51,13,120/- under Section 40A(3) and treated it as deemed income. The assessee contested that the disallowance made under Section 40A(3) would enhance the profit and thereby the deduction under Section 80IB should be allowed on the recomputed profit. The CIT(A) held that since the assessee is entitled for 100% deduction of the profits under Section 80IB of the Act, the disallowance made by the AO under Section 40A(3) would enhance the profits of the business and therefore the assessee is entitled to deduction under Section 80IB on the enhanced profit. The ITAT placed reliance on the ***Hon'ble Bombay High Court in the case of CIT Vs. Gem Plus Jewellery India Ltd., 233 CTR 24***, held as under:- *"Exemption under Section 10A - profits and gains derived from exports - addition on account of disallowance of employer's and employees' contribution towards PF/ESIC*

- Disallowance of the PF/ESIC payments has been made because of the statutory provisions i.e. Section 43B in the case of the employer's contribution and Section 36(1)(v)r.w.s. 2(24)(x) in the case of the employee's contribution which have been deemed to be the income of the assessee- plain consequence of the disallowance and the add back that has been made by the AO is an increase in the business profits of the assessee - Exemption under Section 10A is allowable with reference to such enhanced income." Thus the ITAT confirmed the order of the CIT(A) and the grounds raised by the revenue on this issue was dismissed.

5.1 In view of the above judicial pronouncements, the Assessing Officer before making any disallowance should collect facts to clearly establish that the enhanced income is not the income, which would form part of the income eligible for deductions. The following points may be kept in mind while framing the assessment order:

- In case assessee claims to take deduction on the excess stock surrendered at the time of survey, the Assessing Officer should rebut the claim by shifting the onus on the assessee to show that the amount which was invested in the excess stock and was surrendered at the time of survey was derived from industrial undertaking. If the assessee is not able to substantiate or establish nexus then it is a clear-cut case of non-allowance of the deduction on the excess stock amount surrendered at the time of Survey Operation.
- Examine the nature of income enhanced because of the disallowances. As per the facts of the

case, if the income enhanced doesn't have the characteristics that warrants allowance of deduction then the enhanced income shouldn't be allowed the benefit of the deduction under Section 80IA/80IB of the Act. For example, enhanced income not falling under the purview of "derived from" undertaking or enterprise, income not forming part of the regular business income etc.

- Assessing Officer should check whether the additional (enhanced) income results in enhancement of the business profits or not. If the enhanced income were from the source other than the business profits eligible for deduction, then the enhanced income will not be eligible for deduction. The AO should give a clear finding that the said income was derived from an undisclosed source and not from eligible business.

6. ISSUE : "INITIAL ASSESSMENT YEAR FOR DEDUCTION"

The deduction under Section 80IA/80IB is available to the assessee for specified number of years. The controversy is mainly on account of the year that should be considered as the first/initial assessment year for the purpose of deduction. Relevant portion of the Section 80IA and 80IB stating the starting point/period of deduction is given below:-

"80IA(2) The deduction specified in sub-section (1) may, at the option of the assessee, be claimed by him for any ten consecutive assessment years out of fifteen years beginning from the year in which the undertaking or the enterprise develops and begins to operate any infrastructure facility

or starts providing telecommunication service or develops an industrial park or develops a special economic zone referred to in clause (iii) of sub-section (4) or generates power or commences transmission or distribution of power [or undertakes substantial renovation and modernisation of the existing transmission or distribution lines:

80IB(14) (*c*) "initial assessment year" –

(i) in the case of an industrial undertaking or cold storage plant or ship or hotel, means the assessment year relevant to the previous year in which the industrial undertaking ***begins to manufacture or produce articles or things****, or to operate its cold storage plant or plants or the cold chain facility or the ship is first brought into use or the business of the hotel starts functioning;*

(ii) in the case of a company carrying on scientific and industrial research and development, means the assessment year relevant to the previous year in which the company ***is approved by the prescribed authority*** *for the purposes of sub-section (8);*

(iii) in the case of an undertaking engaged in the business of commercial production or refining of mineral oil referred to in sub-section (9), means the assessment year relevant to the previous year in which the undertaking ***commences the commercial production or refining*** *of mineral oil;*

(iv) in the case of an undertaking engaged in the business of processing, preservation and packaging of fruits or vegetables or in the integrated business of handling, storage and transportation of food grains, means the assessment year relevant to the previous year in

which the ***undertaking begins such business****;*

(v) in the case of a multiplex theatre, means the assessment year relevant to the previous year in which a cinema hall, being a part of the said multiplex theatre, ***starts operating on a commercial basis****;*

(vi) in the case of a convention centre, means the assessment year relevant to the previous year in which the convention centre ***starts operating on a commercial basis****;*

(vii) in the case of an undertaking engaged in operating and maintaining a hospital in a rural area, means the assessment year relevant to the previous year in which the undertaking begins to provide medical services;

6.1 As seen from the above, Section 80IA as it stands presently does not define the term 'initial assessment year'. However, S. 80-IA as it stood prior to 31-3-2000, defined the term 'initial assessment year' basically in two ways depending on the type of deduction available. Erstwhile S. 80-IA provided for the following two types of deductions :

(i) Ten or fixed consecutive years starting from the first year of commencement – like an undertaking engaged in cold storage plant, ship or hotel;

(ii) Ten years out of twelve/fifteen years starting from the first year of commencement – like an undertaking engaged in the business of developing, maintaining and operating any infrastructure facility;

The new Section 80IA w.e.f. 1-4-2000 inserted vide the Finance Act, 1999, w.e.f 1-4-2000 substituted the

erstwhile Section S. 80-IA with two sections, namely, 80-IA and 80-IB. While doing so, the undertakings originally eligible for deduction for a fixed block of years like the one stated in clause (i) above, namely, the cold storage plant, ships, etc. are covered by S. 80-IB and undertakings which have the option to claim deduction for ten consecutive years within a block of twelve or fifteen years, like the infrastructure undertakings, are retained under the new S. 80-IA. A brief comparison is given below:

Erstwhile S. 80-IA effectiveupto31.3.2000	**Present S. 80-IA**	**New 80-IB (Similar to old 80-IA)**
Eligible period of deduction varied from undertaking to undertaking, industry to industry.	Deduction is available for ten years in a block of fifteen years for all undertakings (Ss.2).	Eligible period of deduction varies from undertaking to undertaking.
Initial assessment year varied from undertaking to undertaking as defined in sub-section(12)(c).	Not defined.	Initial assessment year is defined for each type of undertaking separately in sub-section (14)

A few of the issues with regard to the determination of the initial year for the purpose of deduction are highlighted below.

6.2 The Hon'ble Gujarat High Court in the case of ***CIT v. Jolly Polymers, 342 ITR 87 (Guj.)*** stated that in order to qualify for deduction under Section 80IB(4) of the Act, one of the essential requirement is that the industrial undertaking should have begun to manufacture or produce articles or things on or before March 31, 2004. It was held that where the assessee had not even applied for a factory license before 31 March 2004, the necessary condition under Section 80IB was not

fulfilled. However, where application for license was already made before 31 March 2004, but license was obtained shortly thereafter, such lapse must be viewed as purely technical and it would not come in way of grant of deduction under Section 80IB.

The High Court, Delhi in the case of ***CIT vs. Nestor Pharmaceuticals Ltd. 322 ITR 631 (Delhi) [2010]*** held that the Initial assessment year for the purpose of Section 80IA is the assessment year relevant to the previous year in which the commercial production is started and not the assessment year in which there was only a trial production. **Trial production does not amount to manufacture of the products.** It is only when commercial production commences, that the assessee would become entitled to deduction under Section 80-IA/80-IB. Trial production is not regarded as beginning to manufacture or to produce articles because of the reason that the assessee has to produce trial production to verify whether it can be used ultimately in the manufacture of the final article. These are, therefore, 'trial runs'. Therefore, with mere trial production, the manufacture for the purpose of marketing the goods has not started which starts only with commercial production, namely, when the final product to the satisfaction of the manufacturer has been brought into existence and is now fit for marketing. The quantum of commercial sale would be immaterial. Merely because some closing stock was shown as on 31-3-1988, would not lead to the conclusion that there was commercial production as well. Naturally, even for the purpose of trial production material would be needed and there

would be production which will result in stock of finished goods.The year of trial production will not be treated as 'initial year' for purpose of Section 80-IA/80-IB.

In the case ***Madras Machine Tools Mfrs. Ltd. v. CIT [1975] 98 ITR 119 (Mad.)*** it was held that production of small quantities of insignificant value will not suffice. Where there has not been any regular and substantial production or manufacture of articles, and the few articles, produced are quite insignificant in value and quantity, it could not be said that the company has started production and manufacture of the articles in the relevant accounting year.

In the case ***Addl. CIT v. Southern Structurals Ltd. [1977] 110 ITR 164 (Mad.)*** it was highlighted that Production of prototype will not suffice to commence the claim of deduction. The manufacture or production of articles must be in some commercial sense. Mere manufacture of a prototype will not amount to commencement of manufacture.

The ITAT Agra Bench in the case of ***Aqua Plumbing (P) Ltd v Asst CIT, 46 SOT 366(Agra) (Trib)*** held that the conditions as laid down for claiming deduction under Section 80IA /80IB are to be complied within the initial year and not in all the assessment years in which the assessee is eligible for deduction. Once the assessee has complied with the conditions as laid down in Sections 80IA / 80IB in the initial year, expansion or extension of the existing unit by acquiring assets of another units in a subsequent year does not disentitle the assessee to claim deduction under Sections 80IA/80IB

in respect of increased profit due to such expansion or extension of industrial undertaking.

The ITAT, New Delhi Bench in the case of ***Tata Communication Internet Services Ltd. v. ITO, APPEAL NO: ITA No. 4214/Del/2010*** held that bar provided in Section 80-IA(3) is to be considered only for first year of claim of deduction under Section 80-IA. Thus, the eligibility for the claim of deduction under Section 80-IA by applying the restraints of Section 80-IA(3) cannot be considered for every year of the claim of deduction under Section 80-IA but can be considered only in the year of formation of the business. Once the assessee has been shown to have used new plant & machinery which was not previously used for any purpose and once it is shown that the undertaking is not formed by splitting up or reconstruction of a business already in existence and the assessee becomes entitled to the deduction under Section 80IA, in the subsequent years, it is well available to the assessee to acquire fresh machinery and plant whether new or previously used for any purpose. As the deduction is available on the income of the undertaking and the bar provided under Section 80IA(3) is in relation to the formation of undertaking, once the formation is complete the development of undertaking cannot be put under restrain of Section 80IA(3) of the Act. The eligibility for the claim of deduction under Section 80IA by applying the restraints of Section 80IA(3) cannot be considered for every year of the claim of deduction under Section 80IA but can be considered only in the year of formation of the business.

6.3 In view of the facts of the case and the above judicial positions, the Assessing Officer may check the correctness of the claim of the assessee. However, the following check-points may be considered for the AO:-

- Whether the production started by the assessee is trial production or commercial production. In case the assessee claims to be trial run then the claim should be substantiated by sufficient documentary evidences.
- When did the assessee apply for the requisite licenses/permissions.

7. ISSUE: "SET OFF OF LOSSES"

In recent times, huge controversy has arisen on the issue of notional carry forward and set-off of loss from eligible undertaking as mentioned in Section 80IA(5) of the Act. This is an important issue in determining the eligible profit of the eligible undertaking and the available period of deduction under Section 80-IA.

Section 80-IA(5) reads as under :

"Notwithstanding anything contained in any other provision of this Act, the profits and gains of an eligible business to which the provisions of sub-section (1) apply shall for the purpose of determining the quantum of deduction under that sub-section ***for the assessment year immediately succeeding the initial assessment year*** *or any subsequent assessment year, be computed as if* ***such eligible business were the only source of income of the assessee during the previous year relevant to the initial assessment year*** *and*

to every subsequent assessment year up to and including the assessment year for which the determination is to be made."

Section 80IB does not provide for notional losses in the Section 80IA(5) literally. But sub-section of Section 80-IB envisages that "the provisions contained in sub-section (5) and sub-sections (7) to (12) of Section 80-IA shall, so far as may be, apply to the eligible business under this section", so what has to be done under Section 80-IA(5) has to be done, in the context of Section 80-IB also.

7.1 The dispute with regard to the Section 80IA(5) are on two counts. First, is the mandate of fiction created by the Section 80IA(5) to carry forward and set off the notional loss of the eligible business. Second, is the year of applicability of the fiction i.e. if the notional loss has to be carried forward then what should be the "initial year" for consideration i.e. first time the deduction is claimed or year the eligible business is started.

There are case laws in support of the stand that Section 80IA(5) creates a fiction and it mandates a notional carry forward of loss from eligible business presuming that the eligible business is the only source of income. Reference may be had to the findings of the ITAT Ahmedabad in the case of ***Asstt. CIT v. Goldmine Shares & Finance (P.) Ltd. [2008] 113 ITD 209 (Ahm.) (SB)*** wherein it was held that the Section is a Legal Fiction and though losses were set off against other sources income, they are to be assumed as not set off in absence of existence of another source and for computing the profit and gains for the purposes of

determination of the quantum of deduction one has to once again notionally bring back already set off losses, etc. and set off the same against the profits and gains in a year in the deduction is claimed.

This view is supported in the case of ***Income tax Officer (OSD), Company Circle VI(3), Chennai v. Sicgil India (P.) Ltd. [2009] 119 ITD 184 (CHENNAI) (TM)*** which gave a finding that in view of the specific provisions of Section 80-IA(5) of the Income-tax Act, 1961, the profit from the eligible business for the purpose of determination of the quantum of deduction under Section 80-IA of the Act has to be computed after deduction of the notional brought forward losses and depreciation of eligible business even though they have been allowed set off against other income in earlier years.

Now the issue for consideration is that, though the provisions of S. 80-IA(5) are unambiguous and it warrants notional loss to be set off, which year onwards the fiction would be applicable i.e. first time the deduction is claimed or year the eligible business is started.

Let say in the case of Windmill the Section 80IA provides for deduction of 100% of income for a period of ten consecutive years out of fifteen years. One possible interpretation of Section 80IA(5) is that the loss of the undertaking of the windmill from the year in which **it starts generating electricity** is to be notionally carried forward for setting off against the profits from windmill in the subsequent years and only after the entire loss is absorbed by the income from windmill,

deduction under Section 80IA is available. The other interpretation is that only the loss incurred in any year **after first time deduction is claimed** is required to be set off before deduction can be claimed in any subsequent year. Thus, one method of working would be to treat the windmill division as the only source of income from the first year, notionally carry forward the loss including the unabsorbed depreciation and set off against the income from windmill division till that entire loss is fully set off and then start claiming deduction under Section 80-IA. Other alternative would be to set off the loss of windmill division against the income from the other division and once the loss of windmill is fully set off against either income from the windmill or other division, then start claiming deduction under Section 80-IA. By this method, the assessee would be in an advantageous position since he can claim the deduction in respect of windmill from an earlier point of time and also for the entire period of ten consecutive years within the span of 15 years.

The question here is which method is the correct one for claiming deduction under Section 80-IA in respect of income from the windmill. In order to analyse this further, we need to find answer to below questions:

1. Whether the 'initial assessment year' referred in S. 80-IA(5) is the first year of commencement of production or the first year claim of deduction under Section 80-IA ?

2. Whether the fiction, namely, 'eligible business was the only source of income' under Section 80-IA(5) is to be

applied only from the second year of the claim or from the second year of the commencement of operation of the windmill?

There are arguments on both sides for the above two questions. As regards the first question, we need to look at concept of 'initial assessment year' as per Section 80-IA. The section as it stands presently does not define the term 'initial assessment year' and the assessee has an option to claim deduction for ten consecutive years within a block of twelve or fifteen years . In connection to the above section following clauses mentioned in Form 10CCB, under the Rule 18BBB, indicate that the date of commencement of operation by the undertaking is different from initial assessment year from when the deduction is claimed, as shown below:

(a) *Clause 8* – "Date of commencement of operation/ activity by the undertaking"

(b) *Clause 9* – "initial assessment year from when the deduction is being claimed".

7.2 In view of the changed position of Section 80IA post Finance Act, 1999, one may claim that the term the 'initial assessment year' under the present S. 80-IA is the first year of claim and not the first year of operation/ commencement of production.

Assuming there is no dispute that Section 80IA(5) creates a fiction and the fiction mandates a notional carry forward of loss from eligible business presuming that the eligible business is the only source of income, the moot issue is the year of applicability of the fiction.

One interpretation could be that the losses of the years prior to the initial assessment year need to be notionally carried forward. Another interpretation could be that the loss of the years commencing from the initial assessment year (*i.e.,* the first year of claim) alone is to be notionally carried forward. Therefore, loss from the eligible business in the years prior to the initial assessment year absorbed against the profits of other businesses, need not be notionally brought forward and has no effect on the deduction claimed. Accordingly, the fiction under Section 80-IA(5) is applicable only from the second year of claim and not prior to it.

The tilt of the Judiciary is towards the second interpretation that the fiction is applicable from the second year of claim and not prior to it. The fiction in Section 80IA(5) is limited to assuming that, during the previous year relevant to the initial assessment year, the eligible business is the only source of income. The provision looks forward to a period of ten years from the initial assessment year (year of option). The fiction does not look backwards to the year beginning, referred to in subsection(2). In construing a fiction, it is impermissible to invoke a further fiction or enlarge the same. Ref:AIR 1966 SC 870; AIR 1963 SC 448 1996 (2) SCC 449.

Above stand is also taken in the case of ***Mohan Breweries v. ACIT, 116 ITTD 241 (Chennai).*** This case pertains to A.Y. 2004-05 (*i.e.,* after the amendment of S. 80-IA by the Finance Act 1999), In this case, the Madras Tribunal has held that the initial assessment year is the first year of claim and S. 80-IA itself becomes applicable only when the assessee makes

the claim for the first time and not before that.

It is argued that, in the case of ***ACIT v. Goldmine Shares and Finance P Ltd., 113 ITD 209 (Ahd.) (SB),*** the undertaking had been set up prior to 31-3-2000, and is not applicable to the changed position of Section 80IA post amendment by Finance Act, 1999. The Special Bench held that before claiming deduction, the losses of the earlier years (*i.e.,* the first year of commencement of business being the initial assessment year) are to be brought forward notionally and set off against the income of the current year. It placed reliance on the Circular 281, dated 22-9-1980. However, the ratio of this decision and the said Circular are relevant for undertakings set up till 31-3-2000 and not for those set up on or after 1-4-2000. When the Mohan Breweries case was referred before the Special Bench, the Tribunal distinguished it on facts. It pointed out that the assessee, Goldmine Shares had claimed deduction in the year of setting up of undertaking itself and whereas in Mohan Breweries case, the year of claim was after the year of setting up of the undertaking.

The Madras High Court in the case of ***Velayudhaswamy Spinning Mills (P) Ltd. Vs. ACIT (2010 38 DTR (Mad) 57)*** considered both the above decisions. It held that provision of Section 80-IA(5), treating eligible undertaking as a separate sole source of income, is applicable only when the assessee chooses to claim deduction under S. 80-IA and same cannot be applied to a year prior to the year in which assessee opted to claim relief under S. 80-IA for the first time. As initial

year is not defined in S. 80-IA, the year of option has to be treated as the initial assessment year for the purpose of S. 80-IA. Thus, Madras High Court overruled the Ahmedabad Special bench decision and upheld the judgment of Chennai Bench in the case of Mohan Breweries & Distilleries Ltd. Vs ACIT(2008) 114 TTJ 532 which has held that Section does not mandate that first year of 10 consecutive assessment years should be always first year of set-up of enterprise. The High Court has held that as initial year is not defined in Section 80IA as compared to Section 80IB where it is specifically provided that the year of commencement of business will be the initial year for the purpose of claiming the deduction, the year of option has to be treated as initial assessment year for the purpose of Section 80IA.

The ***ITAT, Bangalore in the case of Anil Lad Vs DCIT [2011]*** held that loss and depreciation of eligible unit prior to "initial assessment year" , if set-off against other income, then it is not to be notionally carried forward. The facts of the case were that in AY 2006-07 the assessee installed a windmill, the profits of which were eligible for 100% deduction under Section 80-IA. Owing to depreciation and loss, the assessee did not claim s. 80-IA deduction in AY 2006-07 & 2007-08 and set-off the loss and depreciation against other income. In AY 2008-09, the assessee earned profits from the windmill and claimed deduction under Section 80-IA. The AO & CIT (A) relied on the Special Bench decision in ACIT vs. Gold Mines Shares & Finance 116 TTJ (Ahd) (SB) 705 and held that in view of Section 80IA(5), the loss and unabsorbed depreciation of the

eligible unit, though set-off against the other income, had to be "notionally" carried forward for set-off against the profits of the eligible undertaking. Allowing the appeal the ITAT held that, though in Gold Mines Shares & Finance 116 TTJ (Ahd) (SB) 705 it was held that in view of Section 80IA(5), the eligible unit had to be treated as the only source of income and the profits had to be computed after deduction of the notionally brought forward losses and depreciation of the eligible business even though they were in fact set-off against other income in the earlier years, the **Madras High Court held in Velayudhaswamy Spinning Mills P. Ltd. v. ACIT 38 DTR 57** held that such a notional exercise was not contemplated by Section 80IA(5). It was held that the fiction in Section 80-IA(5) that the eligible unit is the only source of income begins from the "initial assessment year" which is not the same thing as the year of commencement of activity. The law contemplates **looking forward** to a period of ten years from the initial assessment and does not allow the Revenue to look backward and find out if there is any loss of earlier years and bring forward notionally even though the same were set off against other income of the assessee and the set off against the current income of the eligible business. Once the set off has taken place in an earlier year against the other income, the Revenue cannot rework the set off amount and bring it notionally. The fiction in Section 80-IA(5) is for a limited purpose and does not contemplate to bring set off amount notionally. The judgement of a constitutional court has overriding effect.

7.3 As seen from the above judicial pronouncements, the Courts have interpreted the start year of applicability of the fiction i.e. the initial assessment year as the first year of claim and not the first year of operation/ commencement of production.

8. Another issue is whether in computing deductions under Section 80-IA loss of one eligible unit can be set off or adjusted against the profit of another eligible unit ?

In view of Section 80-IA(5), which begin with a non-obstante clause, the quantum of deduction is to be computed as if the eligible undertaking were the only source of income of the assessee during the relevant years. In other words, each eligible undertaking or unit is to be treated separately and independently. It is only those undertakings, which have a profit or gain, which would be considered for computing the deduction, not the loss making undertakings. The plain reading of the provision suggests that the loss of one such eligible undertaking cannot be set off against the profit of another such eligible undertaking to arrive at a computation of the quantum of deduction that is to be allowed to the assessee under the said sections.

8.1 In this regard, we may refer to the decision of Supreme court in the case of **Dewan Kraft Systems [297 ITR 305 (Delhi)]**, which considered the provisions of Section 80IA(7) of the Income Tax Act. In that case, the question arose with respect to computation of the deduction in relation to three units – the Kalamb Unit, the Delhi Unit and the Noida Unit. This court held that while computing the deduction under Section 80-IA of the said Act, the profits and gains of the Kalamb unit for

the purposes of determining the quantum of deduction under Section 80-IA(5) was to be computed as if such eligible business of the said unit was the only source of income of the assessee. This court observed that the Assessing Officer had erroneously mixed the profits of the Delhi and Noida units and had thereby restricted the deduction to the extent of business income and that such an exercise was in total disregard of the provisions of sub-section (7) of Section 80-IA of the said Act. It was held that the Kalamb unit, being the only unit of the assessee eligible for deduction under Section 80-IA, was to be treated as an independent unit and the same was to be treated as the only source of income of the assessee for the purposes of computing deduction under Section 80-IA.

Similar view was held by Delhi High Court in the case of **CIT vs. Sona Koyo Steering Sys. Ltd.[2010] 189 Taxman 110 (Delhi).** In this case the assessee has two units, namely, a steering unit and an axle unit. In all these years, the assessee was incurring losses in one of the two units and profits in the other unit. The assessee claimed deduction under Section 80-I of the Income-tax Act, 1961 - The Assessing Officer, while computing the deduction allowable to the assessee, set off the losses of one unit against the profits of the other unit and, thereafter, sought to compute the deduction. – Commissioner of Income-tax (Appeals) also took the same stand as the Assessing Officer. The plea of the assessee before the Income-tax Appellate Tribunal was that the two units are independent units and only the profit making unit should be considered eligible for the

purposes of computing the deduction under Section 80-I(6) read with the provisions of Section 80-1(6). The Tribunal accepted the plea of the assessee and held that undertaking entitled to special deduction to be treated as an independent unit. The court observed that the test for deciding whether two units are independent or not is to see whether they are capable of functioning autonomously without relying on each other. It is irrelevant whether the two units are producing same or different products as long as they satisfy the above test.

8.2 Thus for the purposes of determining the quantum of deduction under Section 80-IA the taxable income of the eligible business of the industrial undertaking is to be ascertained as if such undertaking were an independent unit owned by the assessee concerned and the assessee has no other source of income. Consequently, the unabsorbed losses, unabsorbed depreciation, etc. relating to the eligible industrial undertaking etc., are to be taken into account in determining the quantum of deduction under Section 80-IA even though these may actually have been set off against the profits of assessee from other sources. There is no warrant for reducing the loss of one eligible undertaking from the profits of the other eligible undertaking. Such an analysis will lead to misinterpretation of the unambiguous language of section, which otherwise talks of granting deduction in respect of the profits and gains derived from such industrial undertaking. It is abundantly clear that there is no reference to the aggregate of profits from all the eligible industrial undertakings. Therefore, if there is profit derived from a particular industrial undertaking

that will qualify for deduction without reduction of loss suffered by any other eligible industrial undertaking.

9. ISSUE: MEANING OF WORD 'UNDERTAKING'

In Section 80-IA the concept of 'undertaking' is a critical condition for the application of section. Other conditions mentioned in the Section 80-IA can be satisfied only when there is an 'undertaking'. Thus it is important to understand the meaning of the term 'undertaking' in order to understand the scope of deduction available under Section 80-IA. It is to be noted that the deduction under Section 80-IA is applicable to 'Undertaking' or 'Enterprise' and not to the 'Assessee' per se.

The benefit of Section 80-IA is not available to a unit or new unit unless the unit is in the nature of an 'undertaking'. The term 'unit', according to the New Oxford Dictionary of English, signifies an individual thing or person regarded as single and complete, especially for purposes of calculation. It also signifies a 'device that has a specified function'. The term 'undertaking', on the other hand, is defined in the same Dictionary as 'task that is taken on' and also as 'the action of undertaking to do something.' The Income-tax Act does not define the term 'undertaking' though the term 'industrial undertaking' is defined in Section 33B as 'any undertaking which is mainly engaged in the business of .... or in the manufacture or processing of goods ...'

In the absence of an explicit statutory definition of the term 'undertaking', it is subject to various interpretations. In order to constitute an 'undertaking', the unit must undertake the specified task. In the context of Section 80-IA, the obligation or task to be undertaken by a unit is the manufacture or production of articles or things specified in that section **in**

its own right and consequently derives the profits or gains there-from. It should not only be a separate and independent unit but a well integrated **unit capable of** undertaking the manufacturing or production of articles or things.

Mere existence of an 'undertaking' is not sufficient. The 'undertaking' should **also be new** in the sense that it should have begun to manufacture or produce specified articles or things after the prescribed time schedule. Therefore, there must primarily be manufacture or production of articles or things involving a new undertaking or undertakings.

9.1 A few of the case laws in relation to the issue of Industrial undertaking, reconstruction, number of workers etc. is tabled below for ready reference.

Head	**Citation**	**Observations in brief**
Meaning of Industry	CIT v. J.B. Kharwar & Sons [1987] 163 ITR 394 (Guj.)	Where there is systematic activity, organised by co-operation between employer and employee (the direct and substantial element is commercial), for the production and/or distribution of goods and services calculated to satisfy human wants and wishes, prima facie, there is an 'industry' in that enterprise. The true focus is functional and the decisive test is the nature of the activity with special emphasis on the employer-employee relations
Hotel is not an industrial undertaking	Indian Hotels Co. Ltd. v. ITO [2000] 245 ITR 538 (SC).	Taking this into account, apparently, the business of a hotel, is a trading activity and not that of an industrial undertaking. A flight kitchen operating as an ancillary unit of a hotel cannot also be treated as an industrial undertaking

New industrial undertaking	CIT v. Mahaan Foods Ltd. [2009] 177 Taxman 274 (Delhi).	True test to claim deduction under Section 80-IA is not whether new industrial undertaking connotes expansion of existing business of assessee but whether it is all the same a new and identifiable undertaking, separate and distinct from existing business.
Reconstruction'	Textile Machinery Corporation Ltd. v. CIT [1977] 107 ITR 195 (SC)/CIT v. Orient Paper Mills Ltd. [1989] 176 ITR 110 (SC).	Reconstruction of business involves the idea of substantially the same persons carrying on substantially the same business. Where the new industrial undertakings are separate and independent productionunits in the sense that the commodities produced or the results achieved are commercially tangible products and the undertakings can be carried on separately without complete absorption and losing their identity in the old business, they are not to be treated as business formed by reconstruction of the old business. The fact that an assessee by establishment of a new industrial undertaking expands his existing business would not on that score deprive him of the benefit. The true test is not whether the new industrial undertaking connotes expansion of the existing business of the assessee but whether it is all the same a new and identifiable undertaking separate and distinct from the existing business. There must be a new emergence of a physically separate unit which may exist on its own as a viable industrial unit. One thing is certain that the new undertaking must be an integrated unit by itself

Take-over of firm by company is not reconstruction	CIT v. Gaekwar Foam & Rubber Co. Ltd. [1959] 35 ITR 662 (Bom.).	Where under an agreement a company took over the business of a partnership firm by allotting shares to its partner, the take-over did not amount to 'reconstruction' -
'Splitting up' -	CIT v. Hindustan General Industries Ltd. [1982] 137 ITR 851 (Delhi)	The expression 'splitting up' of the business already in existence indicates a case where the integrity of a business earlier in existence is broken up and different sections of the activities previously conducted are carried on independently
Worker	CIT v. K.G. Yedyurappa & Co. [1985] 152 ITR 152 (Kar.).	In the absence of any definition of the word 'worker', the court has to take its ordinary meaning which may mean casual, permanent or temporary. There is therefore no reason why the word 'worker' should not include all these three categories
Average number is to be worked out	CIT v. Sawyer's Asia Ltd. [1980] 122 ITR 259 (Bom.)/CIT v. Ormerods (I) (P.) Ltd. [1989] 176 ITR 470 (Bom.)	There can be no hard and fast rule by which one can determine whether there has been substantial compliance with the prescribed limit of at least 10 workers. It would suffice if, on an average, there had been 10 workers employed in the undertaking, even though the number of workers employed during some part of the previous year was less than 10

'Owner' cannot be counted as worker	CIT v. P.R. Alagappan [1988] 173 ITR 82 (Mad.).	When the clause refers to 'undertaking employs ten or more workers', it is not intended to convey that the undertaking is to be treated as an employer independent of the assessee who owns the undertaking. Hence, the owner must not be counted as a worker for computing the number of workers
Position during abnormal situations like strike	CIT v. Abhirami Cotton Mills (P.) Ltd. [1996] 220 ITR 84/87 Taxman 152 (AP).	Where the number of workers employed by the assessee fell below the minimum stipulated number owing to the closure, strike or other valid reasons, the strength of employees during such abnormal situations could not be taken as a criterion for denying relief
Employment during substantial period may suffice	CIT v. Taluja Enterprises (P.) Ltd. [2001] 250 ITR 675 (Delhi).	In order to qualify for relief, the undertaking must have employed ten or more workers substantially during the period for which relief was claimed. There could be no hard and fast rule by which one could determine whether there had been substantial compliance. It is for the authority or the court to so decide based upon the facts before it
Succession or sale does not amount to reconstruction	CIT v. Devson Ltd./CIT v Kashmir Fruit and Chemical Industries [1975] 98 ITR 311 (J&K).	If a new business has come into existence by virtue of succession or sale, the question of reconstruction does not arise at all

Workers deployed on all processes must be counted	CIT v. Sultan & Sons Rice Mill [2005] 272 ITR 181 /CIT v. Hanuman Rice Mills [2005] 275 ITR 79 (All.)/CIT v. Ajmani Industries [2006] 153 Taxm 43(All.).	Various processes starting from purchase of raw material and till the sale of finished goods form an integral part of manufacturing process and workers and labourers employed in all these processes are 'workers employed in the manufacturing process'. The words 'employ ten or more workers in the manufacturing process' normally would cover the entire process carried on by the industrial undertaking for converting the raw material into finished goods
Contract labourers, job workers etc. can't be counted for determining the number of workers	R & P Exports v. CIT [2005] 146 Taxman 404/279 ITR 536 (All.).	The words 'to employ' would take colour from associated words and expressions such as 'worker', 'industrial' undertaking' used in the section. The employee is one who works for others for hire. The employer is one who employs services of other persons. In the context of the section, there fore, 'employee' will include only such workers who are directly employed by the assessee. If the employer is an assessee, only then the deduction can be claimed. The word 'employee' has been used in the sense of contract of service and not contract for service. Thus, the artisans and karigars from whom the work is got done on contract basis, job basis or per piece basis are not workers employed by the assessee and they cannot be counted for finding out the minimum number of stipulated workers

(Contra) Contract labourers must be counted as 'workers'	CIT v. Prithviraj Bhoorchand [2005] 280 ITR 94 (Guj.).	The term employed by the statute is 'employs' twenty or more workers. The plain dictionary meaning of 'employ' is to use the services of a person in return for payment. The Tribunal would therefore be right in law in holding that,where the assessee had the ultimate control over the affairs of the establishment which comprised more than 20 workers through the contractor, the statutory requirement had been met with, and that the assessee was entitled to the deduction

10. ISSUE: MANUFACTURING VS. PROCESSING

The fine line of dissimilarity between manufacturing and processing for the purpose of deduction under Section 80IA/80IB is one of the most debated issues in these sections. The relevant portion of the section mentioning these terms is reproduced below for ready reference.

Sections 80-IA and 80-IB substituted for Section 80-IA by the Finance Act, 1999, w.e.f. 1-4-2000.

" *Eligibility conditions are enumerated in subsection (2) (iii) of Section 80-IB, which is:*

(2) This section applies to any industrial undertaking which fulfils all the following conditions, namely : –

.....

(iii) it ***manufactures or produces*** *any article or thing, not being any article or thing specified in the list in the Eleventh Schedule, or operates one or more cold storage plant or plants, in any part of India :"*

Also wef 01.04.2009 following definition of the term manufacture has been inserted:

(29BA) ***"manufacture",*** *with its grammatical variations, means a change in a non-living physical object or article or thing,*

(a) resulting in transformation of the object or article or thing into a new and distinct object or article or thing having a different name, character and use; or

(b) bringing into existence of a new and distinct object or article or thing with a different chemical composition or integral structure;

10.1 A few recent and important **case laws** addressing the controversy of manufacturing vs processing are discussed below to understand the determining factors relevant to the issue.

Case laws	Important observations
1) [2010] 186 TAXMAN 439 (SC) ***Income-tax Officer, Udaipur*** **v.** ***Arihant Tiles & Marbles (P.) Ltd. ****	**Facts:** The assesses were engaged in the business of manufacture/production of polished slabs and tiles from marble blocks. The activities included excavation /extraction of marble blocks by mine owners in raw shape; processing of such blocks on single blade/wire saw machines using advanced technology to square them up by separating waste material; sawing of squared up blocks for making slabs; filling cracks by epoxy resins and fibre netting; polishing of slabs on polishing machines and cutting them into required dimensions and buffing of polished slabs and tiles by shiner. They had been consistently regarded as manufacturer/ producer by the various Government departments and agencies and the processes undertaken by them had been treated as manufacture under the Excise Act and allied tax laws. For the relevant assessment year, they claimed deduction under Section 80-IA on the plea that the activities undertaken by them constituted manufacture or production in terms of Section 80-IA. The lower authorities including the Tribunal disallowed the claim of the assessees. However, the High Court accepted the claim of the assessees holding that in the instant case, polished slabs and tiles stood manufactured/produced from the marble blocks and, consequently, the assessees were entitled to the benefit of deduction under Section 80-IA. **Observations:** The word 'production' is wider in its scope as compared to the word 'manufacture'. Further, the Parliament itself has taken note of the ground reality and has amended the provisions of the Act by inserting Section **2(29BA)** vide the Finance Act, 2009, with effect from 1-4-2009, wherein the word 'manufacture' is defined. In the instant case, the Court was not concerned only with cutting of marble blocks into slabs, but was also concerned with the activity of polishing and ultimate conversion of blocks into polished slabs and tiles. From the processes/activities undertaken by the assessees, it was clear that there were various stages through which the blocks had to go through before they became polished slabs and tiles. One has to examine the scheme of the Act also while deciding the question as to whether the activity constitutes manufacture or production. In the instant case, the blocks converted into polished slabs and tiles after undergoing the various processes certainly resulted in emergence of a new and distinct commodity. The original block did not remain the block; it became a slab or tile. In the circumstances, not only there was manufacture, but also an activity which was something beyond manufacture and which brought a new product into existence. Therefore, the activity undertaken by the assessees constituted manufacture or production in terms of Section 80-IA.

2) [2009] 177 TAXMAN 217 (MAD.) ***Commissioner of Income-tax*** **v.** ***Vinbros & Co.**** **(Confirmed by Supreme Court)**	**Facts:** The assessee, engaged in manufacturing and bottling of Indian Manufactured Foreign Liquor (IMFL) from rectified spirit, claimed deduction under Section 80-IB. The Assessing Officer rejected the claim on the ground that the process carried on by the assessee did not constitute 'manufacture' within the meaning of Section 80-IB. On appeal, the Commissioner (Appeals) confirmed the disallowance. On second appeal, the Tribunal allowed the deduction on the ground that the rectified spirit was not mentioned in the 1st item of 11th Schedule, 'bear, wine and other alcoholic spirits' and, consequently, the assessee being a small scale industrial unit was entitled to deduction under Section 80-IB. **Observation:** The assessee did not just add water before selling the final product. It was an admitted fact that quite apart from water, the assessee had to add several items to make it fit for human consumption. **Following the decision in the case of Dy. CST (Law), Board of Revenue (Taxes) v. Pio Food Packers [1980] 46 STC 63 (SC), wherein it was observed that the test for determination of whether manufacture can be said to have taken place is whether the commodity which is subject to the process of manufacture can no longer be regarded as the original commodity, but it is recognised in the trade as a new and distinct commodity,** the Tribunal held that what was purchased by the assessee was not a potable product and but for the blending, the commodity could not have become a saleable commodity. Even though the raw materials were not manufactured by the assessee, yet there was nexus of the process by blending original product to make it a saleable commodity totally different from the one originally obtained. The end product was totally different and commercially a different commodity than the major input, rectified spirit, which was not fit for human consumption and hence, the changes made to the original product resulted in as different commodity, which was recognized in the trade.

3) **[2010] 188 TAXMAN 188 (SC)** ***Commissioner of Income-tax, Mumbai*** **v.** ***Emptee Poly-Yarn (P.) Ltd.****	**Facts:** The question which arose for determination in the instant appeal was as to whether twisting and texturising of partially oriented yarn ('POY') would amount to 'manufacture' in terms of Section 80-IA. **Observation:** POY (Partially Oriented Yarn) is a semi-finished yarn not capable of being put in warp or weft. It can only be used for making a texturised yarn, which, in turn, can be used in the manufacture of fabric. In other words, POY cannot be used directly to manufacture fabric. According to the experts, crimps, bulkiness, etc., are introduced by a process called as thermo-mechanical process into POY which converts POY into a texturised yarn. If one examines this thermo- mechanical process in details, it becomes clear that texturising and twisting of yarn constitutes 'manufacture' in the context of conversion of POY into texturised yarn. The definition of the word 'manufacture' is made explicit by the Finance (No. 2) Act, 2009 which states that 'manufacture' shall, inter alia, mean a change in bringing into existence of a new and distinct object or article or thing with a different chemical composition or integral structure. Applying this definition to the facts of the instant case, it could be mentioned that the above thermo-mechanical process also ought to be about a structural change in the yarn itself, which is one of the important tests to be seen while judging whether the process is manufacture or not. The structure, the character, the use and the name of product are the indicia to be taken into account while deciding the question whether the process is a manufacture or not. However, it cannot be said that texturising or twisting per se in every matter amounts to manufacture. It is the thermo-mechanical process embedded in twisting and texturising when applied to a partially oriented yarn which makes the process as a manufacture.

4) **[2010] 187 TAXMAN 275 (SC)** ***Oracle Software India Ltd.***	**Facts:** The assessee was a 100 per cent subsidiary of a USA company. It was incorporated with the object of developing, designing, improving, producing, marketing, distributing, buying, selling and importing of computer softwares. It was entitled to sub-licence the software developed by the US company. It imported master media of the software from the US company which was duplicated on blank discs, packed and sold in the market along with relevant brouchers. According to the assessee, it used machinery to convert blank CDs into recorded CDs which along with other processes became a software kit and process undertaken by it to convert blank CDs into recorded CDs constituted manufacture or processing of goods in terms of section 80- IA and, thus, it was entitled to deduction under that section. The Assessing Officer held that since the software on the master media and the software on the recorded media remained unchanged, there was no manufacture or processing of goods involved in the activity of copying or duplication and, hence, the assessee was not entitled to deduction under section 80- IA. The High Court, however, allowed the assessee's claim. **Observation:** In the instant case, it was found that the software on the master media was an application software. It was not an operating software or a system software. It could be categorized into 'Product Line Applications', 'Application Solutions' and 'Industry Applications' . A commercial duplication process involves four steps. For the said process of commercial duplication, one requires master media, fully operational computer, CD blaster machine (a commercial device used for replication from Master Media), blank/unrecorded compact disc, also known as recordable media and printing software/labels. The master media is subjected to a validation and checking process by software engineers by installing and rechecking the integrity of the master media with the help of the software installed in the fully operational computer. After such validation and checking of the master media, the same is inserted in a machine which is called as the CD Blaster and a virtual image of the software in the master media is thereafter created in its internal storage device. This virtual image is utilized to replicate the software on the recordable media. Virtual image is an image that is stored in computer memory but it is too large to be shown on the screen. Therefore, scrolling and panning are used to bring the unseen portions of the image into view. If one examines the above process in the light of the details given hereinabove, **commercial duplication cannot be compared to home duplication.** Complex technical nuances are required to be kept in mind while deciding issues of the instant nature. 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 above process. **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 the above test to the facts of the instant case, it was clear that the assessee had undertaken an operation which rendered a blank CD fit for use for which it was otherwise not fit. The blank CD was an input. By the duplicating process undertaken by the assessee, the recordable media, which was unfit for any specific use, got converted into the programme which was embedded in the Master Media and, thus, blank CD got converted into recorded CD by the aforestated intricate process. The duplicating process changed the basic character of a blank CD, dedicating it to a specific use. Without such processing, blank CDs would be unfit for their intended purpose. Therefore, processing of blank CDs dedicating them to a specific use, constitutes a manufacture in terms of section 80- IA(12)(b) , read with section 33B. [Para 10]

5) **[2001] 117 TAXMAN 368 (SC)** **Gem India Mfg. Co.**	**Facts:** The assessee was engaged in cutting and polishing of diamonds. The Tribunal as well as the High Court allowed its claim under Section 80-I on ground that its activities amounted to manufacturing or production of goods. Observation: 1. The Tribunal took the view that because in 'common parlance and commercial sense raw diamonds are not the same thing as polished and cut diamonds. The two are different entities in the commercial world. Though the chemical composition remains the same, the physical characteristics of shape and class, etc., are substantially different'. It would appear that no material had been placed on the record before the Tribunal upon which it could have reached the conclusion that, either in common or in commercial parlance, raw diamonds were not the same thing as polished and cut diamonds, and that they were different entities in the commercial world. An *ipse dixit* of the Tribunal is not the best foundation for a decision. **2.** The High Court, as aforestated, concluded that the case was covered by its decision in the case of *London Star Diamond Co. (I.) Ltd.* (*supra*). It was not pointed out to the High Court that the question in that case was whether the assessee was an industrial company within the meaning of Section 2(8) of the Finance Act, 1975, and that, in answering that question, the High Court had held that raw diamonds and cut and polished diamonds were different and distinct marketable commodities having different uses; therefore, a company engaged in cutting and polishing raw diamonds for the purpose of export was engaged in the 'processing of goods' to convert them into marketable form. The question that the High Court and we are here concerned with is whether in cutting and polishing diamonds the assessee manufactures or produces articles or things. **3.** There can be little difficulty in holding that the raw and uncut diamond is subjected to a process of cutting and polishing which yields the polished diamond, but that is not to say that the polished diamond is a new article or thing which is the result of manufacture or production. There is no material on the record upon which such a conclusion can be reached.

10.2 After going through the provisions of the Act, background of the provisions as well as the legislative intent coupled with important arguments in favor and against the provisions, following important areas emerge, which are to be kept in mind at the time of investigation as well as drafting the assessment order.

- After the definition of the term manufacture has been added to the Act, the controversy of manufacturing vs processing has been put to rest to some extent.
- The new and distinct object should come

into being and the manufactured item should have different name, character, use, chemical composition or integral structure.

- It is also important to understand the process in detail, through which the new product or article comes into existence without which a rational opinion may not be formed.
- Wherever possible, in order to understand an intricate process advice of experts may be taken by the AO. At the senior level a panel of experts may be kept ready to take a decision on such issues, which will also help in creating a database for all future reference (Hon'ble Supreme Court suggested while remitting the case of **Morinda Co-operative Sugar Mills Limited** to CIT(A) in its order dated 26.09.2012)

11. ISSUE: CONTRACTOR Vs. DEVELOPER

The distinction between contractor and developer for the purpose of deduction under Section 80IA/80IB has always been a point of controversy. Before going into the relevant case law highlighting the issue, the relevant portion of the section is reproduced below for ready reference.

Sections 80-IA and 80-IB substituted for Section 80-IA by the Finance Act, 1999, w.e.f. 1-4-2000.

" Eligibility conditions are enumerated in subsection (4)(i) of Section 80-IA, which is:

(4) This section applies to –

(i) any enterprise carrying on the business [of (i) ***developing*** *or (ii)* ***operating and maintaining*** *or (iii)* ***developing, operating and maintaining]*** *any*

infrastructure facility which fulfils all the following conditions, namely : –

[**75.** Substituted for "of (i) developing, (ii) maintaining and operating or (iii) developing, maintaining and operating" **by the Finance Act, 2001, w.e.f. 1-4-2002.**]

(a) it is owned by a company registered in India or by a consortium of such companies or by an authority or a board or a corporation or any other body established or constituted under any Central or State Act;

[(b) it has entered into an agreement with the Central Government or a State Government or a local authority or any other statutory body for (i) developing or (ii) operating and maintaining or (iii) developing, operating and maintaining a new infrastructure facility;

(c) it has started or starts operating and maintaining the infrastructure facility on or after the 1st day of April, 1995:"

Following explanation has been added to this section explaining that the deduction is not allowable to a contractor:

***[Explanation**. – For the removal of doubts, it is hereby declared that **nothing contained in this section shall apply in relation to a business referred to in sub-section (4) which is in the nature of a works contract** awarded by any person (including the Central or State Government) and executed by the undertaking or enterprise referred to in sub-section (1).]"*

*{**9.** Substituted by the Finance (No. 2) Act, 2009, w.r.e.f. 1-4-2000. Prior to its substitution, Explanation, as inserted by the Finance Act, 2007, w.r.e.f. 1-4-2000, read as under :*

"Explanation. – For the removal of doubts, it is hereby declared that nothing contained in this section shall apply to a person who executes a works contract entered into with the undertaking or enterprise, as the case may be."}

The above explanation was added for the reasons expressed in the memorandum to the Finance Act-2007, which is reproduced below.

"Clarification regarding developer with reference to infrastructure facility, industrial park, etc. for the purposes of Section 80-IA

Section 80-IA, inter-alia, provides for a ten-year tax benefit to an enterprise or an undertaking engaged in development of infrastructure facilities, Industrial Parks and Special Economic Zones.

The tax benefit was introduced for the reason that industrial modernization requires a massive expansion of, and qualitative improvement in, infrastructure (viz., xpressways, highways, airports, ports and rapid urban rail transport systems) which was lacking in our country. The purpose of the tax benefit has all along been ***for encouraging private sector participation by way of investment in development of the infrastructure sector and not for the persons who merely execute the civil construction work or any other works contract.***

Accordingly, it is proposed to clarify that the provisions of Section 80-IA shall not apply to a person who executes a works contract entered into with the undertaking or enterprise referred to in the said section. ***Thus, in a case where a person makes the investment and***

himself executes the development work i.e., carries out the civil construction work, he will be eligible for tax benefit under Section 80-IA. *In contrast to this, a person who enters into a contract with another person [i.e., undertaking or enterprise referred to in Section 80-IA] for executing works contract, will not be eligible for the tax benefit under Section 80-IA.*

This amendment will take retrospective effect from 1st April, 2000 and will, accordingly, apply in relation to the assessment year 2000-2001 and subsequent years."

11.1 Relevant Circulars:

In this connection following circulars are important to note, as the same clarify the position to be taken by the department while deciding the issue at hand related to this controversy as well as various appellate authorities have also referred to these circulars while deciding the cases.

A. Definition of Port as Infrastructure facility for the purpose of Sections 10(23G) and 80-IA

1. *The Board has received various representations seeking clarification whether structures at ports for storage, loading and unloading etc. will fall under the definition of "port" for the purposes of Sections 10(23G) and 80-IA of the Income-tax Act, 1961.*

2. *The Board has considered the matter and it has been decided that* ***such structures will be included in the definition of "port" for the purposes of Sections***

10(23G) and 80-IA of the Income-tax Act, 1961, if the following conditions are fulfilled:

(a) the concerned ***port authority has issued a certificate*** *that the said structures form part of the port, and*

(b) ***such structures have been built under BOT or BOLT schemes*** *and there is an agreement that the same would* ***be transferred to the said authority*** *on the expiry of the time stipulated in the agreement.*

Circular : No. 793, dated 23-6-2000*.*

CLARIFICATION ONE

1. *Reference is invited to Board's Circular No. 793, dated 23-6-2000 and amendment in Section 80-IA by the Finance Act, 2001.*

2. *"Port", for the purposes of Sections 10(23G) and 80-IA of the Income-tax Act, 1961, includes structures at the ports for storage, loading and unloading etc., if the following conditions are fulfilled:*

(a) the concerned port authority has issued a certificate that the said structures form part of the port, and

(b) such structures have been built under the BOT or BOLT schemes and there is an agreement that the same would be transferred to the said authority on the expiry of the time stipulated in the agreement.

This definition is applicable to assessment year 2001-02 and any earlier assessment year.

3. *However,* ***for and from assessment year 2002-03 onwards, structures at the ports for storage, loading and unloading etc. will be included in the definition of "port" for the purpose of Sections 10(23G) and 80-IA of the Income-tax Act, 1961, if the following condition is fulfilled:***

the concerned port authority has issued a certificate that the said structures form part of the port,

Circular : No. 10/2005, dated 16-12-2005.

B. Whether Build-Own-Lease-Transfer (BOLT) Scheme of Indian Railways shall be eligible for benefit under Section 80-IA, since it is not legally possible for any enterprise other than Indian Railways to maintain and operate Railway System

1. *The Finance Act, 1995 has introduced sub-section (4A) in Section 80-IA of the Income-tax Act, 1961 providing for a five-year tax holiday and a deduction of 30 per cent in the subsequent five years within a period of twelve assessment years beginning with the assessment year in which an enterprise (which may be owned by a company or a Consortium of companies) begins operating and maintaining an infrastructure facility on Build-Operate-Transfer (BOT) or on Build-Own-Operate-Transfer (BOOT) basis, subject to certain conditions specified in that sub-section.*

One of the conditions to be fulfilled by the enterprise is that it should develop, maintain and operate a new infrastructure facility which shall be transferred to the Central Government, etc., within the period stipulated in the agreement. The definition of infrastructure as

per sub-section (12) of Section 80-IA includes a rail system also.

2. *The Indian* ***Railways have formulated a Build-Own-Lease-Transfer (BOLT) Scheme****, whereunder a private enterprise will provide the necessary and crucial components of a Railway system, own them for a stipulated period but will not maintain or operate the same. Instead, the enterprise will lease the asset (only necessary and crucial components of a Railway System) back to Indian Railways for maintenance and operation, and shall ultimately transfer it to Indian Railways.*

3. *This is to clarify that, the said (BOLT) Scheme of the Indian Railways shall be eligible for the benefit of Section 80-IA of the Income-tax Act, 1961, since it is not legally possible for any enterprise other than the Indian Railways to maintain and operate a Railway System. However, this concession shall be applicable only to an infrastructure facility meant for development of Rail System and not to any other infrastructure facility including Rolling Stocks.*

***Circular** : **No. 733, dated 3-1-1996**.*

11.2 Some recent and important **case laws** addressing the controversy of Contractor vs Developer are discussed below. The case might have been decided against the revenue but the important observations by the court/ tribunal and arguments raised on behalf of the assessee are key take away for future cases. It also acts as guide as to what facts should be collected and incorporated in the order.

1) **322 ITR 323 (BOM) (2010)** ***ABG Heavy Engg. Ltd.***	**Facts:** The assessee was awarded a contract for leasing of container handling cranes at the Jawaharlal Nehru Port Trust ('JNPT') in terms of the policy of the Government of India to encourage private sector participation in the development of infrastructure. Under the contract, the assessee was responsible for supplying installation, testing, commissioning and maintenance of the cranes. In terms of the agreement, the JNPT agreed to pay certain lease charges over a period of ten years. The contract envisaged two options. Under the first option, operation and maintenance was to be carried out by the assessee and under the second option, only maintenance was to be carried out by it. In the event, the assessee was not to carry out operation of the cranes, the lease charges were to be reduced by certain amount. The assessee assumed the responsibility of making the equipments available for operation for a minimum number of days as stipulated in the contract and became liable to pay liquidated damages for non-availability of the equipments after their commissioning. After the expiry of the lease period of ten years, the assessee was liable to hand over the equipments to the JNPT free of cost. The assessee claimed the benefit of deduction under Section 80-IA. The Assessing Officer rejected the claim holding that the assessee was merely engaged in the business of supplying, installing, testing, commissioning and maintaining cranes at the Port and was not in the business of developing, maintaining and operating a Port and, consequently, it could not be held to be in the business of developing an infrastructural facility. **Observations:** 1. The first circular in that regard was issued on 23-1-1996, which specifically dealt with whether Section 80-IA(4A) would be applicable to a BOLT Scheme involving an infrastructure facility for the Indian Railways. The circular clarified that an infrastructure facility set up on a BOLT basis for Railways would qualify for deduction. 2. That was followed by the two circulars of the CBDT dated 23-6-2000 and 16-12-2005. The first of those circulars recognized that structures for storage, loading and unloading, etc., at a port built under a BOT and BOLT scheme would qualify for deduction. 3. The subsequent circular dated 16-12-2005 once again clarified the position of the CBDT that structures, which have been built, inter alia, under a BOLT Scheme up to the assessment year 2001-02, would qualify for a deduction under Section 80-IA. In fact, from the assessment year 2002-03, the process was further liberalized, consistent with the basic purpose and object of granting the concession. 4. This was perhaps a practical realisation of the fact that a developer may not possess the wherewithal, expertise or resources to operate a facility, once constructed. The Parliament eventually stepped in to clarify that it was not invariably necessary for a developer to operate and maintain the facility. The fact that in such a scheme, an enterprise would not operate the facility itself was not regarded as being a statutory bar to the entitlement to a deduction under Section 80-IA. The Court could not be unmindful in the instant case of the underlying objects and reasons for a grant of deduction to an enterprise engaged in the development of an infrastructure facility. 5. The assessee undertook an obligation for supplying, installing, testing, commissioning and maintenance of container handling equipments, namely, the cranes in question. The JNPT had a dedicated container handling terminal. The only activity at the terminal consisted of the loading, unloading and storage of the containers. Under the contract, the assessee was obligated to provide the equipment in question in an operable condition. The terms of the contract, however, made it clear that it was the obligation of the assessee to make the equipment available for operation for a stipulated minimum number of days during the year and made the assessee liable to liquidated damages in the event it was not possible to make equipment available. 6. The assessee did not have to develop the entire Port in order to qualify for a deduction under Section 80-IA. The condition of a certificate from the Port Authority was fulfilled and the JNPT certified that the facility provided by the assessee was an integral part of the Port. The assessee developed the facility on a BOLT basis under the contract with the JNPT. On the fulfilment of the lease of ten years, there was a vesting in the JNPT free of cost.

2) **[2012] 25 taxmann.com 260 (Bang.) ITAT** **Yojaka Marine (P.) Ltd.**	**Facts:** The assessee-company was a marine works contractor and supplier of machinery and equipment on hire. It claimed deduction under Section 80-IA on the ground that it had undertaken the construction operation and maintenance of an infrastructure facility in pursuance of an agreement with 'IWAI' which consisted of bank protection work in the Champakara and Udyog Mandal Canals in Kerala and protection of Tapi river bank under the authority of Surat Municipal Corporation, Gujarat. The Assessing Officer, after examining the agreements for the works undertaken by the assessee, concluded that the agreements represented only a works contract granted to the assessee for refurbishment of a portion of the protection wall of the canals and the river bank respectively and the work orders issued by IWAI and Surat Municipal Corporation carried out by the assessee did not have any element of developing, operating and maintaining any infrastructural facility as claimed by the assessee and, therefore, disallowed the assessee's claim for deduction under Section 80-IA. **Observation:** 1. The description of the work executed by the assessee in the relevant period is certainly not development of infrastructure as the Champakara and Udyog Mandal Canals in Kerala were constructed/developed decades ago. 2. Work of the assessee executed in respect of these two canals and the Tapi river bank, is, at best, work which is a sub-activity in the category of repairs and maintenance. 3. The assessee executed works contracts for and on behalf of the concerned Government bodies and there is certainly no element of developing or operating and maintaining or developing, operating and maintaining of any infrastructure facility as envisaged in clause (c) to the Explanation to sub-section (4) of Section 80-IA. 4. The Explanation to Section 80-IA inserted by the Finance Act, 2007, is retrospective in effect from 1-4-2000; it is clarificatory in nature and clearly spells out the legislative intent that the benefit of deduction under Section 80-IA was not to be granted or extended to work contractors as in the instant case of the assessee.
3) **[2010] 35 SOT 171 (MUM.) (LB)** **ITAT (LARGER BENCH)** **B.T. Patil & Sons Belgaum Construction (P.) Ltd.**	**Facts:** The assessee was a civil contractor, engaged in the construction of various projects of the Government of Maharashtra, the Government of Karnataka and various local authorities. The Assessing Officer did not allow the deduction as in his opinion, the assessee had not fulfilled conditions stipulated in sub-section (4) of Section 80-IA inasmuch as the infrastructure was not owned by the assessee-company; there was no agreement between the assessee-company and the Central Government or a State Government or a local authority or any other statutory body for developing or operating and maintaining or developing, operating and maintaining any infrastructure facility which fulfilled the conditions as set out in clause (*i*) of sub-section (4); the assessee did not carry any business in infrastructure facility; the assessee was not in any business of infrastructure facility as it had just constructed the properties belonging to the Government/statutory bodies and parted with them after getting the contract amount fixed for this purpose; the construction was done by the assessee as per the requirements of the Government/ statutory bodies and this work was done for and on behalf of the Government and statutory bodies and not for operating any infrastructure facility. **Observation**: 1. 'Infrastructure facility' as per the Explanation , it is found to have been defined exhaustively by referring to a road project, airport, port, etc., a highway project, a water supply project and irrigation project, etc. 2. What are eligible for deduction under this sub-section are the profits and gains derived from the development of infrastructure facility and not something de hors it. 3. So, in order to be eligible for deduction the development should be that of the infrastructure facility as a whole and not a particular part of it, it may be possible that some part of development work is assigned by the developer to some contractor for doing it on his behalf. That will not put the undertaker of such work into the shoes of a developer.

5.) [2004] 4 SOT 1 (MUM.) **ITAT** **Patel Engineering Ltd.**	**Facts:** During the relevant assessment year, the assessee was engaged in the business activity of construction of two projects, allotted by two State Governments. The assessee claimed that the above two projects of construction of specialised structures and tunnels were 'infrastructure projects' and it 'developed' the same and, therefore, it was entitled to deduction under Section 80-IA(4). The Assessing Officer rejected the assessee's claim. On appeal, the Commissioner (Appeals) agreed with the Assessing Officer. **Observation**: 1. When an assessee is only developing an infrastructure facility/project and is not maintaining and not operating it, obviously, such an assessee will be paid for the cost incurred by it; otherwise how will the person, who develops the infrastructure facility project, realise its cost? If the infrastructure facility is just after its development, transferred to the Government, naturally the cost would be paid by the Government. Therefore, merely because the Maharashtra Government or APSEB had paid for the development of infrastructure facility carried out by the assessee, it could not be said that the assessee did not develop the infrastructure facility. 2. Mere 'development' as such and unassociated/unaccompanied with 'operate' and 'maintenance' also falls within such business activity as is eligible for deduction under Section 80-IA. 3. Projects which were executed by the assessee were highly technical and specialised, as also extremely tricky and did involve huge risks as well. It was also revealed from record that for executing such projects, the assessee had deployed people, plant and machinery, technical expertise, know-how and the financial resources. 4. The term 'contractor' is not essentially contradictory to the term 'developer'. On the other hand, rather Section 80-IA(4) itself provides that assessee should develop the infrastructure facility as per agreement with the Central Government, State Government or a local authority. So, entering into a lawful agreement and thereby becoming a contractor should, in no way, be a bar to the one being a developer.
5) ***Sugam constructions Ltd..ITAT-D-Bench Ahemdabad*** ***Date of order:*** ***26.12.2012***	**Facts:** The assessee is engaged in the construction of rail/road bridges of certain govt. authorities and bodies. Assessee claimed deduction under Section 80-IA and AO has disallowed the same on the ground that assessee is a contractor and not a developer. **Observation**: 1. Assessee has undertaken responsibility of execution of work. 2. It has developed its own design and applied the technology to complete the work. 3. Risk in execution of the work was taken by assessee. It was responsible for any damage or loss. 4. On ownership , the term" it is owned" applies to the enterprise carrying out the business and not the infrastructure facility being developed. 5. Merely because the agreement mentions the assessee as contractor, does not mean that assessee is not a developer. 6. ITAT relied on the Decision of Guj HC in case of Radhe developers.

11.3 After going through the provisions of the Act, background of the provisions as well as the legislative intent coupled with important arguments in favor and against the provisions, following important areas emerge, which are to be kept in mind by the Assessing Officer at the time of investigation as well as drafting the assessment order.

➢ The Explanatory Memorandum to Finance Act 2007 clearly states that the purpose of the tax benefit has all along been to encourage investment in development of infrastructure sector and not for the persons who merely execute the civil construction work. It categorically states that the incentive is intended to benefit developers who undertake entrepreneurial and investment risk and not contractors who only undertake business risk. Without a doubt, both developer and contractor undertake huge risks, deployment of technical personnel, plant and machinery, technical expertise, know-how and financial resources. Distinction between the two would be the key to determine the eligibility for tax holiday. Typically, this difference can be brought out based on the following parameters:

- **Capital investment**: Whether the investment is intended for the project as a whole or merely with respect to construction activity.
- **Risks undertaken**: Entrepreneurial risk associated to the project versus risk limited to the services provided or work done.

- **Responsibility:** Designing and execution versus execution based on instructions.
- **Performance guarantees:** Extended to entire project (including issues arising due to external factors) versus covering construction work done alone (limited to work done by the contractor)

➢ In practice, however, it is not so easy to clearly compartmentalize the developer and the contractor. This is because in a large number of contracts, the developer / contractor undertakes a large number of risks, which could be more than the risks in a works contract but less than risks undertaken by a developer in, say, a BT contract. Therefore, **the interpretation should be on a case-to-case basis keeping in mind the initial Request for Proposal (RFP) floated by the government. The initial tender floated mentioning the exact comprehensive work to be undertaken by the successful bidder may be an important determinant as to what is the level of risk and investment , that is taken by the assessee.**

The facts should be gathered keeping in mind the above determinants and should be clearly brought out in the order, if the assessee is not found eligible for deduction.

12. WAY FORWARD

Generally, all beneficiary sections (deductions, exemptions etc.) of the Act are associated with bundle of controversies; likewise, Sections 80IA and 80IB of the Act also have

their share of large number of debatable issues. In order to minimize litigations in respect of these sections, following structural mechanisms are suggested:-

- **Better co-ordination between different Departments**: - The assesses, intended to be benefited by the tax holiday provisions of Section 80IA/80IB of the Act, are invariably required to take several sanctions, approvals etc. from other Departments. The conditions stipulated in the Act in respect of the eligible class of assessees, may be circulated to relevant Departments, and modalities may be worked out in such a manner that unless these conditions of the I.T. Act are fulfilled, no or conditional approvals or sanctions are extended. This would not only protect the interest of the Revenue but also enable better co-ordination between various Departments to ensure that only the targeted beneficiaries derive the benefits.

- **Standing Committee for clarifying or modifying the issues under litigation**:- The Department should form a standing committee to look into the ongoing litigations and come out with suggestions regularly for amendments in the Act or Circular or Notification or Instructions in order to reduce litigation. For example, in the changed scenario of compulsory e-filing of returns of income for companies, whether filing of audit report with the return of income is still compulsory, especially in the situation where there is no mechanism to upload audit report electronically. Further, the Section 80IA(7) states audit report to be filed along with the "return of income". Now, the debatable issue is whether 'return of income' means original return of income only or does it include belated / revised returns of income

also. If the intent of legislature is to make filing of audit report mandatory along with original return of income then the phrase "return of income" may be changed to "return of income under Section 139(1) of the Act". Also, the Department can think of changing the format of e-filed return ITR-4 to include details that are required to be filed in the requisite Form 10CCB so that there is no need to further file the audit report manually.

- **Clarification regarding nature of certain provisions; mandatory or directory**:- Although, all the conditions mentioned in various provisions of the Sections of the Act including Section 80IA/80IB of the Act are intended to be mandatory in nature i.e. to be complied in strict and literal manner. However, especially in respect of these beneficial sections, Hon'ble Courts on several issues have stated that the conditions mentioned in the sections are not mandatory but are merely directory in nature particularly in respect of filing of details like returns, audit reports. Inspite of Circulars and Explanation Memorandum clearly stating the mandatory nature of conditions, the Courts have taken liberal view on several occasions. One way out can be that, the Department may come out with an umbrella Circular / guidance note stating the sections and the conditions thereof that are exclusively mandatory in nature so that there is no ambiguity in this regard.

12.1 The **Section 80IA(3)** stipulates condition that deduction shall not be available in cases where the undertaking is formed by splitting up, or the reconstruction, of a business already in existence. What constitutes splitting/reconstruction is a matter

of debate. When an assessee acquires under a slump sale the entire business consisting of eligible undertakings, whether the assessee violates the condition of splitting/reconstruction mentioned above? Where the ownership of a business or undertaking changes hands, whether the eligibility for deduction is attached with the undertaking or with the person/ entity who owns the undertaking?

12.2 There are several litigation issues in respect of **Section 80IB(10)** like whether deduction is available to the person who is developing and building housing project who doesn't have the ownership over the land ? Whether the developer/contractor should follow the accounting method of "percentage completion method" or "project completion method"? Whether breach in upper limit of 1500 sq. ft. for built-up area in Delhi and Mumbai for some of the units would warrant disqualification of deduction for whole of the project or on proportionate basis ? What should be the treatment of common area, commercial area in housing project ?

The Explanation to **Section 80IA(4)(i)** states the meaning of "infrastructure facility" as (a) road including toll road, a bridge or a rail system (b) a highway project .....(c) a water supply project, water treatment system, irrigation project.....(d) a port, airport, inland waterway, inland port or navigational channel in the sea. As seen from the Explanation defining "infrastructure facility", most of the facility mentioned are in the nature of system or project

whereas clause (d) states a port, airport etc. Thus, this has led to debate what exactly is a port? Whether work of creating facility related to part of the port system fall under the definition of "infrastructure facility". Although Circular No. 793 dt. 23.06.2000 has defined the meaning of port but still this has not settled disputes. The moot question remains, whether the intent of the section is to provide deduction benefits only to those enterprise who are involved in carrying on business of (i) developing or (ii) operating and maintaining or (iii) developing, operating and maintaining of whole of the project or system or deduction is also available to facilities forming sub-part of the project/system ?

12.3 There are several debatable issues related to **Section 80IB(9)** providing deduction to undertaking for a period seven consecutive assessment years engaged in refining of mineral oil or commercial production of natural gas in blocks. The amendment made by Finance Act 2009 vide the Explanation, explaining the meaning of 'undertaking' as all blocks licensed under a single contract, has got into controversy with the writ petition filed by M/s Niko Resources and M/s Jyothi Technologies. These assesses claim to interpret 'undertaking' as one well or cluster of wells and not the whole block for the purpose of deduction. Therefore, the meaning of 'undertaking' as per Section 80IB(9) is under controversy. Secondly, the assessee claim that the period of deduction of seven years is applicable for each well/cluster of wells separately, however, the Department is of the view

that the deduction is available for the period of 7 years for the whole block in view of the definition of undertaking. Further, the amendment vide Finance Act 2009 inserting Section (iv) and (v) to 80IB(9) clearly reveals the intent of the legislature that prior to the amendment no deduction was available in respect of Natural Gas, whereas several assesses have claimed that Mineral Oil includes Natural Gas prior to this amendment also.

15 Deduction in respect of Co-operative Societies – Section 80P

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1. Section 80P

The provisions of Section 80P are reproduced hereunder:

80P. (1) Where, in the case of an assessee being a co-operative society, the gross total income includes any income referred to in sub-section (2), there shall be deducted, in accordance with and subject to the provisions of this section, the sums specified in sub-section (2), in computing the total income of the assessee.

(2) The sums referred to in sub-section (1) shall be the following, namely:

(*a*) In the case of a co-operative society engaged in –

(i) Carrying on the business of banking or providing credit facilities to its members, or

(ii) A cottage industry, or

(iii) The marketing of agricultural produce grown by its members, or

(iv) The purchase of agricultural implements, seeds, livestock or other articles intended for agriculture for the purpose of supplying them to its members, or

(v) The processing, without the aid of power, of the agricultural produce of its members, or

(vi) The collective disposal of the labour of its members, or

(vii) fishing or allied activities, that is to say, the catching, curing, processing, preserving, storing or marketing of fish or the purchase of materials

and equipment in connection therewith for the purpose of supplying them to its members, the whole of the amount of profits and gains of business attributable to any one or more of such activities:

Provided that in the case of a co-operative society falling under sub-clause (*vi*), or sub-clause (*vii*), the rules and bye-laws of the society restrict the voting rights to the following classes of its members, namely:

(1) The individuals who contribute their labour or, as the case may be, carry on the fishing or allied activities;

(2) The co-operative credit societies which provide financial assistance to the society;

(3) The State Government;

(b) In the case of a co-operative society, being a primary society engaged in supplying milk, oilseeds, fruits or vegetables raised or grown by its members to –

(i) A federal co-operative society, being a society engaged in the business of supplying milk, oilseeds, fruits, or vegetables, as the case may be; or

(ii) The Government or a local authority; or

(iii) A Government company as defined in Section 617 of the Companies Act, 1956 (1 of 1956), or a corporation established by or under a Central, State or Provincial Act (being a company or corporation engaged in supplying milk, oilseeds, fruits or vegetables, as the case may be, to the public), the whole of the amount of profits and gains of such business;

(c) In the case of a co-operative society engaged in activities other than those specified in clause (a) or clause (b) (either independently of, or in addition to, all or any of the activities so specified), so much of its profits and gains attributable to such activities as does not exceed,

(i) Where such co-operative society is a consumers' co-operative society, [one hundred] thousand rupees; and

(ii) In any other case, fifty thousand rupees.

Explanation. – in this clause, "consumers' co-operative society" means a society for the benefit of the consumers;

(d) in respect of any income by way of interest or dividends derived by the co-operative society from its investments with any other co-operative society, the whole of such income;

(e) In respect of any income derived by the co-operative society from the letting of godowns or warehouses for storage, processing or facilitating the marketing of commodities, the whole of such income;

(f) in the case of a co-operative society, not being a housing society or an urban consumers' society or a society carrying on transport business or a society engaged in the performance of any manufacturing operations with the aid of power, where the gross total income does not exceed twenty thousand rupees, the amount of any income by way of interest on securities or any income from house property chargeable under Section 22.

Explanation – For the purposes of this section, an "urban consumers' co-operative society" means a society for the benefit of the consumers within the limits

of a municipal corporation, municipality, municipal committee, notified area committee, town area or cantonment.

(3) In a case where the assessee is entitled also to the deduction under Section 80HH or Section 80HHA or Section 80HHB or Section 80HHCor Section 80HHD or Section 80 or Section 80-IA or Section 80J, the deduction under sub-section (1) of this section, in relation to the sums specified in clause (*a*) or clause (*b*) or clause (*c*) of sub-section (2), shall be allowed with reference to the income, if any, as referred to in those clauses included in the gross total income as reduced by the deductions under Section 80HH, Section 80HHA, Section 80HHB,section 80HHC, Section 80HHD,section 80-I,section 80-IA,section 80J and Section 80JJ.

(4) The provisions of this section shall not apply in relation to any co-operative bank other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank.

Explanation – For the purposes of this sub-section, –

(a) "Co-operative bank" and "primary agricultural credit society" shall have the meanings respectively assigned to them in Part V of the Banking Regulation Act, 1949 (10 of 1949);

(b) "Primary co-operative agricultural and rural development bank" means a society having its area of operation confined to a taluk and the principal object of which is to provide for long-term credit for agricultural and rural development activities.

2. Analysis

A perusal of various provisions of Section 80P indicates

that the provisions are meant for deductions in respect of income of the co-operative societies. It is noted that various words /terms used in the section have not been defined in the Act except the definitions of co-operative society, co-operative bank and primary co-operative agricultural and rural development bank. Therefore, other terms used in the section will have to be interpreted by using the common meaning of those words and the interpretations made by various judicial forums such as ITAT, High Courts and the Hon'ble Supreme Court. In order to have a clear and easy understanding of various provisions of the section, the provisions are being discussed in the order it appears in the section.

Definition of Co-operative Society:

The word "Co-operative Society" has been defined in the Act in Section 2(19), which read as under:

"Co-operative society means a society registered under the Co-operative Societies Act, 1912, or under any other law for the time being in force in any State for the registration of co-operative societies."

Further as per Circular No. 319, dated January 11, 1982 a regional rural bank (to which provisions of the Regional Rural Banks Act, 1976, apply) is deemed as co-operative society.

2.1 Income of banking business [Section 80P(2)(a)(i)]

In the case of a co-operative society providing credit facilities to its members, the whole of the amount of profits and gains from such business are deductible. From the assessment year 2007-08, deduction under Section 80P will not be available to any co-operative bank (even Regional Rural Banks will not be eligible

for deduction under Section 80P – **Circular No. 6/2010,** dated September 20, 2010). A primary agricultural credit society or a primary co-operative agricultural and rural development bank will continue to claim the benefit of deduction under Section 80P. Various terms used in this section has been interpreted by various courts in the following manner:

2.1.1 Meaning of Credit Facilties

- The expression 'facilities' used in the provision is an inclusive term of wide import embracing anything which aids or makes easier the performance of a duty – Andhra Pradesh Co-op. Central Land Mortgage Bank Ltd. v. CIT [1975] 100 ITR 472 (AP).
- The expression 'providing credit facilities' would comprehend not only the business of lending money on interest but also the business of lending services for guaranteeing payments – CIT v. U.P. Co-op. Cane Union Federation Ltd. [1980] 122 ITR 913 (All.).
- When Section 80P (1)(a)(i) refers to a co-operative society engaged in providing credit facilities to its members, it really refers to a credit society whose primary object is to provide loans or other credit facilities to its members; it does not include any society whose primary object is something other than the provision of loans or other credit facilities, such as a consumer co-operative society – Rodier Mill Employees' Co-op. Stores Ltd. v. CIT 135 ITR 355 (MAD).

2.1.2 **Meaning of Members**

- In Section 80P(2)(*a*)(*i*) when Parliament has used the expression "members", it has used it in the normal sense of a member of a co-operative society. The intention was to extend the exemption to co-operative societies directly extending credit facilities to its members. There is nothing in the said provisions to show that the intention was to grant exemption to co-operative societies which were extending credit facilities to the person, who, though not the members of the said society, were members of another co-operative society which was a member of the co-operative society seeking exemption. The meaning of the expression "members" cannot, therefore, be extended to include the members of a primary co-operative society which is a member of the federated co-operative society seeking exemption – *U.P. Co-operative Cane Union Federation Ltd.* v. *CIT* [1999] 237 ITR 574/103 Taxman 376 (SC).

In addition to the above judgments which are defined important terms used in section80P (2) (a) (i) the following judgments are also worth noting and must be kept in mind while making the assessment-

- The facility of selling goods on credit to members is an activity of business of selling of goods, of which the credit facility is only an incidence; it will **not amount to providing credit facilities** in the nature of the business

of banking so as to amount to carrying on the business of banking or providing credit facility to its members – CIT v. Co-operative Supply & Commission Shop Ltd. [1993] 204 ITR 713 (Raj.), CIT v. Kerala State Co-operative Marketing Federation Ltd. [1998] 234 ITR 301 (Ker.).

- Conducting chit fund amounts to providing credit facilities – CIT v. Kottayam Co- operative Bank Ltd. [1974] 96 ITR 181 (Ker.).
- Selling goods on hire-purchase basis does not amount to providing credit facilities – CIT v. Madras Autorickshaw Drivers' Co-operative Society Ltd. [1983] 143 ITR 981 (Mad.).
- Where the assesee-society had been carrying on business of providing facilities to its members for obtaining fertilizers, etc., as also arranging loans from bank by giving certificates about cultivated land,etc., for which certain amount was charged as service charges,such service charges received by the assessee would not be eligible for deduction under Section 80P(2)(a)(i) – CIT v. Anakapalli Co-op. Marketing Society Ltd. (2000) 111 Taxman 702/ 245 ITR 616 (AP).
- If a society regularly earns interest on funds (not required immediately for business purposes), such interest income is taxable under Section 56 under the head "Income from other sources" and not eligible for deduction under Section 80P – Totgars' Co-operative Sale Society Ltd. v. ITO [2010] 188 Taxman 282 (SC).

- Interest received on income-tax refund is subject to deduction under Section 80P(2)(*a*)(*i*) – Maharashtra State Co-operative Bank Ltd. v. CIT [2010] 38 SOT 325 (Mum.)(SB), CIT v. Haryana State Co-operative Apex Bank Ltd. [2010] 322 ITR 404 (Punj. & Har.).

2.2 Cottage industry [Section 80P(2)(a)(ii)]

In the case of a co-operative society engaged in cottage industry, the whole of the amount of profits attributable to such activity are deductible under Section 80P(2)(a)(ii). The Circular No. 722, dated September 19, 1995 issued by CBDT defines the term cottage industry and has laid down various criteria which should be verified before granting the deductions in a case. Para-3 of the circular reads as under :

"What constitutes a "cottage industry" has been the subject- matter of discussion in a number of cases decided by various courts. The term as such does not define in the Act. Based on the ratio of the decision, a co-operative society engaged in cottage industry is required to broadly satisfy the following criteria for availing of the benefits under Section 80P(2)(*a*)(*ii*) –

a. Cottage industry is one which is carried on in a small scale with a small amount of capital and a small number of workers and has a turnover which is correspondingly limited;

b. It should not be required to be registered under the Factories Act;

c. It should be owned and managed by the co-operative society;

d. The activities should be carried on by the members of the society and their families [for this purpose, a family would include self, spouse, parents, children, spouses of the children and any other relative who customarily lives with such a member. Outsiders (i.e., persons other than members and their families) should not work for the society. In other words, the co-operative society should not engage outside hired labour. [However, it has certain exceptions];

e. A member of co-operative society means a shareholder of the society;

f. The place of work could be an artisan shareholder's residence or it could be a common place provided by the co-operative society;

g. The cottage industry must carry on activity of manufacture, production or processing; it should not be engaged merely in trade, *i.e.,* purchase and sale of the same commodity.

Para-4 of the same circular also explains that in the case of a weaver's society, so long as weaving is done by the members of the society at their residences or at a common place provided by the society, without any outside labour, such a society will be eligible for deduction under Section 80P(2)(a)(ii) even if certain payments have been made to outside agency for dyeing, bleaching, transport arrangements, etc., provided it satisfies all other conditions necessary for availing deduction under Section 80P(2)(a)(ii).

The following important judgments should also be kept in mind before accepting or refusing the claim

of the assessee for deduction in this section.

- A cottage industry is one which is carried on by the artisan himself using his own equipment with the help of the members of the family. It is the family unit which provides the labour force. The idea of cottage industry is alien to the idea of industry where hired labour is engaged and the relationship of employer and employee exists – Distt. Co-op. Development Federation Ltd. v. CIT [1973] 88 ITR 330 (All.).
- It has been held by the Kerala High Court that where members of the assessee, a co-operative society, were artisans weaving handloom cloth and workers were carrying out work in thatched shed belonging to the assessee, where looms were kept, the assessee was engaged in a cottage industry and was entitled to relief under Section 80P(2)(a)(ii).
- A co-operative society can be regarded as a family consisting of its members and the premises belonging to the society can be regarded as its home or cottage – CIT v. Chichli Brass Metal Workers Co-op. Society Ltd. [1978] 114 ITR 720 (MP).
- Before it can be said that a co-operative society is engaged in an industry, it is necessary that there must be an activity relating to an industry. An industry obviously implies manufacture of certain articles and it cannot embrace a business of mere purchase and sale of goods – CIT v. Indian Co-operative Union Ltd. [1982] 134 ITR 108 (Delhi).
- An apex society for coir marketing cannot be said to be engaged in regard to any affairs of cottage industry

so as to be entitled to deduction under Section 80P(2)(a)(ii) – CIT v. Quilon Central Coir Marketing Co-operative Society Ltd. [1998] 229 ITR 348 (Ker.).

- The assessee-society had the power to direct, supervise and control over the manufacturing of cloth through the primary societies which were the members of the assessee-society. Members of the primary societies ran cottage industries in their houses. In these circumstances, it could not be said that the assessee-society was not engaged in the manufacturing activities carried out by the weavers. The weavers got the raw material, *i.e.*, yarn through their primary societies, but thereafter weaving charges were paid by the assessee and it purchased the cloths through primary societies- CIT v.Rajasthan Rajya Bunker Sahakari Sangh Ltd. [2002] 24 Taxman 135 (Raj.).
- Expression 'whole of the amount of profits and gains of business attributable to any one or more of such activities' indicates that deduction under Section 80P (2) (*a*) is to be given to the extent of whole of profit attributable to cottage industry without deducting there from any loss arising in any other activity – CIT v. Agency Marketing Co-operative Society Ltd. [1993] 201 ITR 881 (Ori.).

2.3 Marketing of Agricultural Produce [Section 80P(2)(a)(iii)]

The whole of the amount of profits attributable to the marketing of agricultural produce grown by the members of society is deductible under Section 80P (2) (a) (iii). For this clause also the help is to be taken

for interpreting the term marketing which is nowhere defined in the Act. The common meaning of the marketing is the effort or the sum total of the activities which are involved or put for taking a particular product or good to the sale point or to the market where it is ultimately sold.

The Courts have held that 'Marketing' is an expression of wide import, and it generally means 'the performance of all business activities involved in the flow of goods and services from the point of initial agricultural production until they are in the hands of the ultimate consumer'. The marketing functions involve exchange functions such as buying and selling physical functions such as storage, transportation, processing and other commercial functions such as standardization, financing, market intelligence, etc. The leading judgments regarding this definition are – CIT v. Karjan Co-op. Cotton Sale Ginning & Pressing Society Ltd. [1981] 129 ITR 821 (Guj.). CIT v. Ryots Agricultural Produce Co-op. Marketing Society Ltd. [1978] 115 ITR 709 (Kar.) and Meenachil Rubber Marketing & Processing Co-operative Society Ltd. v. CIT [1992] 193 ITR 108 (Ker.),

The following judgments are also worth noting:

- **Manufacture of sugar** - Where the assessee, a co-operative society, incorporated for manufacture of sugar, purchased sugarcane from its members as well as non-members as well as a co-operative society and manufactured sugar to sell the same in open market to earn profit, since profit so derived was not on account

of marketing of sugarcane of its members but was on account of manufacturing of sugar out of sugarcane purchased on its own account, deduction claimed under Section 80P(2)(a)(iii) would not be available thereon to the assessee society – Kamal Co-op. Sugar Mills Ltd. v. Dy. CIT [1998] 66 ITD 521 (Delhi).

- **Buying Sugar cane" and "selling sugar" is not "marketing of agricultural produce" "grown by it's members":**

  The Hon. Supreme Court in the case of Assam Co-operative Apex Marketing Society Ltd. v. CIT [1993] 201 ITR 338 wherein the Society engaged in marketing of agricultural produce of its members also had other co-operative societies as its members. Since the agricultural produce marketed by the Society was not produced by the primary marketing Societies, being its members, the assessee society was not held to be entitled to exemption under Section 81(1)(c) [now Section 80P(2)(a)(iii)].

- The Hon'ble Punjab & Haryana High Court in the case of Karnal Co-operative Sugar Mills Ltd. v. CIT [2001] 170 CTR (P&H) 590 : [2002] 253 ITR 659 (P&H) has held as under :

  .....assessee processed the sugarcane. It manufactured and sold sugar. The product which was sold in the market did not belong to the members. Sugar had not been described as an agricultural produce in the Act. Thus, it could not be said that the petitioner was marketing an agricultural produce. The society was incorporated for the primary purpose

of manufacturing sugar. Thus, its basic activity was production of sugar.

It was engaged in manufacturing and not marketing. Since, it was the admitted position that the petitioner was using power and even paying excise duty, it was not entitled to the special deduction under Section 80P(2)(*a*)(*iii*)."[Gurdaspur Co-Op. Sugar Mills *v.*Deputy Commissioner of Income-tax [2009] 122 TTJ 528(ASR)].

- Assessee buying surgarcane from agriculturists, crushing same and then selling sugar , was not entitled to deduction under Section 80P(2)(a)(iii) [In favour of revenue] [Assessment year 2003-04] Gurdaspur Co-Op. sugar Mills *v.*Deputy Commissioner of Income-tax [2009] 122 TTJ 528(ASR).
- Poultry farming being an extended form of agriculture, eggs qualify to be treated as 'agricultural produce' – CIT v. Mulkanoor Co-op. Rural Bank Ltd. [1988] 173 ITR 629 (AP).
- Amount of subsidy received by the assessee from National Co-operative Development Corpn. towards loss incurred on account of price fluctuation qualifies for deduction – CIT v. Punjab State Co-operative Supply & Marketing Federation Ltd. [1989] 46 Taxman 156/ [1990] 182 ITR 58 (Punj. & Har.).

2.4 Purchase of agricultural implements [Section 80P(2)(a)(iv)]

Whole of income from the purchase of agricultural implements, seeds, livestock or other articles intended

for agriculture for the purposes of supplying them to its members is deductible under Section 80P(2)(*a*)(*iv*). While granting the deduction under this section, the following judgements and points should be kept in mind.

- It is necessary that the assessee must prove that it has purchased certain articles, which means that it has acquired property in certain articles, and those articles have been sold to the members – Vidarbha Co-op. Marketing Society Ltd. v. *CIT* [1985] 156 ITR 422 Bombay.
- Section 80P (2) (a) (iv) does not require that the supplies shall be made by the co-operative society only to members and to no one else – *CIT* v. Guntur Distt. Co-op. Marketing Society Ltd. [1985] 154 ITR 799 (AP). However, deduction is not available under Section 80P (2) (a) (IV) in respect of profit on sale of commodities to non-members – CIT v. Vidarbha Co-operative Marketing Society Ltd. [1995] 212 ITR 327 (Bom.).
- The expression 'members' in Section 80P (2) (a) (iv) cannot be restricted to either a member of a primary society or to an agriculturist alone (Apex Society can also claim deduction) – CIT v. Tamil Nadu Co-op. Marketing Federation Ltd. [1983] 144 ITR 744 (Mad.).
- Coal is not an article which can be described as an "article intended for agriculture" – U.P. Co-operative Federation Ltd. v. CI*T* [1972] 84 ITR 317 (All.).
- It cannot be said that cattle-feed meant for livestock has no connection with agricultural operations and as such is outside the exemption contemplated under Section 80P(2)(*a*)(*iv*) – CIT v. Thudialur Co-operative Agricultural Services Ltd. [1997] 143 CTR (Mad.) 362.

- Where the assessee was a co-operative marketing federation registered under the Co-operative Societies Act, and it mainly dealt, inter alia, in general fertilizers, products from mixing units, etc., it would be entitled to deduction in respect of profit from sale of fertilizers to its members – CIT v. Tamil Nadu Co-operative Marketing Federation Ltd. [1999] 151 CTR (Mad.) 232.
- Where the assessee undertook schemes to lift water from rivers known as Lift Irrigation Scheme and the water lifted by the assessee was supplied by it to its members for the purpose of cultivation, water being purchased by the assessee, the assessee would be entitled to deduction in respect of income from Lift Irrigation Scheme – CIT v. Shetkari Sahakari Sakhar Karkhana Ltd. [1999] 107 Taxman 532/238 ITR 983 (Bom.).
- By purchasing different kinds of manures and pesticides and mixing them up for the purpose of selling the same to the small farmers in retail, it cannot be said that the assessee is indulging in any manufacturing activity or processing of goods, so as to disentitle it to exemption under Section 80P(2)(a)(iv) – CIT v. Thudialur Co-operative Agricultural Services Ltd. [1997] 143 CTR (Mad.) 362.

2.5 Processing of agricultural produce [Section 80P(2)(a)(v)]

Income from the processing (without the aid of power) of the agricultural produce of its members is deductible under Section 80P(2)(*a*)(*v*). For this section the word "processing" and the "agricultural produce" are important. These terms have not been defined in the Act but have been used in other sections also

and therefore, for defining these words help should be taken from the judgements which are given by various Courts while dealing the issues arising in other sections.

The most important point to be taken note is that the processing should be done without the aid of power. The condition of 'grown' by its member is not stipulated here as compared to clause (iii). However, in my opinion, the clause requires that the agricultural produce should be grown by the members of the society. Only in that condition the deduction can be claimed. In case the produce is bought from open market and is brought for processing, no deduction should be allowed.

2.6 Collective disposal of labour [Section 80P(2)(a)(vi)]

Income from the activity of collective disposal of the labour of its members is deductible under Section 80P (2) (a) (vi). This section has been introduced mainly for the labour co-operative societies. These societies consist of the persons who are offering their services as labour through it. The labour can be manual or some technical or other similar services. The following judgments also clarify the deduction and should be kept in mind while dealing with the case.

- This deduction is available only when the earning of the society is through the utilisation of the actual labour of its members. Thus, a society of engineers engaged in collective disposal of labour of members where actual supervision of work in field is done by paid employees, will not be entitled to exemption, since there is no direct connection between the work

executed and the speciality of members of the society as engineers – Nilagiri Engg. Co-op. Society Ltd. v. CIT [1994] 208 ITR 326 (Ori.).

- Where not only members but also a large number of non-members were contributing collective disposal of labour and condition laid down in proviso to Section 80P(2)(*a*)(*vi*) was not fulfilled, the assessee-society would not be entitled to exemption of its income – Assessing Officer v. Ganesh Co-op. (L&C) Society Ltd. [1998] 67 ITD 436 (Asr.).

The proviso below sub- Section (vi) & (vii) imposes further restriction on the voting rights of the members of the society. It provides that the deduction shall be available only to the societies subject to the conditions that the rules and bye-laws of the society restrict the voting rights to the following classes of its members:

a. Individuals, who contribute their labour;

b. the co-operative credit societies which provide financial assistance to the society; and

c. the State Government.

For this section an important landmark judgment given by the Hon'ble Gujarat High Court i.e. jurisdictional High Court in the case of Gora Vibhag Jungle Kamdar Mandali v. *CIT* [1986] 161 ITR 658 (Guj.) should be kept in mind while analyzing the claim of the assessee. According to this judgement, if the co-operative society as specified in sub-clause (*vi*) wants to claim full deduction of the profits made by it, persons other than those falling under the three specified categories can be members of the society, but they should not be given the right to vote and that fact should be clearly

borne out from the rules and bye-laws restricting the right to vote only to members specified in the proviso.

2.7 Fishing and allied activities [Section 80P(2)(a)(vii)]

The whole of the profits of a co-operative society engaged in fishing and allied activities are deductible under Section 80P(2)(vii). Fishing and allied activities include the catching, curing, processing, preserving, storing or marketing of fish or the purchase of materials and equipment in connection therewith for the purpose of supplying them to its members. The Proviso regarding restriction of voting rights which has been discussed in the preceding paragraph is also applicable to this sub-clause and, therefore, while allowing the deduction the bye-laws of the societies should be analysed and it should be verified whether the voting rights confirm to the Proviso or not.

Accordingly, the class of members entitled to voting rights should be individuals who carry on the fishing or allied activities, the co-operative credit societies which provide financial assistance to the society and the State Government.

2.8 Primary society engaged in supply of milk, oil seeds, fruits, etc. [Section 80P(2)(b)]

The deductions of the whole of the amounts of profits and gains of a co- operative society is available if the following conditions are satisfied-

1. The co-operative society is a primary society engaged in supplying milk, oil seeds, fruits or vegetables.
2. Milk, oil seeds, fruits or vegetables are grown or raised by its members.

3. Milk, oil seeds, fruits or vegetables are supplied to the following:

To whom milk, oil seeds, etc. are supplied	Object of the society/company to whom milk, oil seeds, etc. are supplied
A federal co-operative society	It must be engaged in the business of supplying milk, oil seeds, fruits or vegetable as the case may be.
The Government or a local authority	–
A Government company or a statutory corporation	The company/corporation must be engaged in the business of supplying milk, oil seeds, fruits or vegetables as the case may be.

2.9 Income from other activities [Section 80P(2)(c)]

If a co-operative society is engaged in any other activity (either independently or in addition to those specified in clause (a) or clause (b) then the following amount is deductible under Section 80P(2)(*c*) :

a. In the case of a consumer co-operative society (*i.e.,* a society for the benefits of consumers): Rs. 1,00,000; and

b. In any other case: Rs. 50,000.

This is a general deduction available to any co-operative society which does not carry any of the activities which are specified. The explanation below this clause also defines the consumer's co-operative society as a society for the benefit of consumers.

As it is evident from the language of the section that it is a general section and no specific restriction or classification has been made. It only mentions the cases which are to be excluded and, therefore, there

is bound to be litigation on the issue. Therefore, the following points/ judgments should also be kept in view while deciding the cases in this clause –

- Though income derived by the assessee co-operative housing society from letting out of shops to persons other than its members is not its primary activity, but being an activity in addition to its primary activity, it would fall within ambit of Section 80P(2)(*c*), and, therefore, the assessee would be entitled to deduction in respect of profits and gains attributable to the activity of letting out of shops to non-members – CIT v. Ratanabad Co-operative Housing Society Ltd. [1995] 81 Taxman 257/215 ITR 549 (Bom.).

- This rule is applicable in the case of a co-operative society engaged in the business of letting out of building (maybe shops) even if such income is computed under the head "Income from house property" – *Film Nagar Co- operative Housing Society Ltd.* v. *ITO* [2004] 91 ITD 27 (Hyd.) (SC).

- The rule is not applicable if the society is not engaged in the letting out of buildings, where surplus land is given on rent, such income is not subject to deduction under Section 80P(2)(*c*) – Kottayam District Co-operative Bank Ltd. v. CIT [1988] 172 ITR 443 (Ker.).

- A co-operative bank is legally obliged to invest part of deposit received from its members as reserve fund in Government Securities. Generally

such reserve funds cannot be utilized as working capital and the same can be withdrawn only to meet losses or when the bank is wound up. Interest on such Government securities cannot be treated as essential part of banking activity as the same is not part of stock-in-trade or working/ circulating capital. Such interest income is not fully deductible under Section 80P(2)(a)(i), but deduction is available under Section 80P(2)(*c*) – Madhya Pradesh Co-operative Bank Ltd. v. CIT [1996] 84 Taxman 640 (SC).

- Where the assessee a co-operative society running a sugar mill had not commenced any business of production of sugar and its activities undertaken were pre-operative activities, it was not entitled to deduction under Section 80P(2)(*c*) – National Co-operative Sugar Mills Ltd. v. CIT [1998] 96 Taxman 352 (Punj. & Har.). Karnal Co-operative Sugar Mills Ltd. v. CIT [1998] 233 ITR 531 (Punj. & Har.).

- A society supplying coal and diesel to its members, who are manufacturers of bricks and tiles, is not a "consumer" co-operative society. A "consumer society" means a registered society which has as its principal object the supply of the requirements of its members for the consumption of such members. Tamil Nadu Brick & Tile Mfrs. Industrial Service Co-operative Society Ltd. v. CIT [2003] 129 Taxman 343 (Mad.).

2.10 Interest/ Dividend Income [Section80P(2)(d)]

The whole of interest and dividend income derived by a co-operative society from its investments in any other co-operative society is deductible under Section 80P(2)(*d*). The provisions of this clause are very clear and almost all the terms are clearly defined. However, the term 'whole of interest and dividend' has been subject matter of litigation. The judgment on the issue indicates that the deduction is for the entire income without adjusting the outgoings. The Hon'ble Courts have held as under :

In Totgars' Co-operative Sale Society Ltd. v. ITO [2010] 188 Taxman 282 (SC) it was held that the words 'the whole of the amount of profits and gains of business' emphasise that the income, in respect of which deduction is sought, must constitute the operational income and not the other income which accrues to the society.

Interest derived by the assessee co-operative sugar mill from its investment in co-operative bank would qualify for deduction in its entirety under Section 80P(2)(d), without adjustment of interest paid by the assessee to the co-operative bank – CIT v. Doaba Co-operative Sugar Mills Ltd. [1998] 96 Taxman 509/230 ITR 774 (Punj. & Har.).

In another judgment of ITAT Chandigarh in the case of ITO Vs. Punjab State Co-operative Milk Producers Federation Ltd.(2010) 3 ITR (Trib.) 586 it has been held that the exemption would only be on the net income there from and not on the entire interest receipts.

Therefore, considering the language of the section and contradictory opinion of the judicial forums, the A.O. should verify whether there is a nexus between the income and the expenditure and in case it is noted that certain expenditure is attributable to the exempt income, the same should be reduced before granting the deduction. Needless to say that the facts in each case should carefully be noted and the A.O. should not be guided merely by the judicial pronouncements.

2.11 Letting of godowns [Section 80P(2)(e)]

The whole of the income derived by a co-operative society from the letting of godowns or warehouses for storage, processing or facilitating the marketing of commodities is deductible under Section 80P(2)(*e*). For this clause the term godown or warehouses is very important and in a landmark judgment in the case of CIT v. Ahmedabad Maskati Cloth Dealers Co-operative Warehouses Society Ltd. [1986] (162 ITR 142) the Hon'ble Gujarat High Court has defined these words. The Court has held that first of all it should be a godown or warehouse which should be let out for the purpose specified in the clause. However, if the godown or warehouse is let for a purpose other than storage, processing or facilitating the marketing of commodities, the income derived there- from by a co-operative society would not be deductible under Section 80P. The judgment is very important and should be kept in mind. The facts of letting out are very important and the A.O. should get the inspection of the let-out property done to ascertain the correct facts.

The judgement of Hon'ble Supreme Court is also important – Udaipur Sahkari Upbhokta Thok Bhandar Ltd. v. CIT [2009] 182 Taxman 287 (SC). While delivering the judgment it has been held by the Hon'ble Court that the deduction is available in respect of income derived from the letting out of godowns and warehouses only where the purpose of letting is storage, processing or facilitating marketing of commodities. In that case the facts revealed that the assessee was storing commodities in its godowns as its own trading stock and, therefore, it was held to be not entitled for claim of deduction under Section 80P(2)(*e*).

The A.O. should also keep in view the following judgments –

- Commission received by the assessee-society from State Government for stocking its goods in godown, would qualify for deduction under Section 80P(2)(*e*) – CIT v. Coimbatore District Central Co-op. Supply & Marketing Society Ltd. 1995 Tax LR 1308 (Mad.).
- The commission received by the assessee, a co-operative society, from Food & Civil Supplies Corporation for procurement of paddy and rice and reimbursement of transport charges in relevant assessment year, was not eligible for deduction under Section 80P(2)(*e*) – Udupi Taluk Agricultural Produce Co-operative Marketing Society Ltd. v. CIT [1987] 166 ITR 365 (Kar.).
- Shops in which wholesale or retail business in cloth is carried on, cannot come within the meaning of 'godowns' or 'warehouses' – CIT v. Ahmedabad Maskati Cloth Dealers Co-operative Warehouses Society Ltd. [1986] 162 ITR 142 (Guj.).
- Amount received for letting of godowns, where incidental

services of taking delivery of stock at rail-head and transporting it to godowns are also rendered is wholly exempt – *CIT* v. South Arcot District Co-operative Marketing Society Ltd. [1989] 176 ITR 117/43 Taxman 328 (SC).

- Where the assessee-co-operative society is appointed the sole agent and entrusted with the handling, distribution and sale of fertilizers and it received commission-cum-incidental charges, it is entitled to exemption only on that part of its income which is attributable to storage of fertilizers in its godowns – CIT v. J & K Co-operative Supply & Marketing Federation Ltd. [1993] 204 ITR 289 (J & K).

- Deduction under Section 80P(2)(*e*) is available only in respect of income from letting out of storage and if the assessee uses storage only for marketing, deduction is not permissible – CIT v. Haryana State Co-op. Supply & Marketing Federation Ltd. [2011] 201 Taxman 169 (Punj. & Har.).

2.12 Interest on securities/property income [Section 80P(2)(f)]

The whole of the interest income from securities and property income in the case of a co-operative society (other than housing society or an urban consumers' society or a society carrying on transport business or a society engaged in manufacturing operations with the aid of power) is deductible under Section 80P(2)(f) provided the gross total income of such co-operative society does not exceed Rs. 20,000.

2.13 Computation of deduction [Section 80P(3)]

This section provides that the deduction under Section80P shall be computed after reducing the gross

total income by certain sections mentioned therein. Accordingly deduction under Section 80P in respect of business income of a co-operative society shall be available with reference to income after claiming deduction under sections 80HHB, 80HHC, 80HHD and 80-IA.

2.14 Withdrawal of Deduction for Co-operative Banks [Section 80P(4)]

The deduction under Section 80P is not available for Co-operative banks from A.Y. 2007-08. It has been explained by the Finance Minister while moving the amendment that the co-operative banks were functioning at par with other commercial banks, which do not enjoy any tax benefit. Therefore Section 80P has been amended and a new sub-section (4) has been inserted to provide that the provisions of the said section shall not apply in relation to any co-operative bank other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank. The expressions 'co-operative bank', `primary agricultural credit society' have been taken as per the definition given in Part V of the Banking Regulation Act, 1949 (10 of 1949). The `primary co-operative agricultural and rural development bank' have also been defined in the act to bring clarity. The definitions as per BR Act are given in the Appendix to the Act which are clear and self explanatory.

Further, a new sub-section (viia) has also been inserted in clause (24) of Section 2 to provide that the profits and

gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members shall be included in the definition of 'income'.

The CBDT vide Circular No. 6/2010 [F.No. 173(3)/44/2009-IT (A-I)] dated 20-9-2010 has also issued a circular for the sake of clarity the circular is reproduced as under-

"Section 80P of the Income-tax Act, 1961 provides for a deduction from the income of co-operative societies referred to in that section.

As Regional Rural Banks (RRB) are basically corporate entities (and not co-operative societies), they were considered to be not eligible for deduction under Section 80P when the section was originally introduced. However, as Section 22 of the Regional Rural Bank Act provides that a RRB shall be deemed to be co-operative society for the purposes of the Income-tax Act, 1961, in order to make such banks eligible for deduction under Section 80P, CBDT issued a beneficial Circular No. 319 dated 11-1-1982, which stated that for the purpose of Section 80P, a Regional Rural Bank shall be deemed to be a co-operative society.

Section 80P was amended by the Finance Act, 2006, with effect from 1-4-2007 introducing sub-section (4), which laid down specifically that the provisions of Section 80P will not apply to any co-operative bank other than a Primary Agricultural Credit Society or a Primary Co-operative Agricultural and Rural Development Bank. Accordingly, deduction under

Section 80P was no more available to any Regional Rural Bank from assessment year 2007-08 onwards.

An OM dated 25-8-2006 addressed to RBI was issued by the Board clarifying that Regional Rural Banks would not be eligible for deduction under Section 80P of the Income-tax Act, 1961 from the assessment year 2007-08 onwards.

It has been bought to the notice of the Board that despite the amended provisions, some Regional Rural Banks continue to claim deduction under Section 80P on the ground that they are co-operative societies covered by Section 80P(1) read with Boards Circular No. 319 dated 11-1-1982.

It is, therefore, reiterated that Regional Rural Banks are not eligible for deduction under Section 80P of the Income-tax Act, 1961 from the assessment year 2007-08 onwards. Further more, the Circular No. 319 dated 11-1-1982 deeming any Regional Rural Bank to be co-operative society stands withdrawn for application with effect from assessment year 2007-08.

The field officers may take note of this position and take remedial action, if required."

All urban Co operative credit society and Pat-Pedhis are defined by virtue of provisions of [Note :Part V contains amendment in definition] - Section 5(ccii), 5(ccv) and 5(ccvi) of Banking Regulation Act, 1949. Further, Section 5A of Banking regulation Act,1949 overrides Bye laws of the co op credit society whose principal business of

a primary credit society is the transaction of banking business and when its paid up capital and reserves attain the level of Rs.1 lakh, a primary credit society automatically becomes a primary co-operative bank.

Further, vide para 8 in the case of [Salgaon Sanmitra Sahakari Pathpedhi Ltd. *v.* Additional Commissioner of Income-tax, Ward-17(3),Mumbai. - [12 Taxmann.com 246 (2011)] the assessee society was classified as 'co-operative bank' under Section 12(1) of the Maharashtra Co-operative Society Act, 1960 as per the registration certificate issued by the Assistant Registrar, Co-operative Society, Mumbai. Once the urban Co operative credit society and Pat-Pedhis are classified as Bank then they are not eligible for benefit provided under Section 80P of the Income Tax Act,1961, from Assessment Year 2007-08 by virtue of Section 80P(4) read with Section 2(24)(viia) both of income Tax Act, 1961.

Further, Federation doing Banking Activities with co operative credit societies or Pat Pedhi's who are its members and located in urban area is also not entitled for benefit provided under Section 80P of the Income Tax Act,1961, from Assessment Year 2007-08 by virtue of Section 80P(4) read with Section 2(24)(viia) of income Tax Act, 1961. The said view is supported by Kerala State Co-operative Agricultural Rural Development Bank Ltd. Vs. The Assistant Commissioner of Income-tax, Circle-1(2), Trivandrum vide ITA No. 506/Coch/2010 & S.P. No.67/Coch/2010 For AY 2007-08.(unreported but available on internet).

Since the amendment is recent, not many decisions are available on the subject. The issue has not yet been decided by any High Court and only the ITAT cases are available.

The most detailed decisions are in the cases of Kerala State Co-operative Agricultural Rural Development Bank Ltd. Vs. The ACIT and Vidisha Bhopal Kshetriya Gramin Bank, Vidisha VS. ACIT. The gist of the leading judgments on this issue is as under:

i) **Citizen Co-op. Society Ltd. VS. Addl CIT**

Assessee co-operative society was providing banking and credit facilities to its members only. It was found that certain activities carried on by assessee were not as per requirements of principles of co-operative society and that assessee was also engaged in activity of bill discounting and providing accommodation cheques by taking cash from members. In view of aforesaid facts, assessee was held not entitled to deduction under Section 80P. Further it was also held that assessee society being a co-operative bank providing banking facilities to members was not eligible to claim the deduction under Section 80P(2)(i)(a) after introduction of sub-section (4) to Section 80P.--[2012] 24 taxmann.com 347 (HYD.)

ii) **Vidisha Bhopal Kshetriya Gramin Bank, Vidisha VS. ACIT**

Assessee was a regional rural bank engaged in banking and financing activity. It claimed deduction under Section 80P. Assessing Officer rejected assessee's claim holding that assessee was neither a Primary Agricultural Credit Society (PACS) nor Primary co-operative Agricultural and Rural Development Bank (PCARDB). It was noted from records that range of assessee's activities were not confined to one taluk

but was extended to entire district and, thus, in view of Explanation to Section 80P(4), assessee was not PCARDB. Further primary object as well as activities of assessee were not confined to agricultural purposes but other purposes also and, hence, assessee could not be regarded as PACS. In view of above facts, the impugned order of Assessing Officer rejecting assessee's claim was upheld by ITAT.-- [2012] 24 taxmann.com 278 (INDORE) / [2012] 54 SOT 51 (INDORE).

iii) **DCIT VS. Jayalakshmi Mahila Vividodeshagala Souharda Sahakari Ltd.**

The Hon'ble bench considered the provisions of Section 80P of the Income-tax Act, 1961, read with sections 5(b), 5(cci) and 5(ccv) of the Banking Regulation Act, 1949 related to deductions for Income of co-operative societies for Assessment years 2007-08 to 2009-10. The Assessee was a society engaged in business of providing credit facilities to its members by granting loans for purposes like business, housing, vehicles, etc. Section 80P deduction was denied by Assessing Officer in view of amendment brought into Section 80P whereby co-operative banks were excluded from purview of Section 80P with effect from 1-4-2007. Held that since on facts none of assessee's aims and objects allowed assessee to accept deposits of money from public for purpose of lending or investment, it could not be said that principle business of assessee was banking business and , therefore, assessee could not be regarded as a primary co-operative bank and, hence, was not entitled to deduction under Section

80P(2)(a)(i). --[2012] 23 taxmann.com 313 (PANAJI) / [2012] 137 ITD 163 (PANAJI) / [2012] 149 TTJ 356 (PANAJI)

iv) **Kekri Sahakari Bhumi Vikas Bank Ltd. VS. Income-tax Officer**

In view of amendment to Section 80P vide Finance Act, 2006 with effect from 1-4-2007, from assessment year 2007-08 onwards, an assessee would be eligible for relief there under only if it falls within two categories of co-operative banks allowed by Section 80-P(4), i.e., 'primary agricultural co-operative society' and 'primary co-operative agricultural and rural development bank'. Assessee was a co-operative society, formed under Rajasthan State Co-operative Societies Act, 2001 - It filed its return claiming exemption under Section 80P(2)(a)(i). Relying upon amended provisions of Section 80P, Assessing Officer rejected assessee's claim holding that it was engaged in financing activities even other than purely agricultural activities. In order to claim deduction, assessee was required to show that its principal business consisted of providing financial accommodation to its members for agricultural purposes or for purposes connected with agricultural activities (including marketing of crops) and the aforesaid requirement had to be satisfied by assessee independently for each year, as there could well be a change in profile of its lending activities with time. In view of facts stated under heading - 'Deductions - Income of co-operative socieites' and, further having regard to fact that area of operation of

assessee-society exceeded 'a taluk', there was no basis to consider assessee as being a primary co-operative agricultural and rural development bank as defined in Section 80P, so as to be entitled for tax benefit there under on its income.[In favour of revenue] --[2012] 22 taxmann.com 63 (JP.) / [2012] 54 SOT 64 (JP).

v) **Kerala State Co-operative Agricultural Rural Development Bank Ltd. Vs. The ACIT-(I.T.A. No. 506/Coch/2010 & S.P. No.67/Coch/2010)**

The above decision is unreported but can be downloaded from web from ITAT.NIC.IN. The decision is most comprehensive and detailed one on the issue. Hon'ble members have discussed all the provisions of the I.T.Act, BR Act and the NBARD Act which are relevant for the section and have decided the issue. It would be better if the complete decision is read to understand the issue. However, for the sake of brevity, the important paragraphs of the order are reproduced as under-

"4.5 Here it may be pertinent to state that the NBARD Act was enacted by the Parliament in the year 1981 to establish a bank known as `National Bank for Agricultural and Rural Development' (`NBARD' hereinafter), for promoting and regulating credit and other facilities for the promotion and development of agriculture, including agricultural small scale industries and other allied economic activities in the rural areas with a view to promote integrated rural development. The terms `agriculture' and `rural development' stand defined

per ss. 2(a) and 2(q) thereof respectively in very broad and comprehensive terms. It provides loans and advances, by way of re-finance, to inter alia, state co-operative banks for financing agricultural operations and growing of crops; marketing and distribution of inputs necessary for agricultural or rural development; in fact, any activity for the promotion of or in the field of agricultural and rural development, besides also, commercial and trade activities in the rural sector. The same are repayable on demand or on the expiry of fixed periods not exceeding 18 months. It also provides long-term financial assistance to, among others, state co-operative banks, by way of refinancing, for promotion of agricultural and rural development. Section 2(v) of the NBARD Act defines the `state land development bank' as the principal co-operative society in a State which has, as its primary object, the providing of long-term finance for agricultural development. The Notes on Clauses to Finance Bill, 2006, vide clause 19 thereof, clarifies that the deduction under Section 80P, which is qua the income of co-operative societies engaged in, inter alia, carrying on the business of banking or providing credit facilities to its members (s. 80P(2)(a)(i)), is withdrawn for all co-operative banks except primary agricultural credit society and primary co-operative agricultural and rural development bank. As such, but for these two primary units, all the co-operative societies, as covered under Section 80P(2)(a)(i), shall no longer (effective A.Y. 2007-08) be eligible for deduction under Section 80P.

4.6 Continuing further, as would be self-evident, the definition of a `co-operative bank' does not enlist the condition of the conduct of the `business of banking' as the criterion for a co-operative society to be a co-operative bank. In fact, it is not even stated as one of the qualifying activities; the sole and defining activity that qualifies a co-operative society to be a co-operative bank, be it at the primary, district or state level, is the financing of its members, rendering the conduct of the `business of banking', even if so, irrelevant. Clause (viia) stands inserted [by Finance Act, 2006 (w.e.f. 1/4/2007)] in Section 2(24) of the Act, defining `income' inclusively, to include the profits and gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members. Two things, thus, bear mention; firstly, the amendment only impacts co-operative societies and, secondly, only those in the business of banking, which is construed broadly so as to include provision of credit facilities to the constituents.

Now, without doubt, the said profits and gains would even otherwise, i.e., independent of the amendment, qualify to be `income' assessable as business income u/c IV-D under Section 28(i) r/w s. 2(24)(i). The only purpose that the amendment therefore serves, is to delineate such income of the specified entities (i.e., co-operative societies) separately and, further, clarify that for the purposes of the Act the `financing of its constituents' is to be considered as integral to banking, i.e., as a part of the business of banking. That is, qua the underlying economic activity generating the income, financing forms part of banking, or at least

as far as the specified entities, being co-operative societies, are concerned.

5. In view of the obtaining legal position, as discerned from the reading of the applicable laws, i.e., the BR Act and the NBARD Act, in conjunction with which the relevant provisions of the Act are to be read, and the judicial precedents brought to our notice, we are of the clear view that the assessee is a `co-operative bank' and, consequently, hit by the provision of s. 80P(4), so that the deduction provided by the said section would not be available to it from A.Y. 2007-08 onwards and, accordingly, stood rightly denied the impugned claim in its assessment for the year. So, however, we also clarify that to the extent the assessee is (also) or is acting (also) as a `state land development bank', which too falls within the purview of the NBARD Act, exigible for financial assistance from NBARD, the assessee's claim merits acceptance, and it would be entitled to deduction under Section 80P(2)(a)(i) on the income relatable to its lending activities as such a bank. The matter is, therefore, remitted to the file of the AO for a consideration of this aspect of the matter and adjudication as per law on factual verification and determination, pass a speaking order, after allowing reasonable opportunity to the assessee to establish its claims, the onus for which is only on it. We decide accordingly.''

2.15 **Provision of Section 80A(5):**

From A.Y.2003-04 onwards the deduction under Section 80P is not available unless it is claimed in the return of income by virtue of amended provision of Section 80A(5).

2.16 **Other Relevant Judgments** :

The following judgments are also worth keeping a note –

- **Deduction is on net computed income and not on gross profits -** Co-operative society is entitled to deduction of exemption from income-tax payable by it only on its net profits and gains – Sabarkantha Zilla Kharid Vechan Sangh Ltd. v. CIT [1993] 203 ITR 1027 (SC).
- **Unabsorbed losses/depreciation should first be set off -** Deduction under Section 80P should be allowed after set off of unabsorbed loss and unabsorbed depreciation of earlier years – CIT v. Kotagiri Industrial Co-operative Tea Factory Ltd. [1997] 91 Taxman 214/224 ITR 604 (SC).
- **Where income is partly exempt and partly taxable, proportionate share of expenses should only be allowed against taxable part -** Where a co-operative society was earning income which was partly taxable and partly entitled to special deduction, proportionate share of expenses attributable to earning income which was entitled to deduction should be deducted in computing such income – Kota Co-operative Marketing Society Ltd. v. CIT [1994] 207 ITR 608 (Raj.), CIT v. Rajasthan Rajya Sahkari Upbhokta Sangh [1995] 215 ITR 448 (Raj.).
- **Other activities -** A society is not disentitled from claiming exemption only because it also carries on the activities, income from which is not exempt – CIT v. Nagpur Zilla Krishi Audyogik Sahakari Sangh Ltd. [1994] 75 Taxman 399/209 ITR 481 (Bom.).

- **Mutual concern -** If a co-operative society is a mutual concern, exemption can be claimed on the principle of mutuality – **CIT** v. **Standing Conference of Public Enterprises** [2010] 186 Taxman 142 (Delhi).
- No disallowance can be made under Section 14A in respect of income on which deduction is allowed under Section 80P - [2012] 23 taxmann.com 312 (DELHI) / [2012] 209 TAXMAN 252 (DELHI) / [2012] 252 CTR 374 (DELHI) Commissioner of Income-tax VS. Kribhco.
- Deduction under Section 80P(2)(e) is available only in respect of income from letting out of storage and if assessee used storage only for marketing, deduction is not permissible- Commissioner of Income-tax, Panchkula VS. Haryana State Co-op. Supply & Marketing Federation Ltd -[2011] 12 taxmann.com 330 (PUNJ. & HAR.) / [2011] 201 TAXMAN 169 (PUNJ. & HAR.
- Deduction under Section 80P(2)(d) would be allowed to assessee after excluding expenditure attributable to earning of eligible income- Punjab State Co-operative Milk Producer's Federation Ltd. VS. Commissioner of Income-tax-II- [2011] 12 taxmann.com 471 (PUNJ. & HAR.) / [2011] 201 TAXMAN 138 (PUNJ. & HAR.) (MAG.) / [2011] 245 CTR 432 (PUNJ. & HAR.) / [2011] 336 ITR 495 (PUNJ. & HAR.)
- Assessee-society was not entitled to deduction under Section 80P(2)(d) in respect of interest received on advances provided to its member co-operative societies- Punjab State Co-operative Milk Producers Federation Ltd. VS. Commissioner of Income-tax.- [2012] 20 taxmann.com 834 (PUNJ. & HAR.) / [2011] 336 ITR 501 (PUNJ. & HAR.)

- Unabsorbed losses of earlier years are to be set off before allowing deduction under Section 80P- Shahbad Co-operative Sugar Mills Ltd. VS. Deputy Commissioner of Income-tax. [2012] 20 taxmann.com 789 (PUNJ. & HAR.) / [2011] 336 ITR 222 (PUNJ. & HAR.)

- Assessee-society claimed deduction of income from marketing produce of farmers without showing that said produce was grown by members-farmers. The court held that there was an amendment to Section 80P(2)(a)(iii) vide Income-tax (2nd Amendment) Act, 1998 which operates from 1-4-1968 in terms of which word 'of' has been substituted by 'grown by'. Thus, deduction in respect of income from marketing of agricultural produce 'of members' was no longer available to assessee unless produce was grown by members of society -[2011] 196 TAXMAN 401 (PUNJ. & HAR.) / [2010] 8 taxmann.com 131 (PUNJ. & HAR.) Punjab State Co-operative Supply & Marketing Federation Ltd. VS. Union of India.

Concept of mutuality why not applicable : There is no aspect of mutuality in the case of the assessee registered under the Co-operative Societies Act as one of the objectives of a co-operative society will be to make profits and declare dividends to its members. In the case of a mutual concern, there is no room for such intention of making profit and distribute the same among the members. [Sri Laxminarayana Swamy Co-Operative Society Ltd. *v.* Income-tax Officer [2010] 4 ITR(TRIB.) 27 (BANG.)][*Totgar's Co-operative Sale Society Ltd.* v. *ITO* [2010] 322 ITR 283 (SC) ; 229 CTR 209].

3. Inputs on Important Factual areas

During the course of scrutiny, the assessing officer should carefully examine the factual aspects first and on the basis of those facts the decision should be taken. Unless, there is a direct judgment of the jurisdictional High Court or the Hon'ble Supreme Court and the department has accepted the same the A.O. should take the decision without getting influenced by the judicial pronouncement. The following important points should be examined during the course of scrutiny.

i. Whether the assessee which has claimed deduction under Section 80P is a co-operative society or not as per the definition given in the act (section 2(19)). The society should be registered under the Co-operative Society Act, 1912 or with some other agency in the state.

ii. Whether the deduction has been claimed in the return of income filed or not? This is applicable from A.Y.2003-04 onwards.

iii. Examine the memorandum of association, the articles of association, the Income-tax Returns filed with the Department, the status of the business indicated in such returns.

iv. Examine the byelaws and other documents explaining the rules and regulations of the society so as to clearly understand the purpose and the nature of business done by it.

v. Examine the list of the members of the society and verify whether the members have been made as per the byelaws of the society or not.

vi. Certain deductions in clause-2(a)(i), 2(a)(ii), 2(a)(iii), 2(a)(iv) and 2(a)(v) are available only on income arising out of the transactions with the members. Whereas

clause-2(a)(vi) and 2(a)(vii), there is no such restriction of income being generated amongst the members. However, there are restrictions in clause-2(a)(vi) & (vii) on voting rights given to the members. Therefore, the AO has to carefully examine these facts.

vii. What business activity being done by the society? Whether the business activity is in accordance or authorized by the byelaws or not?

viii. If the assessee is a co-operative bank, it is not entitled for deduction under Section 80P(a)(i) from A.Y.2007-08 onwards.

ix. Note whether there is any income other than the authorized activity or income other than the activity amongst the members or the activity which is not covered by the provisions of Section 80P. In case there is some other activity only the proportionate deduction has to be allowed.

x. Actual conduct of business activity should be examined by calling various records so as to verify whether it is actually being done in the manner indicated in the byelaws or the activities have been camouflaged to look as the genuine activity.

4. Drafting of assessment orders

Following points should be taken care of while framing the assessment order-

i. The most important point is marshelling of facts correctly and clearly. The facts on the basis of which the decision is to be taken should clearly come out from the order. The reader should be able to understand the facts without much difficulty.

ii. The clauses or items of the byelaws which are being relied while disallowing particular claim should be clearly mentioned. As a

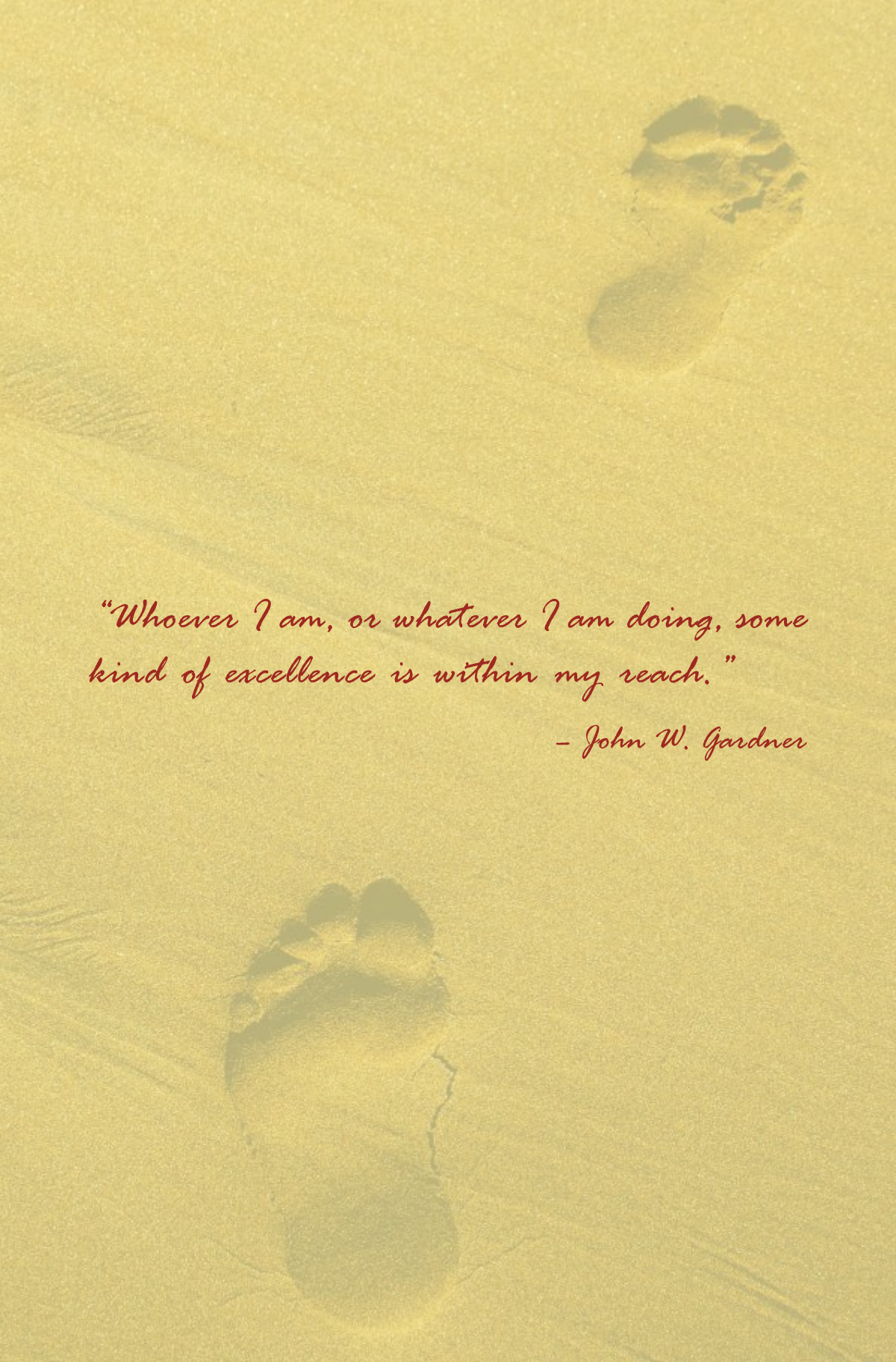
matter of practice, the relevant clause should be reproduced so that there is no confusion at the appellate stage.

iii. Any other fact which is being relied while disallowing the claim of the assessee should also be clearly brought out and details should be provided. Needless to say if the A.O. has collected any fact which has not been confronted to the assessee, the same should be brought to notice of the assessee and after giving due opportunity and sufficient time to the assessee, the decision should be taken. The fact that proper opportunity has been given should be clearly mentioned in the order by giving the relevant facts such as date of show cause notice, etc.

iv. It has been observed that the AOs rely on judicial pronouncements or the case laws without mentioning the correct facts and linking the facts with the judgments. It is advised that the help of the judicial pronouncement should be taken to understand the issue and taking the rational decision. While drafting the order, an attempt should be made, as far as possible, to rely on facts. Unnecessary reliance on the case laws should be avoided at the level of the Assessing Officer.

v. At the cost of repetition it would be prudent to mention and remind the A.O. to clearly mention the basic facts such as date of filing of return, status, nature of business, conformity with the byelaws of the society, date of issue of notice under Section 143(2), etc. in the assessment order.

vi. Deduction under Section 80P in respect of business income of a co-operative shall be available with reference to income after claiming deduction under Sections 80HHB, 80HHC, 80HHD and 80-IA.



"Whoever I am, or whatever I am doing, some kind of excellence is within my reach."

– John W. Gardner

16 Issues pertaining to Minimum Alternate Tax (MAT) - Section 115JB

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Section 115JB was inserted by the Finance Act, 2000, w.e.f. 01/04/2001. It had replaced Section 115JA, which was inserted by the Finance Act, 1996 w.e.f. 01/04/1997. Section 115JA was replacement of earlier Section 115J, which was inserted by the Finance Act, 1987 w.e.f. 01/04/1988.

The objective and philosophy of the provisions of Section 115J, Section 115JA and Section 115JB are same; however, the method of computation has been slightly changed in these sections.

It was seen by the policy framers that certain companies were making huge profits and were also declaring substantial dividends; however, they were not paying any tax as a result of various tax concessions and incentives and because of managing their affairs in such a way as to avoid payment of income-tax. Therefore, Section 115J was introduced in the Income-tax Act, 1961 and subsequently it was replaced by Section 115JA and Section 115JB.

As per sub Section (1) of Section 115JB of the Act, if total income of a company in any year commencing from A.Y. 2012-13 is less than eighteen and one half per cent on its book profit, then such book profit shall be deemed to be the total income of the assessee company and the tax payable by such company will be eighteen and one half per cent of such book profit.

Sub Section (2) of Section 115JB mandates that every company shall prepare its P&L Account in accordance with the provisions of parts-II & III of Schedule-VI to the Companies Act, 1956.

For arriving book profit of the company, the net profit as shown

in the P&L Account as per the provisions of the Companies Act is to be increased by the items mentioned in clause (a) to (j) to Explanation-1 of Section 115JB (if these items are debited to the P&L account) and is to be reduced by the items mentioned in clause (i) to (viii) to Explanation-1 of Section 115JB of the Act.

It is to be noted that rate of eighteen and one half per cent is applicable for A.Y. 2012-13 onwards. These rates were eighteen per cent for A.Y. 2011-12 and fifteen per cent for A.Y. 2010-11.

2. There are many issues related to Section 115JB, which have been the matter of contention between the assessees and the Department. Some of these issues have been settled by way of amendment in the Act or by way of judgements of the Hon'ble Supreme Court; however, some of these issues are still controversial. Both type of issues are discussed here under-

   1. **The amount of deferred tax and the provision therefor:**

      Earlier deferred tax was not added back by the assessees while computing book profit on the plea that this is not an income-tax as mentioned in clause (a) in Explanation-1. Clause (h) was inserted in the Explanation to remove this difficulty. Now, if deferred tax or any provision on this account is debited in P&L account, then it has to be added back as per clause (h) of Explanation-1. This amendment was made by the Finance Act, 2008 and it has been made effective from A.Y. 2001-02 onwards.

   2. **The provision for doubtful debts:**

      Majority of the A.Os. were adding this item while computing book profit under clause(c) of Explanation-1. Clause (c) refers to the amount set-aside for liabilities, other than ascertained liabilities. The Hon'ble Supreme

Court in the case of CIT v/s HCL Comnet Systems & Services Ltd., 174 Taxman 118 has held that provision for doubtful debts is not a liability. The provision for doubtful debt is a provision made for likelihood of ir-recoverability of any money *advanced* by the assessee. Hence, by no stretch of imagination it can be termed as *liability*.

The Act has now been amended and clause (i) has been inserted in Explanation-1 by Finance Act, 2009 w.r.e.f. 01/04/2001. As per clause (i), the amount or amounts set-aside as provision for diminution in the value of any asset has to be added back in net profits, if this amount was debited to P&L account.

Thus, now provision for doubtful debts should be added under clause (i) of Explanation-1.

3. **Scope of the term 'Income-tax':**

As per clause (a) the amount of Income-tax paid or payable and the provision therefor is to be added back while computing book profit, if the same is debited in the P&L account. Whether tax on distributed profits or surcharge on Income-tax is covered in clause (a) was a matter of dispute between the assessees and the Department. This dispute has been settled by way of insertion of Explanation-2 in Section 115JB of the Act. Explanation-2 has been inserted by the Finance Act, 2008 w.r.e.f. 01/04/2001. As per this explanation, dividend distribution tax, surcharge, education cess and secondary and higher education cess is included in the definition of Income-tax for the purposes of clause (a).

A peculiar situation arises sometimes when it is observed

that the companies make provision for taxation to be paid by their foreign branches under tax laws of those countries. The question arises that such tax payable in foreign countries is to be added back or not while computing book profits. The AAR in the case of **Bank of India, In re AAR No.732 of 2006** has held that such provision is required to be added back to book profits, because 'income-tax' in clause (a) does not mean only income-tax payable in India..

4. **Applicability of the provisions of Advance tax:**

It has been clarified by Circular No.13/2001 dated 09/11/2001 that provisions of advance tax are also applicable on the companies paying MAT and interest under Section 234B & 234C is leviable in case of default by these companies. This view has been affirmed by the **Honb'le Supreme Court in the case of JCIT vs. Rolta India Ltd. reported in 196 Taxman 594**.

5. **Tax credit under Section 115JAA and calculation of interest under Section 234B:**

The controversy in this regard has been settled in favour of the assessee by way of substitution of explanation to sub-section(1) of Section 234B of the Act. The tax credit under Section 115JA has to be given before calculating the shortage in respect of payment for advance tax. This explanation was substituted by the Finance Act, 2006 and is applicable from A.Y. 2007-08 onwards.

6. **Depreciation on account of revaluation of assets:**

Earlier there was a dispute whether higher amount of depreciation on re-valued assets can be allowed while

computing book profit. The dispute has been settled now by way of amendment in the Act. The depreciation on account of revaluation of assets cannot be reduced while calculating book profit and this can be understood from combined reading of clause (g) and clause (iia) of Explanation-1. The amount of depreciation is to be added back to the net profits, if debited to P&L account as per provisions of clause (g) of Explanation-1. As per the provisions of clause (iia), the amount of depreciation debited to the P&L account (excluding the depreciation on account of revaluation of assets) is to be reduced from the net profits. The net effect is that depreciation on account of revaluation of assets is not to be reduced for the purpose of computation of book profit. Clause (g) and clause (iia) were inserted in the Act by the Finance Act, 2006 and are applicable for A.Y. 2007-08 onwards.

However, it has to be noted that if any amount is withdrawn from revaluation reserve *and credited to P&L account*, the amount *to the extent of* depreciation on account of revaluation of assets would be reduced while computing the book profit as per the provisions of clause (iib) of explanation-1.

7. **Amount withdrawn from any reserve:**

As per clause (i) of Explanation-1 to Section 115JB of the Act, the amount withdrawn from any reserve or provision and credited to the P&L account is to be reduced while computing book profits only *if the book profit was increased by amount of reserve in the year in which the reserve was created*.

Therefore, the A.O. should examine the P&L account

of the year in which the reserved was created. The P&L account of the assessee company should be effectively credited by the amount of reserve in the year of creation and it should not be merely an adjustment contra entry. The Hon'ble Supreme Court in a very well reasoned and speaking judgement in the case of **Indo Rama Synthetics (I) Ltd. vs. CIT, 196 Taxman 535** has discussed this provision at length. This judgement should be read by every A.O. in order to clarify concepts regarding reserves and credits in P&L account.

It is to be further noted that amount transferred to every kind of reserve is to be added to net profit to determine book profit. Therefore, if any amount is transferred to reserve account under Section 36(1)(viii), 80IA(6), 10A(1A) or 10AA of the Act; though it is allowed as a deduction while computing the total income under normal provision, it should be added back to compute book profits, if debited to P&L account.

8. **Carry forward of unabsorbed depreciation and business losses:**

Taxation on the basis of book profits does not affect the carry forward and set off of business losses and unabsorbed depreciation under the normal provisions of the Act. This has been amply clarified in sub-section (3) of Section 115JB of the Act. Carry forward of losses for the purposes of book profits and carry forward of the losses for the purposes of normal provisions of the Act are two parallel streams and each stream is unaffected and untouched by the other stream. It is to be further observed that carry forward of losses and unabsorbed

depreciation under the normal provisions of the Act will be computed as per the provisions of Income-tax Act. On the other hand the carry forward of business losses and unabsorbed depreciation for the purposes of book profits will be as per the books of account of the assessee company.

The hon'ble **Supreme Court in the case of Karnataka Small Scale Industries Development Corporation vs. CIT, 258 ITR 770** has held that the brought forward business losses, unabsorbed depreciation or investment allowance etc determined as per the normal provisions of the Act should be set-off against the total income as per the normal provisions and only balance amount should be carried forward, even if when the tax has been determined and paid on the basis of book profits and not on the basis of total income as per the normal provisions.

The AAR in the case of **Rashtrya Ispat Nigam Ltd., In re reported in 155 Taxman 60** has ruled that the applicant does not have the option to reduce the current year's profits by the loss brought forward or unabsorbed depreciation for the purpose of carry forward under Section 115JB in its accounts *in a manner different* from the manner adopted for determination of book profits under Section 115JB of the Act.

In the above case, the applicant had correctly applied the provisions of Section 115 JB in the current year by reducing brought forward business losses , but while carrying forward it had adjusted the book profit from unabsorbed depreciation. This was done in order to ensure that figure of carried forward business losses does

not become nil in near future. The applicant pleaded that it has right to set-off income as per its option in its books of account and it is not bound by the manner of computation specified in Section 115JB for carry forward of business losses and unabsorbed depreciation.

The AAR did not accept the contentions of the assessee. Although the ruling of AAR is only applicable for a specific case under consideration, but it has a persuasive value. Further, the reasoning given in the ruling is very sound. Therefore, the A.O. should carefully scrutinise the manner of computation of carry forward of losses and unabsorbed depreciation in earlier years, while computing book profit. The correct manner has also been explained in Circular No.495, dated 22/09/1987.

9. **The amount of loss brought forward or unabsorbed depreciation, whichever is less as per books of account:**

As per clause (iii) of Explanation-1 of Section 115JB of the Act, the amount of loss brought forward or unabsorbed depreciation, whichever is less as per books of account has to be reduced for the purpose of computation of book profit. The controversy regarding whether loss shall include depreciation or whether provisions of clause (iii) will apply in case if any of these amounts is nil has been put to rest by insertion of explanation in clause (iii) itself. It has been clarified that the business loss shall not include depreciation loss and should be calculated after reducing deprecation amount. It has been further clarified that the provisions of this clause shall not apply if the amount of loss brought forward or unabsorbed depreciation is nil.

However, one more debatable issue whether accumulated figures of unabsorbed depreciation/brought forward loss is to be taken into account and lesser of these two is to be reduced or whether unabsorbed deprecation/brought forward loss is to be reckoned on year to year basis has not been resolved. The view of the Department is that the quantification should be done on year to year basis. The view of the assessee is that the quantification should be done on the accumulated amount. This can be understood from the following table -

	Depreciation as per books	**Loss as per books excluding depreciation**	**Total (Rs.)**
A.Y. 1999-2000	42,25,696/-	94,88,756/-	1,37,14,352/-
A.Y. 2000-2001	44,42,777/-	1,30,33,168/-	1,74,76,945/-
A.Y. 2001-2002	44,53,565/-	(7,30,402)	37,23,163/-
A.Y. 2002-2003	19,93,456/-	22,84,195/-	42,77,650/-
	1,51,15,393/-	2,40,75,717/-	3,91,91,110/-

In the above case, the assessee had reduced Rs. 1,51,15,393 while computing book profit as per clause (iii). However, the A.O. allowed reduction of only Rs.1,06,61,828. The A.O. took the correct plea that since there was no loss in AY 2001-02, therefore, no amount was available for set-off as per clause (iii) in this year.

Although the ITAT in the case of Amline Textiles (P) Ltd v/s ITO, 27 SOT, 152 did not accept the plea of the Department and allowed the appeal of the assessee; however with due respect to ITAT, the view taken by it in the above case is not the correct proposition of law and reasoning given in the Order is flawed. Therefore, The A.O. should allow the reduction on year to year basis in the correct spirit of law and not on the consolidated

amount.

10. **Treatment of capital gains:**

There may be instances where the surplus arising out of transfer of capital assets is taken directly by the assessee company to the reserves and said transaction is not routed through the P&L account. The assessee may take plea that since this transaction is not routed through the P&L account, therefore, the A.O. cannot make any adjustment in view of the judgement of the Hon'ble Supreme Court in the case of Apollo Tyres Ltd. vs. CIT.

The Hon'ble Bombay High Court in the case of **CIT vs. Veekaylal Investment Co. (P) Ltd., 116 Taxman 104** has held that capital gains would be part of computation of book profits. It has been held by the Hon'ble high Court that under clause (2) of part-II of Schedule VI to the Companies Act where a company receives the amount on account of surrender of leasehold rights, the company is bound to disclose in the P&L account the said amount as non recurring transaction or a transaction of an exceptional nature irrespective of its being capital or revenue in nature. It would be inappropriate to directly transfer such amount to capital reserve. Such receipts are also covered by clause 2 (b) of Part-II of Schedule VI of the Companies Act which, inter-alia, states that P&L account shall disclose every material feature including credits or receipts and debits or expenses in respect of non recurring transactions or transactions of exceptional nature. The Hon'ble High Court further held that capital gains would certainly be one of the various items whose information is required to be given to the share holders

under clause 3 (xii) (b). The Hon'ble High Court overruled the order of the Calcutta Special Bench of ITAT in the case of Sutlej Cotton Mills Ltd. vs. Asst. CIT, 199 ITR 164 in this case.

It is to be kept in mind by the A.O.s that even if the long term capital gains is nil because of any exemption like exemption under Section 54E of the Act as per the normal provisions of the Act, then also long term capital gains is to be included while computing book profits.

11. **Scope of scrutiny of P&L account by the A.O. while applying MAT provisions:**

The Hon'ble Supreme Court in the landmark judgement of **Apollo Tyres Ltd. vs. CIT, 122 Taxman 562** has held that the A.O. while computing the income under Section 115J has only the power of examining whether the books of account are certified by the authorities under the Companies Act as having been properly maintained in accordance with the Companies Act. The A.O. thereafter has limited power of making additions and reductions as provided for in the Explanation to the said section. To put it differently, the A.O. does not have the jurisdiction to go behind the net profit shown in the P&L account except to the extent provided in the Explanation to Section 115J.

In the case of Malayala Manorama Co. Ltd., the A.O. observed that the depreciation debited in the P&L account as per the IT Rules was not admissible and the company should have debited depreciation as per the provisions of the Companies Act. The case travelled upto the Supreme Court. Following the judgement in the case of Apollo Tyres, the Hon'ble Supreme Court did not accept the

argument of the Revenue that the A.O. can re-scrutinize the account and satisfy himself that these accounts are prepared as per the provisions of the Companies Act.

Fortunately, **Hon'ble Supreme Court in the case of Dynamic Orthopaedics (P) Ltd. vs. CIT reported in 190 Taxman 288** has differed from the above judgement delivered in the case of Malayala Manorama Co. Ltd. vs. CIT 169 Taxman 471 and referred the matter to a larger Bench of the Court.

Therefore, issue of scrutiny of P&L account prepared by the Company is still wide open and it is expected that the issue will be decided by a larger Bench of the Supreme Court.

12. **Applicability of MAT provisions on statutory corporations and boards etc.:**

Sometimes it is observed that some corporation or boards are governed by specific Acts and they are created by such Acts. In the Income-tax proceedings, their status is Company. However, they are not required to prepare their P&L account and balance sheet as per the provisions of the Companies Act and they are required to prepare their P&L account as per their governing Acts. In the case of Kerala State Electricity Board vs. DCIT reported in 196 Taxman 1, the Hon'ble Kerala High Court observed that MAT provisions are not applicable on Kerala State Electricity Board since it is required to prepare its P&L account as per Electricity Act and not as per the Companies Act.

If any corporation/board is not required to prepare its P&L account as per the Companies Act, then it will

be very difficult to put forth the Revenue's case for applicability of MAT provisions. However, this difficulty has been removed in the case of certain companies by way of insertion of clause(b) in sub-section (2) in Section 115JB by the Finance Act, 2012. It has been been mandated in this clause that every company , to which proviso to sub-section (2) of Section 211 of the Companies Act is applicable, shall prepare its P&L account as per the Act governing such company for the purposes of Section 115 JB.

The following companies have been mentioned in proviso to sub-section (2) of Section 211 of the Companies Act-

(i) Insurance or banking company.

(ii) Any company engaged in the generation or supply of electricity.

(iii) Any other class of company for which a form of P&L account has been specified in or under the Act governing such class of company.

13. **Arrears of depreciation:**

Although, the assessee has an option under the Companies Act of adopting a straight line method or WDV method for claiming depreciation; however, deduction of extra depreciation as arrears of past years while computing book profit is not allowable, as has been held by the **Hon'ble M.P. High Court in the case of Gilt Pack Ltd. vs. Union of India reported in 163 Taxman 331**. While arriving this conclusion, the Hon'ble High Court followed the judgement of the Hon'ble Supreme Court in the case of Karnataka Small Scale Industries Development Corporation vs. CIT.

14. **Prior period expenses:**

The predominant view of the Courts is that if prior period expenses are debited in P&L account in accordance with the provisions of the Companies Act, then such expenses are liable for deduction.

However, if it is found by the A.O. that prior period expenses are not debited in P&L account and these expenses are shown in P&L appropriation account, then the A.O. should not allow these expenses to be reduced while computing book profits since the judgement of the Hon'ble Supreme Court in the case of Apollo Tyres is equally applicable to the assessees also. The judgements of the Hon'ble Kerala High Court in the case of **Sree Bhagwathy Textiles Ltd. vs. ACIT, 199 Taxman 14 and Hon'ble Madras High Court in the case of CIT vs. Swamiji Mills Ltd., 25 Taxmann.com 110** are the judgements in the favour of the Department on this issue.

One more example that the judgement of the Supreme Court in the case of Apollo Tyres is equally applicable to the assessee is the case of the **Gujarat State Petroleum Corporation Ltd. vs. JCIT reported in 308 ITR (AT) 248 (Ahmedabad)**. The ITAT, Ahmedabad following the judgement in the case of Apollo Tyres has held that deduction under Section 42 for business engaged in prospecting for extraction or production of mineral oil not debited in the accounts cannot be claimed as deduction while computing book profits.

15. **Applicability of MAT provisions on foreign companies:**

The applicability of MAT provisions on foreign companies has been a matter of dispute since long. The Authority for Advance Ruling in **P.No.14 of 1997, In re 234 ITR 335** held that Dutch Company was liable to tax on book profits. In the case of **Timken Company, In re 326 ITR 193**, the AAR has held that since the non resident US Company has no PE in India, therefore, it cannot be liable for MAT.

16. **MAT credit of amalgamated Company to the amalgamating Company:**

The tax credit determined under Section 115JAA of the Act is allowed as set off in a year in which tax is payable on the total income in accordance with the normal provisions of the Act. Set off of MAT credit brought forward in allowed to the extent of the difference between tax on total income and tax which would have been payable under Section 115JB of the Act. As per the provisions of sub-section (1A) of Section 115JAA of the Act, if tax is paid by any company under Section 115JB then credit in respect of the tax so paid shall be allowed to him in accordance with the provisions of this section.

It is clear from sub Section (1A) that tax credit is to be allowed to the company which has paid taxes under Section 115JB. When amalgamating company has not paid any tax and tax was paid by the amalgamated company, then credit cannot be provided to the amalgamating company. Further, wherever certain benefits are to be provided to the amalgamating company, then the same

have been mentioned in the Act itself. Since there is no specific provision for credit of MAT in the case of the amalgamating company, therefore, the A.O. should not allow any credit to the amalgamating company.

17. **Applicability of MAT on undertakings covered under Sections 10A & 10B:**

Earlier MAT was not applicable on income of the units covered under Section 10A and 10B. Now, these undertakings have been brought under MAT provisions from A.Y. 2008-09 onwards.

17 Rejection of books of Accounts - Section 145(3)

Y K BATRA
CIT (Audit), Ahmedabad

Section 145 of the Income Tax Act 1961, lays down that income chargeable under the head "Profit and gains of business or profession" or "Income from other sources" shall, subject to the accounting standards notified by the Central Government in the Official Gazette, be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Subsection 3 of Section 145 lays down that where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where the method of accounting namely cash or mercantile systems or accounting standards as notified by the Central Government, have not been regularly followed by the assessee, the Assessing Officer may make an assessment in the manner provided in Section 144 of the Act.

2. It may be pointed out that Section 145 of the I.T Act 1961, prior to its substitution by the Finance Act 1995 effective from April 1, 1997, permitted an assessee having income from 'business', 'profession' or 'other sources' to follow either the cash or mercantile or the hybrid system of accounting to arrive at its profit but it also empowers the A.O to reject the accounts and estimate the assessed income if the sytem followed by the assessee was such that his true profits were not ascertainable from it. The present Section 145 restricts the choice of system to either the cash or mercantile system and also invests the Central Government with powers to lay down accounting standards

to be followed by the assessee. In order to appreciate completely the intent and operation of Section 145 in the present form, it is necessary to have a cursory look on the provisions of Section 145 which were effective upto 31st March 1997. The understanding of old provision of Section 145 is also necessary for appreciating the various judgments of the Supreme Court which have been rendered on the basis of those provisions. A number of decisions have been discussed in the following paragraphs upholding the rejection of books of accounts or otherwise have been rendered keeping in view the provisions of old Section 145. Though these decisions have been rendered on the basis of old provisions yet they are relevant in sum and substance in respect of the provisions of Section 145(3).

2.1 It is relevant to quote from the Memorandum to the Finance Bill, 1995 through which Section 145 was amended which explained the provisions as under :-

"The existing section 145(1) of the Income-tax Act provides for computation of income from business or profession or income from other sources in accordance with the method of accounting regularly employed by the assessee. Income is generally computed by following one of the three methods of accounting, namely, *(i)* cash or receipts basis, *(ii)* accrual or mercantile basis, and *(iii)* mixed or hybrid method which has elements of both the aforesaid methods. It has been noticed that many assessees are following the hybrid method in a manner that does not reflect the correct income. It is proposed to amend Section 145 to provide that income chargeable under the head 'Profits and gains of business or profession' or

'Income from other source' shall be computed only in accordance with either the cash or the mercantile system of accounting, regularly employed by an assessee.

The Institute of Chartered Accountants of India (ICAI) have directed its members to ensure that the Accounting Standards formulared by it are followed in the presentation of financial statements covered by their audit reports. It is seen that there is a flexibility in the standards issued by ICAI which makes it possible for an assessee to avoid the payment of correct taxes by following a particular system. Therefore, there is an urgent need to standardize one or more or the alternatives in various standards so that the income for tax purposes can be computed precisely and objectively.

The Bill proposes to amend the Income-tax Act to empower the Central Government to prescribe by notification in the Official Gazette, the accounting standards which an assessee will have to follow in computing his income under the head 'Profits and gains of business or profession' or' 'Inocme from other sources'

The proposed amendements will take effect from April 1, 1997, and will, accordingly, apply in relation to assessment year 1997-98 and subsequent years."

2.2 The new provisions were explained in the Board's Circluar No.717 dated August 14, 1995. The relevant paras 44.1 to 44.3 of the circular are as under :

44.1 "*Section 145(1) of the Income-tax Act prior to its amendment by the Finance Act, 1995, provided for computation of income from business or profession*

or income from other sources in accordance with the method of accounting regularly employed by the assessee. Income is generally computed by following one of the three methods of accounting namely, (i) cash or receipts basis, (ii) accrual or mercantile basis, and (iii) mixed or hybrid method which has elements of both the aforesaid methods. It was noticed that many assessees are following the hybrid method in a manner that does not reflect the correct income. The Finance Act, 1995, has amended Section 145 of the Income-tax Act to provide that income chargeable under the head 'Profits and gains of business or profession' or 'Income from other sources' shall be computed only in accordance with either the cash or the mercantile system of accounting, regularly employed by an assessee. The first proviso to sub-section (1) of section 145 has been deleted."

44.2 The Finance Act, 1995, has empowered the Central Government to prescribe by notification in the Official Gazette, the accounting standards which an assessee will have to follow in computing his income under the head 'Profits and gains of business or profession' or 'Income from other sources.'. These accounting standards will be laid down in consultation with expert bodies like the Institute of Chartered Accountants.

44.3 The amendement will take effect from April, 1 1997 and will, accordingly, apply in relation to assessment year 1997-98 and subsequent years."

Old and new provisions

Old provisions. **–** The existing Section 145 had two sub-sections and three proviso to sub-section (1) of Section 145. Sub-section (1) provided that income from business or profession or income from other sources shall be computed in accordance with the method of accounting regularly employed by the assessee. The first proviso provided that where the accounts are correct and complete but the method of accounting is such from which income cannot be properly deduced, the computation of income shall be done by the Assessing Officer on such basis and in such manner as he may determine. The second proviso provided that where no method of accounting is regularly employed, any income by way of interest on securities shall be chargeable as the income of the previous year in which such interest is due to the assessee. The third proviso provided that nothing shall preclude an assessee from being charged to income-tax in respect of any interest on securities received by him in the previous year, if such interest had not been charged to income-tax for any earlier year. Sub-section (2) of section 145 provided that where the Assessing Officer is not satisfied about the correctness or completeness of the accounts or where no method of accounting has been regularly employed, the Assessing Officer may make an assessment in the manner provided in Section 144 of the Act.

New provisions The choice of selecting the method of accounting – cash, mercantile or hybrid – was with the assessee. The choice still remains with the assessee, but the new sub-section (1) of Section 145 restricts the choice to the cash system or the mercantile system. The concept of the hybrid system has been done away with. Sub-section (2) now authorizes the Central Government to notify from time to time accounting standards to be followed by any class of assessees or in respect of any class

of income, while sub-section (3) authorizes the Assessing Officer to make an assessment in the manner provided in Section 144 in three contingencies – *(i)* where the Assessing Officer is not satisfied with the correctness or completeness of accounts, or *(ii)* where the cash or mercantile sytem of accounting has not been regularly followed; or *(iii)* where the accounting standards as notified have not been regularly followed.

3. Two methods of accounting, the cash system and the mercantile system

3.1 **Cash system**. Broadly, the cash system of accounting is that in which the receipts are accounted for as and when actually received and the debits are made when actual disbursement is made. In *Morvi Industries Ltd.* v. *CIT* [1971] 82 ITR 835, the Supreme Court said that under the cash system, it is only actual cash receipts and actual cash payments that are recorded. In *CIT* v . *A. Krishnaswami Mudaliar* [1964] 53 ITR 122 , the Court observed that in the cash system record is maintained on actual cash receipts and actual disbursements, entries being posted when money or money's worth is actually received, collected or disbursed. It was further stated that under the cash system, no account of what are called the outstandings of the business either at the commencement or at the close of the year is taken. It was further observed that where the cash system is adopted, there are no bad debts or outstandings. In *CIT* v. *K.R.M.T.T. Thiagaraja Chetty & Co.* [1953] 24 ITR 525 , the Supreme Court held that the fact that certain moneys were drawn in cash from time to time did not necessarily lead to the inference that the accounts were kept on cash basis. The cash system will

cover cases where accounts are not maintained on the mercantile basis, as held by the Orissa High Court in *CIT* v. *Bijoy Kumar Das* [1972] 84 ITR 351 . It may even cover cases where no proper accounts are kept as per the decision of the Gauhati High Court in *N.R. Sirker* v. *CIT* [1978] 111 ITR 281. The cash system of accounting does not necessarily mean that income is assessable only when it is reduced to cash; where payment is received in kind, it is income even though it remains in kind and is not converted into cash. The cash system of accounting does not require that it will not be treated as income so long as it is in kind - *Seth Kishorilal Babulal* v . *CIT* [1963] 49 ITR 502 (All). In *Raja Mohan Raja Bahadur* v. *CIT* [1967] 66 ITR 378, the Supreme Court held that where the accounts are kept on cash basis, receipt of money or money's worth and not the accrual of the right to receive, is the determining factor. It was held that if commercial assets are received by a trader maintaining accounts on cash basis in satisfaction of an obligation, income which is embedded in the value of assets is deemed to be received : the receipt of income is not deferred till the asset is realized in terms of cash or money. In *Raja Raghunandan Prasad Singh* v. *CIT* [1933] 1 ITR 113 (PC), the Supreme Court held that where a property is purchased in the Court sale, the profits will be deemed to have arisen on the date of confirmation of sale.

The foregoing discussion explains, in brief, the salient features of cash system of accounting.

3.2 **Mercantile system**. The mercantile system of accounting or the double entry system is different in

substance from the cash system of accounting. The basic features of the mercantile system of accounting were explained by the Supreme Court in *Morer Industries Ltd. 's* case (*supra*) as follows :

"... under the mercantile system, credit entries are made in respect of the amounts due immediately they become legally due and before they are actually received. Similarly, the expenditure items for which legal liability has been incurred are immediately debited even before the amounts in question are actually disbursed. Where accounts are kept on mercantile basis, the profits or gains are credited though they are not actually realized and the entries thus made really show nothing more than an accrual or arising of the said profits at the material time." (p. 836)

Earlier in *CIT* v. *A. Gajapathy Naidu* [1964] 53 ITR 114, the Supreme Court observed that the mercantile system brings into credit what is due immediately it becomes legally due and before it is actually received; and it brings into debit expenditure the amount for which a legal liability has been incurred before it is actually disbursed. The mercantile system, thus, treats profits or gains as arising or accruing at the date of the transaction, notwithstanding the fact that they are not received or deemed to be received. It may, however, be noted that the right or liability must be legally enforceable and must have ripened. A contingent and conditional liability cannot be taken cognizance of, as held by the Allahabad High

Court in *Swadeshi Cotton Mill Co. Ltd.* v. *CIT* [1980] 125 ITR 33 / 3 Taxman 280. The mercantile system cannot be used for provisional, contingent or notional payments. The mercantile system implies passing of entries on the date of transaction and that is the date on which rights accrue or liabilities are incurred irrespective of the date of payment. In the mercantile system, bad debts are allowable when they become irrecoverable.

3.3 **Only two systems of accounting recognised now**. Sub-section (1) of section 145 now recognizes only these two - cash or merchantile - systems of accounting. Besides these two well known systems of accountancy, there are several variations prevalent in the business community keeping in view the nature of particular transaction and commercial expediency. Even the Supreme Court felt in *CIT* v . *A. Krishnaswami Mudaliar* [1964] 53 ITR 122 that in some cases these methods may not give a clear picture of the true profits earned and certainly not of taxable profits.

3.4 All the assessees following the mercantile system of accounting are required to follow the Accounting Standards notified by the Central Government. The main features of these Accounting Standards are as under :-

(i) Significant policies adopted in the preparation and presentation of financial statements shall be disclosed at one place and shall form part of the finanacial statements.

(ii) Any change in the accounting policy affecting the financial effect on the current year and subsequent years or in subsequent year and the impact of the adjustments resulting therefrom, should be stated in the financial statement of the year in which such change takes place.

(iii) Accounting policies adopted should represent a true and fair view of the state of affairs and the major consideration in this respect shall be : (a) provision should be made for all known liabilities and losses, wherever necessary, on the basis of estimate in the light of available information; (b) the accounting standard should be governed by substance and not merely by legal form; and (c) the financial statements should disclose all material items which might influence the decision of the user.

(iv) If any fundamental accounting assumptions relating to a going concern, consistency and accrual are not followed, the fact should be disclosed.

(v) The prior period items should be separately disclosed in the profit and loss account with their nature and amount;

(vi) Extraordinary items of the enterprise should be disclosed in the profit and loss account separately so that their effect on the operating results of the previous year can be perceived.

(vii) A change in accounting policy shall be made only if it is required by statute or it will result

in more appropriate presumptions of financial statements.

(viii) Any change in accounting policy which has a material effect on the financial statements of the period in which such change occurs or if it has effect for the subsequent period, shall be disclosed, indicating its impact.

(ix) A change in an accounting estimate that has a material effect in the previous year or the subsequent year shall be disclosed.

(x) If a question arises as to whether a change is a change in accounting policy or a change in accounting estimate, such a question shall be referred to the Board for decision.

3.5 **Aim of notified standards – transparency in financial statements.** The accounting standards laid down in the notification are not materially different from the principles of the mercanticle system of accounting except that these are aimed at making the financial statements more transparent and require certain vital information to be disclosed in the financial statements. The Department is accepting 97 per cent of the returns under section 143(1) of the Act (subject to prima facie admustments). The scrutiny is now confined to only random selection of 3 per cent cases and a few specified categories of companies. The transparency of the financial statements accompanying the returns of income will enable the Department to locate cases of fraudulent change of accounting policies.

4. The A.O may proceed under Section 145(3) under any of the following circumstances :

(a) Where he is not satisfied about the correctness or completeness of the accounts; or

(b) Where method of accounting cash or mercantile has not been regularly followed by the assessee ; or

(c) Accounting Standards as notified by the Central Government have not been regularly followed by the assessee.

4.1 Though the broad parameters have been laid down in the Section itself under which the provisions are required to be invoked for rejection of books of account in a particular case, yet, a definite ground work is *sine-qua-non* on part of the Assessing Officer before resorting to the provisions of section.

It is noted that in a large number of cases the provisions of Section are invoked on the pretext of fall in gross profit rate. Though the fall in G.P rate definitely provides a ground to the Assessing Officer for invocation of the provisions of Section 145(3) yet it is not a sufficient condition. The Assessing Officer is required to analyse various other parameters which have the effect on the gross profit rate of the assessee for the relevant period, before drawing any conclusion on the merit of such claim. The fall in G.P rate might be a symptom of malice with which the assessee's account would be suffering. However, it is the duty of

the Assessing Officer to pin point the malice and bring it out in the Assessment Order by marshelling the facts encompassing the same. In the case of low gross profit rate, there could be inflated purchases or unrecorded sales besides manipulation in the valuation of closing stock. Therefore, the Courts expect that the Assessing Officer shall bring on record specific defects in the books of account of the assessee before invoking the provisions of Section 145(3). The rejections of books of account simply on lower G.P rate in comparison to earlier years or with other assessees placed in similar circumstances would not suffice and will not stand the test of appeal.

4.2 Where the assessee is unable to reconcile the quantities handled by it as between purchases and sales, subject to adjustment as between opening and closing stocks or where no quantity accounts are kept, the accounts are to be taken as unproved, so that the income returned may well be rejected and income estimated, if the gross profit declared is low. But where quantities in purchases and sales are different in character of the stock, such reconciliation is not possible in CIT v/s. *Saatal Kattha and Chemicals P. Ltd.*[2008] 296 ITR 197 (MP), where the assessee was purchasing timber on the basis of length, girth and weight, but converted them into logs and sold the same in different sizes. The High Court found, that the inference of shortage in the facts of the case was not a sound basis. All the same, the High Court found, that a reasonable addition sustained by the Tribunal,

which reduced the additions made "capriciously" by the Assessing Officer, was held justified.

4.3 In a case, where accounts were rejected on the gound that purchases of raw materials were vouched only by internal debit vouchers, it was found that assessee had explained, that it was not possible to get third party vouchers for purchase of raw materials from sundry dealers in respect of a contract work in State of Assam in a disturbed situation. It was in this context, that the High Court in *Madnani Construction Corporation P Ltd.* v. CIT [2008] 296 ITR 45 (Gauhati) held, that the Tribunal was not justified in merely confirming the addition without considering assessee's case for acceptance of return.

4.4 In yet another case decided by the Tribunal in *ITO v. Girish M Mehta* [2008] 296 ITR (AT) 125 (Rajkot), it was pointed out, that the pre-condition for estimating business income of the assessee, where an assessee keeps accounts is that the assessee's books should have been found to be unreliable or otherwise not capable of proving the assessee's income. Without this first step, the fact that the gross profit is low cannot by itself be a ground for taking a view that it is open to the Assessing Officer to make good the alleged deficiency in gross profit.

4.4 Merely because the value of goods by the customs authorities was higher than the invoice price, the accounts cannot be rejected as found in CIT v. *Central Provinces Manganese Ore Co.Ltd.* (2008) 296 ITR 217 I (Bom).

4.5 In the case of *CIT v. Smt. M.Thankamma* [2010] 326 ITR 249 (Ker), where an undisclosed income based

upon a single document was deleted, the High Court felt that a remand is necessary because the Tribunal had merely confirmed the order of the first appellate authority by referring to the decision of the Supreme Court in *CIT* v. *P.V Kalyansundaram* [2007] 294 ITR 49 (SC), when according to the High Court there were several corroborative materials as alleged on behalf of revenue, which were not examined.

5. REJECTION OF BOOKS OF ACCOUNT IS JUSTIFIED

Hon'ble Allahabad High Court in the case of Awadhesh Pratap Singh Abdul Rehman & Bros v/s. CIT 201 ITR 406(All) held that **"It is difficult to catalogue the various types of defects in the account books of an assessee which may render rejection of account books on the ground that the accounts are not complete or correct from which the correct profit cannot be deduced. Whether presence or absence of stock register is material or not, would depend upon the type of the business. It is true that absence of stock register or cash memos in a given situation may not per se lead to an inference that accounts are false or imcomplete. However, wher a stock register, cash memos, etc., coupled with other factors like vouchers in support of the expenses and purchases made are not forthcoming and the profits are low, it may give rise to a legitimate inference that all is not well with the books and the same cannot be relied upon to assess the income, profits or gains of an assessee. In such a situation the authorities would be justified to reject**

the account books under section 145(2) and to make the assessment in the manner contemplated in these provisions.

In this case, the Tribunal's finding was held giving rise to no question of law and the said finding confirming rejection of books of accounts was held justified because no stock register was maintained nor were the sales found verifiable in the absence of cash memos. The vouchers of expenses were also not forthcoming and the income returned was ridiculously low as compared to the exorbitant turnover and the extent of the business carried on by the assessee.

5.1 Hon'ble Supreme Court in the case of Kachwala Gems V/s. JCIT, Jaipur 288 ITR 10 (SC) held the rejection of books of accounts under Section 145 justified and the best judgement assessment under Section 144 of the Act.

The facts of this case were that the assessee was dealing in precious and semi-precious stones. The Assessing Officer noticed certain defects in books of account of the assessee, viz, that it had not maintained any quantitative details/stock register for the goods traded in by it; that there was no evidence / document or record to verify the basis of the closing stock valuation shown by it; that GP rate declared by the assessee at 13.49 per cent during the assessment year did not match the result declared by the assessee itself in the previous assessment years; and that the gross profit declared by it was much below the rate declared voluntarily by another assessees engaged in similar business. Thereafter, the Assessing Officer rejected the books of account of the assessee and

resorted to best judgment assessment under section 144 and estimated the gross profit rate at 40 per cent. The Assessing Officer, further held that the assessee had shown bogus purchases for reducing the gross profits. On appeal, the Commissioner (Appeals), though reduced the quantum of the gross profit, estimated by the Assessing Officer, yet upheld most of his impugned findings. On further appeal, the Tribunal had also given further relief to the assessee. On appeal to the Supreme Court : the assessee himself who is to blame as he did not submit proper accounts. There was no arbitrariness in the instant case on the part of the authorities. Thus, there was no force in the instant appeal and the same was to be dismissed accordingly.

5.2 In the case of Champa Lal Choudhary vs DCITCent. Cir. 2 ,Jaipur the ITAT Bench-

'A' 54 SOT398(JP) confirmed the rejection of books of account holding that *the addition(s) being agitated would need to be examined, firstly, from the standpoint of the validity or otherwise of the invocation of Section 145(3) of the Act and the concomitant rejection of assessee's book results, and then on the merits of the addition on quantum.* ***The revenue's action in invoking section 145(3) is confirmed. This is principally for the reason that the assessee's books of account do not meet the test of deduction of true and correct profits therefrom in the absence of proper stock records, only whereupon can they be considered as correct and***

complete. The assessee's case is that each piece of stone bears different characterstics and composition and, therefore, it is not possible to maintain the stock register quality-wise. Firstly, therefore, it admits to its books of account as not bearing the quality-wise details of the goods purchased and sold and, thus, in stock at any given point of time and, therefore, not complete. The same may yield or reflect its quantity but then that by itself is of little moment or value in the absence of any indication as to its value which is an essential ingredient in determining the cost of the goods sold and, thus, trading profit, and which, in turn, is necessary to work out the net profit. The value of the stock-in-trade as at the year-end or the year of account, thus, becomes an independent variable, which cannot even be approximated with reference to the books of account as maintained. It is not the assessee's case that stock is valued at the average (weighted) cost of purchase, and which, though not a precise measure, evens out the profits when applied from year to year, so that it may be considered as a viable alternative, employed **bona fide.** ***The same, even otherwise, does not offer itself as an acceptable alternative in the facts and circumstances of the case. This as the average method would yield approximate***

and reasonably correct results only when the conditions for its application exist. That is, the prices of the various stone pieces vary over a given, small range, with a low co-efficient of standard variation. When the individual prices (or data points) vary considerably, which is admitted, employment of such a method would yield irregular and misleading results. Two stones of the same weight may have largely different values or (say value per unit (weight), where their weight differs. Further, how would the stock-in-trade as at the year end be valued? The same is to be at the actual cost of acquisition or production, and which again requires cost of bought out goods/raw material, **i.e.,** ***not only would its characterstics and/ or composition be required to be assessed for the purpose, but also its cost ascertained with reference to the acquisition cost, identifying the relevant purchase bills, which do not bear any such details in respect of such characterstics*** *or composition? [Para 5.1]*

5.3 Similarly , the ITAT Chandigar Bench 'A' in the case of Pawan Kumar vs ITO, Range IV(4), Malerkotla, 137 ITD 85 confirmed the rejection of books of account under section 145(3) holding **that** ***the discrepancies pointed out by the Assessing Officer while rejecting the book results have not been satisfactorily explained by the assessee. The Assessing Officer has observed***

that although the quantity of cotton seed, mustard and groundnut crushed during the previous year were shown separately but the yield of oil and oil cakes have been given in consolidated form at 13.02 per cent and 83.91 per cent respectively. Further, the sales of oil and oil cakes have been shown in the manufacturing account in consolidated form although there was a wide variation in the market price of these products. It is also true that there is always a wide variation in the percentage of yield of oil and sale rates of oil and oil cakes in the market. However, the assessee has preferred to put up a consolidated account of different types of oil seeds for the reasons best known to him. The assessee was asked by the Assessing Officer to rework the yield of oil and oil cakes separately from different types of oil, oil seeds crushed by him. The assessee was also asked to explain the reasons for mixing up the cotton, mustard and groundnut oil seeds in the same category when there was vast variation in market price of these types of oil seeds and other products. When Assessing Officer asked the assessee to give the explanation, the assessee stated that there was not much difference in the market price of both these oils and, therefore, he has made the sales of khal and oil of both these varieties jointly. It is opined that the

Assessing Officer has correctly rejected the above explanation of the assessee stating that assessee's statement in this behalf is not correct, therefore, under no circumstances is acceptable. Unless the yield of oil obtained on the crushing of three types of oil seeds is separately given, the manufacturing results cannot be appreciated in their proper perspective. [Para 11]

There were sufficient reasons to hold that the books of account maintained by the assessee are unreliable, incorrect and incomplete. Therefore, the books of account of the assessee have correctly been rejected under section 145(3). The Commissioner (Appeals) has correctly upheld the action of the Assessing Officer in rejecting the books of account. [Para 13]

6. Rejection of Books of Account under Section 145(3) and Assessment in the manner under Section 144 Connotation thereof

In a case where the provisions of Section 145(3) are attracted, although the assessment is made in the manner provided in Section 144, nevertheless the assessment is made under Section 143(3) of the Act. A clearcut distinction between Best Judgement Assessment and in the manner provided under Section 144 is required to be understood while resorting to the provision of Section 145(3). Under Section 145(3) the assessment is required to be in the manner under Section 144 of the Act only. However, it is well known that in the case of Best Judgement where resort

is taken to Section 144, the Assessing Officer excercising his jurisdiction cannot act arbitrarily or capriciously. The assessment must proceed on judicial considerations in the light of relevant material that may be brought on record. The Hon'ble Allahabad High Court in the case of CIT V/s. Surjeetsingh Maheshkumar (1994) 210 ITR 83 has held that in every case of Best Judgement, the element of guess work cannot be eliminated so long as Best judgement has a nexus with material on record and discretion in that behalf has not been exercised arbitrarily or capraciously.

6.1 Bombay High Court in the case of Bastiram Narayandas V/s. CIT (1994) 210 ITR 438 held the rejection of books of accounts justified under Section 145 and the Best Judgement assessment under Section 144 where the assessee had not produced relevant records relating to its day to day manufacture of *'bidis'* including the quanitity of *bidis* manufactured daily, the figures of *bidi* leaves consumed per day in each factory and the records relating to the daily collection of CHAAT and MAPARI *bidis,* the Tribunal has been held correct in holding that the Income Tax Officer was not satisfied about the fairness or correctness of the accounts of the assessee.

6.2 Although the words "Best of the Judgement" are used in Section 144 alone, the only difference between the assessment under Section 143(3) where books are found to be unreliable and an assessment under Section 144 is that the Act has contemplated a more summary method when the Assessing Officer is acting under Section 144 and that on account

of deliberate default of the assessee. [Gunda Subahiya v/s. CIT (1939) 7 ITR 21 Mad-FB.]

6.3 It may further be noted that the assessment that has to be made after rejection of books under Section 145(3), of the evidence or books produced is not an assessment under Section 144, but is only an assessment under Section 143(3) which is to be made "in the manner provided in Section 144". In such cases, the Assessing Officer has to give an opportunity to the assessee to contradict the materials upon which the Assessing Officer wants to base his estimate. [Addl. ITO V/s. Ponkunnam Traders (1976) 102 ITR 366 (Ker)]

7. POWER TO BE EXERCISED JUDICIALLY

When the Assessing Officer does not accept the assessee's method of accounting then he has to resort to the provisions of Section 145 to 145(2) {now 145(3) } for computation of income by adopting such other basis as determined by him. The Karnataka High Court in the case of Karnataka State Forest Industries Corporation Ltd., V/s. CIT (1993) 201 ITR 674 has held that the Assessing Officer's powers under the Section are not arbitrary and he must exercise his discretion and judgment judicially.

A clear finding is necessary before invoking the Section 145(3) of the Act.

8. Hon'ble Supreme Court and the various High Courts in number of cases have held that before invoking the provisions of Section 145(3) of the Act [earlier Sections 145(1) and 145(2)]. The Assessing Officer has to bring on

record material on the basis of which he has arrived at the conclusion with regard to correctness or completeness of the accounts of the assessee or the method of accounting employed by it.

9. LOW GROSS PROFIT, WHETHER BOOK RESULTS CAN BE REJECTED

In the business of definite finding that the case fall within the ambit of Section 145(3), the rejection of books of accounts cannot be sustained merely on the fact that the gross profit of the assessee is low during the relevant period as compared to book results of other years.

Similarly, the system of accounting adopted by the assessee cannot be rejected merely on the ground that the gross profits disclosed by his books were low as compared unfavourably with those of others in the same line of business.

10. NON MAINTENANCE OF STOCK REGISTER

The fact that there is no stock register only cautions the Assessing Officer against the falsity of the returns made by the assessee. He cannot show that merely because there is no stock register the account books must be false "Pandit Brothers v/s. CIT (1954) 26 ITR 159". In Chhabildas Tribhuvandas Shah V/s. CIT (1966) 59 ITR 733, the Supreme Court held that there was material to support the appellate Tribunals sustaining addition made on the ground that (i) the assessee's business was on wholesale basis and in the absence of tally of quantities in respect of major items of the trading account, the fall in margin of profits could not be satisfactorily explained; and (ii) the fall

was all the more difficult to explain in view of the fact that the assessee had a substantial import quota which could have been given him a handsome margin of profit. The Supreme Court, however, made it clear in the concluding portion of its judgment that it was not concerned with the correctness of the conclusion but was concerned only with the question whether there was any material in support of the Tribunal's findings in the case of Bhundiram Dalichand v/s. CIT(1971 81 ITR 609 (Bombay). The Bombay High Court found the rejection of books of accounts under Section 145 justified in the absence of quantitative tally of purchases and sales besides unexplained lowness of gross profit rate. Similarly, in the case of CIT v/s. Pareck Brothers (1987) 167 ITR 344 (Patna) it has been held that invocation of Section 145 was justified as the assessee was not maintaining day to day stock account and did not furnish any distinctive numbers either of purchases or sales to the Income Tax Officer.

10.1 A number of High Courts have held that the keeping of stock register is of great importance because it is a means of verifying the assessees accounts by having a quantitative tally. If in any case, after taking into account the absence of a stock register coupled with other materials, it is felt that correct profits and gains cannot be deduced from the accounts, resort to the provisions of Section 145(3) can be taken (S N Namashivayam Chettiyar v/s. CIT (1960) 38 ITR 579 (SC); Bombay Cycle Stores Co. Ltd., v/s. CIT (1958) 33 ITR 13 (Bombay).

10.2 The Calcutta High Court in the case of Amiya Kumar

Roy and Brothers v/s. CIT (1994) 206 ITR 306 held that failure to maintain stock accounts by the assessee was a substantial defect in the accounts. It upheld the decisions of Tribunal holding that the estimate which was made in the case and the addition made on such estimate was quite reasonable and fair taking cumulative view of all the factors present in the case.

10.3 In the context of Sales Tax legislation, it has been held that where the relevant statute mandates the dealer to maintain stock books in respect of raw materials as well as products obtained at every stage of production and the dealer does not maintain the stock of books, it leads to the conclusion that the account books are not reliable or that particulars are not properly verifiable. If the account books are rejected, the turnover has to be determined to the best of the Judgement of the assessing authority concerned. In such circumstances, it cannot be said that a defect in non maintenance of stock register is only technical and so the turnover disclosed in account books should be accepted. (CST v/s. Girija Shankar Awanish Kumar (1997) 104 STC 130 (SC).

11. STOCK REGISTER NOT VERIFIABLE AT THE TIME OF SURVEY – PRODUCED AT THE ASSESSMENT STAGE

Where at the time of survey, a stock register was not found at the business premises, that circumstances may create a suspicion about the genuineness of the stock register when it is produced during the assessment proceedings. But the assessing authority has to scrutinize the stock reigister so produced and it is only in case he finds it spurious

that a conclusion can be drawn that the assessee had not maintained its accounts properly. (Delhi Iron Syndicate Pvt. Ltd., v/s. CIT (1979) Tax LR 775 (All).

12. POWER OF THE FIRST APPELLATE AUTHORITY IN THE MATTER OF REJECTION OF BOOKS OF ACCOUNTS

It is well settled position of law that the CIT(A) during the appellate proceedings exercises all the powers vested with Assessing Officer to be exercised while framing the assessment order. Therefore the CIT(A) can reject the books of accounts of the assessee by invoking the provisions of Section 145(3) of the I.T.Act. For the first time, while framing the appellate order provided with all other conditions exist warranting rejection of such books of accounts. In this regard, the decision of Supreme Court in the case of *CIT v/s. Mc Millan and Company (1958) 33 ITR 182 (SC)* is quite relevant. The decision has been rendered in respect of the old provisions of Section 145 neverthless it is equally applicable to the present provisions of Section 145 also.

13. REJECTION OF ACCOUNTS IN EARLIER YEAR(S) CANNOT JUSTIFY REJECTIONFOR CURRENT YEAR

It is a well settled position of law that while making the assessment, the account books for that year have alone to be considered, as each assessment year is independent. There is no scope of presumption that merely because for some reason the account books in earlier years were rejected, these stood condemned forever. In this regard the decision of Allahabad High Court in the case of Ram Avtar Ashokumar v/s. CST (1980) 45 STC 366 (All) is quite relevant.

14. ESTIMATES AFTER REJECTION OF BOOKS OF ACCOUNT

Once the books of account of assessee are rejected, then, profit has to be estimated on the basis of proper material available. An Assessing Officer is not flattered by technical rules of evidence and pleadings, and he is entitled to act on material which may not be accepted as evidence in Court of law. Neverthless, the AO is not entitled to make a pure guess and make an assessment with reference to any evidence or any material at all. There must be something more than mere suspicion to support an assessment under Section 143(3) of the Act. The rule of law on this subject has been fairly and rightly stated by the Lahore High Court in the case of Sheth Gurmukh Singh v/s. CIT (1944) 12 ITR 393 and the Supreme Court in the case of Dhakeswari Cotton Mills Ltd., v/s. CIT (1954) 26 ITR 775.

15. ESTIMATES BASED ON COMPARABLE CASES

The estimate of turnover and fixation of gross profit rate are two important parameters which affect the assessment. If these are fixed or calculated in such a way that they adversely affect the assessee's case, then he is entitled to know the basis and to be given an opportunity to rebut the same. The rule of law on this subject has been well settled that estimates framed without giving the basis for their fixation or without furnishing to the assessee the material on which the rate of gross profit is arrived at or without giving an opportunity to the assessee to rebut it are bad. [Dhakeswari Cotton Mills Ltd., v/s. CIT (1954) 26 ITR 775]

No reliance can be placed on rejected account books for working out Peak Credit. Madras High Court in the case of CIT v/s. KMN Naidu (1996) 221 ITR 451 has held that where assessee's business income is estimated after rejecting the account books produced by the assessee, it is not reasonable on the part of the ITO to work out the *Peak Credit* on the basis of such accounted books.

16. THE COMPARATIVE GP RATE OF EARLIER YEARS

The rate of gross profit in a particular year depends on many factors namely the general market conditions based on demand and supply position, the rise or fall in market rates, specially abrupt ones, the capital position viz-a-viz the turnover acheived and many others. It is for the assessee to explain the fall, if so happens and to substantiate the reasons. Even if, thereafter, the Assessing Officer considers the material placed before him by the assessee to be unreliable, keeping in view the comparative statement of accounts of the earlier years, he cannot proceed to make an arbitrary addition and base his conclusion purely on guess work. He can do so only if he relates to some evidence or material on the record. The Courts have held that if the profit shown by the assessee in his return is not accepted, it is for the taxing authorities to prove that the assessee made more profits. [International Forest Company v/s. CIT (1975) 101 ITR 721 (J & K)]

Further, once the books are properly rejected, the income has to be estimated and in making the estimate of such income, the best record alongwith other things will become the relevant material. [Vrajlal Manilal & company v/s. CIT(1973) 92 ITR 287 (MP)]

17. MANDATORY REJECTION OF BOOKS OF ACCOUNTS UNDER SECTION 145(3) BEFORE REFERENCE UNDER SECTION 142A TO D.V.O.

Section 142A was inserted by the Finance (No.2) Act 2004 with retrospective effect from 15/11/1972, to confer power on the Assessing Officer to refer the matter to the Valuation Officer, which earlier had not been conferred. Earlier there was a provision being Section 55A to ascertain the fair market value of a capital asset for the purposes of Chapter-IV of the Income Tax Act. The Supreme Court after considering the scope and ambit of Section 55A in the case of Smt. Amiya Bala Paul v/s. CIT (2003) 263 ITR 407 held that it would not apply to proceedings under Section 69B. Apparently, Section 142A has been introduced to overcome such situations.

17.1 Supreme Court in the case of Sargam Cinema v/s. CIT (2010) 328 ITR 513 has held that the Assessing Officer cannot refer the matter to the DVO under Section 142A without rejecting the books of accounts under Section 145(3) of the Act. In this regard, reference can also be made to the other judgements e.g., CIT V/s. Lucknow Educational Society (2011) 339 ITR 588 (All) and CIT v/s. Hotel Joshi (2000) 242 ITR 478 (Raj)

18 Intricacies of making addition on account of low GP

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1. Power of the Assessing Officer to estimate profits

Comparison of gross and net margin shown by an assessee is a normal exercise during the course of assessment proceedings. While lower gross profit shown by the Assessee as compared to the preceding years is a red flag for investigation, mere existence of low margin cannot be a ground for addition. While the initial burden is on the assessee to justify the margin shown by it in its books of account, once the AO rejects the contention of the assessee, burden is on him to justify his rejection of the assessee's margins and basis for estimation of a new gross margin. The primary requirement before the assessing officer arrives at the stage of estimation of profits, is to demonstrate the unreliability of the books and consequently, the profit margin shown by the assessee. If the books are found to be correct and no flaw has been detected, it would be incorrect on the part of the Officer to reject the margin computed on the basis of such accounts. The flaw in the accounts drawn by the assessee can be for a variety of reasons - detection of non-recording of sales, booking of fictitious purchases, booking of fictitious expenses, evidence of inflation in expenses, adoption of wrong method of accounting to reduce taxable profits etc. These deficiencies, coupled with a low gross margin shown by the assessee provide the perfect platform for rejection of the books maintained by the assessee and estimate a reasonable profit margin based on margins of similar other assessees.

2. Relevant Legal Provisions

Detection of deficiencies in accounts is primarily work of investigation. The Assessing Officer needs to make proper inquiries in respect of the business dealings of the assessee to find out the correctness of data supplied by the assessee. Once deficiencies are noted in respect of such data and the assessee is not able to explain them satisfactorily, legal provisions are available for rejection of books in such cases. These provisions are contained in Section 144 and 145 of the Income Tax Act.

3. AO's Power To Reject Accounts

It is the duty of the Assessing Officer to consider whether or not the books disclose the true state of accounts and the correct income can be deduced therefrom. The officer is not bound to accept the system of accounting regularly employed by the assessee, the correctness of which had not been questioned in the past. There is no estoppel in these matters, and the officer is not bound by the method followed in the earlier years. But it is also pertinent here to mention that the AO must refer to the inherent defect in the system followed by the assessee, demonstrate that the defect has led to clear mis-statement of its income and record a clear finding that the system of accounting followed by the assessee is such that correct profits cannot be deduced from the books of account maintained by the assessee. In this regard, a factual finding by the assessing officer that part of the receipts or expenses have either not been accounted or wrongly accounted in the books would constitute a clear evidence of such nature. In the following paragraphs some important observations noted by the Courts and Appellate

authorities have been reproduced relevant to this section of the report:

3.1 After going through the provisions of the Act, background of the provisions as well as important case laws in this regards, following important areas emerge, which are to be kept in mind at the time of investigating such cases and rejecting the books of accounts of the assessee.

i. If the assessing officer is not satisfied with the book result i.e. gross profit shown by the assessee, he may reject the books under Section 145(3) and estimate gross profit ratio. But before doing that he has to give a clear finding that the there are **defects in books of accounts** and hence books of accounts are not acceptable. Such instances may be:

a. Purchase, sales, direct expenses, valuation of stock etc shown in the books are not correct.

b. Accounts written are not full and complete and do not reflect the actual receipts on sales.

c. Actual quantity of finished product produced by the assessee appear to be more than what it has shown in the accounts books.

d.. The assessee had made any sale of finished product which has not been reflected in the accounts books.

e. The finished product has been sold by the assessee at a price higher than what is declared in the accounts books.

f. Assessee is not maintaining any stock register

and adopting closing stock without any supporting documents to enable verification.

g. The Central Government had notified a particular accounting standards for a specific trade to be followed by the assessee and the assessee has not followed it.

h. The rate of Gross Profit declared by the assessee is low as compared to other assessee's in the same line of business or with reference to assessee's margins in earlier years.

ii. If the rate of gross profit declared by the assessee in a particular period is lower as compared to the gross profit declared by him in the preceding year that should alert the Assessing Officer and serve as a warning to him, to look into the accounts more carefully for verifying the correctness of accounts. But, a low rate of gross profit, in the absence of any material pointing towards falsehood of the accounts books, cannot by itself be a ground to reject the account books under Section 145(3) of the Act.

For example, in case of transactions in cash, the purchaser and the seller often do not bother to keep details of their identity. So the name of the customer if not mentioned on cash memo cannot be treated as defect in the books of the assessee.

iii. Non maintenance of stock register on day to day basis by itself should not lead to inference that it is not possible to deduce the true income of the assessee from the accounts maintained by assessee, nor can

the accounts be said to be defective or incomplete for this reason alone. If the assessee is dealing in such items where maintenance of stock register is not possible i.e. keeping in mind the quantity, size, varieties, processes involved in production etc it can't be treated as defect for application of section 145(3) of the Act.

In the case of CIT vs M/s Jas Jack Elegance Exports, ITA 681/2010 dated 26/4/2010, Delhi High Court, the Court has dealt on this issue elaborately. Some of the observations are as reproduced below.

1. This is not the case of the Revenue that the assessee had not followed either cash or mercantile system of accounting stipulated in sub- Section (1) of Section 145 of the Act.

2. This is also not the case of the Revenue that the Central Government had notified any particular accounting standards to be followed by manufacturers and exporters of readymade garments.

3. Assessing Officer had not pointed out any defect in the Accounts Books maintained by the assessee, which, admittedly, were produced before the Assessing Officer for his consideration.

4. This is also not the finding of the Assessing Officer that the account of the assessee was not complete.

5. No provision either in the Act or in the

rules requiring an assessee carrying business of this nature, to maintain a Stock Register, as a part of its accounts has been brought to our notice. As regards non-production of Stock Register, the assessee has given an explanation which has been accepted not only by the Commissioner of Income Tax(Appeals) but also by the Tribunal and both of them have given a concurrent finding of fact that maintaining Stock Register was not feasible considering the nature of the business being run by the assessee which was engaged in the business of manufacturing readymade garments by purchasing fabric which was then subjected to embroidery, dyeing and finishing and then converted into readymade garments by stitching.

6. Section 145(3) of the Act therefore could not have been applied by the Assessing Officer to the present case. The Assessing Officer did not point out any difference in the consumption of raw material and production of finished goods when compared to earlier years. The Assessing Officer did not say that after comparing the raw material consumed and finished goods produced in the previous years with the raw material consumed and the finished goods produced in the year in question, he had found that the number of finished goods pieces actually produced by the assessee should have been more than the number of pieces declared in the account books produced before him.

4. Estimation of Profits

The AO need not examine the gross margin of an assessee with respect to its earlier performance. There are cycles of ups and downs in various sectors of economy and it is important for the Officer to examine this issue. A fall in GP for the assessee may be coupled with a general recession in that sector and hence profits of all the peers may have dipped. Similarly, the year may represent an exceptional year wherein all the peers have made exceptional profits. Hence, while examining gross margins, the assessing officer should not only compare the past margins of the assessee but also the current year margins of other assesses engaged in similar business. This would give an insight into the actual profit margins during the year under reference and would be a correct guide for estimation of profits.

4.1 As discussed above, a low gross margin per se can neither constitute a valid ground for rejection of books nor for estimation of profit. However, once the Assessing Officer has demonstrated that the books of accounts of the assessee company are not reliable, he needs to proceed under Section 145 and reject the books. Thereafter, an estimation of profit becomes an essential step towards determining the correct margin earned by the assessee. Once the books of accounts of the assessee are rejected, profit needs to be estimated on the basis of the material available on record. Even in cases where accounts are not rejected profit claimed by the assessee may have to be readjusted on the basis of material made available by the assessee itself. Before arriving at a reasonable

profit estimate the AO must understand the intricacy of the business of the assessee along with the profit earned by other comparable business of the same nature as of the assessee. There may be variation in the profit of the assessee alone or the variation may be seen in the all businesses of the same nature.

4.2 Estimation of profits on account of low GP has been dealt with mercilessly at the appellate level. The main reason for this is that while the officer works very hard in collecting evidences relating to error in accounts for rejection of books, he hardly collects any evidence relating to his estimation of gross margin for the assessee. Most of the time, such estimation is based on the past average GP rate. The assessee can easily demonstrate at the appellate level that the circumstances in the preceding years were different from the year under reference resulting in deletion of the addition. The most important issue which should be examined and arrived at by the officer is the reasonable profit margin for the year under reference based on circumstances prevailing in during the year and the performance of similarly placed assesses.

4.3 In the following paragraphs some important observations noted by the Courts and Appellate authorities have been reproduced relevant to this section of the report:

In case of ***MysoreFertiliser Co.* v. *CIT* [1966] 59 ITR 268 (Mad.)** it was held that the ITO shall make the assessment to the best of his Judgement; it means that he must make it according to the rules of

reason and justice, not according to private opinion, but according to law and not humour, and the assessment is to be not arbitrary, vague and fanciful, but legal and regular.

It was held in case of ***CIT* v. *Surjit Singh Mahesh Kumar* [1994] 210 ITR 83 (All.)** that so long as the Best Judgement has nexus to material on record and the discretion in that behalf has not been exercised arbitrarily or capriciously, it is not open to scrutiny in reference proceedings to give rise to a question of law or to a mixed question of law and fact.

In case of ***CIT* v. *Eastern Commercial Enterprises* [1994] 210 ITR 103 (Cal.)** it was held that where the assessee has given a comparative instance of gross profit rate, it is necessary for the department to come to a finding as to the norm of the gross profit on the basis of comparative cases. Therefore, it is the duty of the Assessing Officer to counter the comparative statement cited by the assessee before he can have the option to estimate the gross profit.

It was observed by Hon'ble Court in case of ***Aluminium Industries (P.) Ltd.* v. *CIT* [1995] 80 Taxman 184 (Gauhati)** that additions to the profits of the assessee made solely on the ground that it was low without giving a specific finding that the accounts of the assessee were not correct and complete, or that the income could not be properly determined and deduced from the accounting method

employed by the assessee, is not justified. The mere fact that there was a less rate of gross profit declared by an assessee as compared to the previous year would not by itself be sufficient to justify the addition.

In a recent landmark decision, the Hon'ble Delhi High Court has dealt with the issue elaborately. In the case of CIT vs Smt Poonam Rani [2010] 192 TAXMAN 167 (DELHI), wherein the Officer had rejected the books because of the quantitative variation in the weight of the output products as against input items, the High Court rejected the addition made on estimate basis because no defect was pointed out in the accounts and there was no basis for estimation. The observations of the High Court are reproduced as below:

1. The Assessing Officer had not pointed out any particular defect or discrepancy in the account books maintained by the assessee. During the course of hearing before the Commissioner (Appeals), it was pointed out by the assessee that her account books were duly audited under Section 44AB of the Central Excise Act and the quantitative details as required by clause 28(b) of Form No. 3CD regarding raw material and finished products were prepared and audited by certified accountant and were enclosed with Form No. 3CD which had been placed on record.

2. As regards the marginal increase in the weight of the finished product, the explanation given by the assessee had been accepted not only

by the Commissioner (Appeals) but also by the Tribunal. The Assessing Officer had no material before him on the basis of which it could be said that the weight of the wire did not increase even marginally during the process of enamelling.

3. The fall in the gross profit ratio could be for various reasons such as increase in the cost of raw material, decrease in the market price of finished product, increase in the cost of processing by the assessee, etc.

4. There was no finding that the actual cost of the raw material purchased by the assessee was less than what was declared in the account books.

5. There was no finding that the actual cost of processing carried out by the assessee was less than what had been declared in her account books.

6. No particular expenditure shown in the account books had been disallowed by the Assessing Officer.

7. There was no finding by the Assessing Officer that the actual quantity of finished products produced by the assessee was more than what was shown in the account books.

8. There was no finding that the assessee had made any such sale of the finished products which was not reflected in the account books.

9. There was no finding by the Assessing Officer that the finished products were sold by the assessee at a price higher than what was declared in the account books.

10. In those circumstances, the Commissioner (Appeals) and the Tribunal were justified in holding that the Assessing Officer could not have increased the gross profit ratio merely because it was low as compared to the gross profit ratio of the preceding year.

11. The revenue contended that the assessee was not maintaining the daily stock register. However, no such finding was found in the assessment order. On the other hand, the assessee had submitted before the Commissioner (Appeals) that Form No. 3CD containing all the quantitative details in respect of raw materials as well as the finished goods and duly audited by the certified accountant had been placed on record, but the Assessing Officer ignored those actual figures enclosed with the return. In any case, there is no statutory provision under the income-tax regime requiring the assessee to maintain the daily stock register.

12. Hence, even if no such register was being maintained by the assessee, that, by itself, would not lead to the inference that it was not possible to deduce the true income of the assessee from the accounts maintained by her, nor the accounts could be said to be defective or incomplete for that reason alone.

13. If the stock register is not maintained by the assessee, that may put the Assessing Officer on guard against the falsity of the return made by the assessee and persuade him to carefully scrutinize the account books of the assessee, but the absence of one register alone does not amount to such a material leading to the conclusion that the account books were incomplete or inaccurate.

14. Similarly, if the rate of gross profit declared by the assessee in a particular period is lower as compared to the gross profit declared by him in the preceding year, that may alert the Assessing Officer and serve as a warning to him to look into the accounts more carefully and to look for some material which could lead to the conclusion that the accounts maintained by the assessee were not correct, but a low rate of gross profit, in the absence of any material pointing towards falsehood of the account books, cannot, by itself, be a ground to reject the account books under section 145(3).

4.4 As clear from the above discussion, not only a proper reason for rejection of accounts is needed but it is equally important to base the estimation on solid facts. While low gross profit may prompt an investigation in respect of the assessee, it may not serve as a guide for estimation of gross margin in the current year. As mentioned above, peer or sectoral analysis is generally available in respect of most of the sectors on the

internet. The AOs should make full use of such data. Further, to factor geographical and other differences, the assessing officers may resort to local comparables in the same trade. Databases like Prowess maintained by CMIE and Capitaline are important source of such data. These databases can be used to find out the normal margins earned by other assesses in the same trade. This would give a sound basis for the assessing officer to arrive at a reasonable gross margin for the purpose of estimation.

19 Re-opening of Assessment - Sections 147/148

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Legal Foundation of Provisions

The fundamental legal and common-sense principle which help understanding and appreciating the requirements of valid actions and procedures for re-opening the assessments is, that in general, the law disfavours the unsettling of settled and concluded status/ proceedings. It is easy to understand why it should be so. First, law believes that apparent is legal and valid and higher degree of basis and need is generally required to attempt to allege otherwise, particularly for concluded proceedings. Second, everyone is entitled to a satisfaction, after the lapse of normal limitation, that some proceedings likely against her are "finally concluded, or not taken". Third, and more important, as the time passes, the evidences which support the claims become difficult to gather and produce and therefore, stringent procedural requirements must be prescribed to reagitate older matters. Fourth, when State is a party, enough procedural safeguards must be prescribed to prevent whimsical or arbitrary misuse of power. Fifth, and topmost, enough inhouse verification by senior functionaries must be inbuilt in the procedure governing the exercise of power to reopen/reagitate to ensure that undue and unjustified inconvenience and harassment is not caused to the subject. The law, on the other hand, must also ensure the levy of rightful taxes when on account of oversight/negligence some tax has been missed to be collected. Thus, the reassessment code prescribed in Sections 147 to 153 is a fine balance between the "due taxation" and "citizen's rights/State's duty to be fair and

reasonable". If viewed in this perspective, the actions/procedural requirements of Sections 147 to 153 are easily and effortlessly integrated into our governing psyche.

The notice for reassessment and the consequential proceedings result primarily in unsettling a settled position or concluded proceedings after a lapse of time. Invariably, as is easy to visualize, such an attempt would entail some inconvenience and perceived harassment to the person who is visited with these reassessment proceedings. Such person justifiably would have a notion of undue, discriminatory and unjust treatment even after the closure of the original proceedings. Moreover, an arbitrary exercise of such power, in the absence of effective machinery to safeguard the interest of the assessee, can lead to excesses and rampant misuse. This is the reason why powers to reassess are not blanket but is substantially restricted and must be exercised strictly within the statutory parameters laid down so as to balance the interest of the revenue vis-à-vis the interest of the assessee. Because the restrictions/conditionalities contained in the provisions are meant to ensure disciplined and judicious exercise of powers by the Assessing Officers and to protect the assesses against the misuse or malafides, the same are always construed strictly by the Judicial Authorities, and even a minor infraction would be enough to vitiate the jurisdiction and the proceedings.

The reassessment can be initiated within the time frame and on satisfaction of the Assessing Officer as detailed in Sections 147 to 153 subject to procedure prescribed in these sections. These are briefly mentioned below, and are meant only to get the "basic content" of the provisions meant to remain in our consciousness though; referring to the relevant provisions themselves every time we deal with them can never be over-emphasized.

1) **Section 147: Income escaping assessment.**

a) When

i) Assessing Officer has *"reason to believe"*

ii) That income chargeable to tax has escaped assessment (explanation below proviso important) for any Assessment Year.

b) She may assess, reassess, recompute loss etc. **subject to** Sections 148 to 153 for that Assessment Year, including any other income that she may discover during the course of 147 proceedings under Section 147.

i) However, Assessing Officer cannot assess or reassess the income involving subject matters of appeal, revision etc (principle of merger of order / proceedings).

c) If however, earlier assessment is under Section 143(3) or 147, then, **after four years from end of Assessment Year**, the action by Assessing Officer is possible **only if** the escapement is on account of *failure of the assessee* to file Return of Income as required, or in response to notice, or to disclose all *"material facts fully and truly etc"* (Expln. 1: mere production of books of account may NOT *necessarily* be 'disclosure' so as to disable Assessing Officer's action).

d) The income from "foreign assets" can be, however, reassessed till 16 years from end of Assessment Year (recent amendment).

e) Explanations below proviso are important for definitions and scope of few phrases/for special cases.

2) **Sections 148, 149, 151: Issue of notice where income has escaped assessment: sanction , time limit**

a) The Assessing Officer shall issue requisite notice before action under Section 147 for relevant Assessment Year

b) Notice under Section 143(2) should be issued/served within prescribed statutory period for undertaking reassessment after filing or deemed filing of return in response to 148 notice under Section 148.

c) Requisite approvals before issuance of notice:

i) If earlier assessment is framed under Section 143(3) or under Section 147, and, if the present Assessing Officer is an ITO, the approval of JCIT, if the reopening is within four years and CIT/CCIT if it is beyond four years from the end of the relevant Assessment Year. In other words, the JC'sIT/Addl. C'sIT or the satisfaction on the fitness of proposed action as required; and,

ii) If earlier assessment is not under Section 143(3) or under Section 147 then no approval is necessary till four years from the end of the Assessment Year for any Assessing Officer, but beyond four years, approval of JCIT/Addl. CIT would be necessary for both the ITO and ACIT/DCIT herself would need no approval.

d) The notice under Section 148 can be issued **after four years** from the end of the Assessment Year **only if:**

i) The income having escaped assessment is not less than Rs. 1 lac for that Assessment Year.

In any case, no notice can be issued after six years from the end of the Assessment Year normally.

ii) The only exception is income from "foreign assets" which, when forms the basis of re-opening, notice in that case the notice can be issued till end of 16 years from the end of relevant Assessment Year without any monetary limit subject only to approvals as above.

3) **Important Concepts/ key words**

a) **'Reason to believe'**:

The reassessment can be initiated only when the Assessing Officer has "reason to believe" that "income chargeable to tax has escaped assessment" for relevant assessment year. The basis of the belief should be discernible from the material on record, which was available with the Assessing Officer, when he recorded reason. There should be a link between the reasons and the evidence/material available with the Assessing Officer. The 'reason to believe' would plainly mean basic cause or justification for the Assessing Officer to initiate proceedings.

The "reason to believe" is different from "reason to suspect" or from "to have an opinion". It has been held that reason to believe can be said to exist only when the Assessing Officer comes into possession or "discovers" "some material", or "gets a new insight" subsequent to the conclusion of the original proceedings. Some "information"/event after the original assessment would normally be required to form a belief that the income chargeable to tax has escaped assessment.

Such material or insight must be bona-fide and must be capable of leading to the "formation of bona-fide belief"

The belief should be that income chargeable to tax has escaped assessment. Such escapement may be escapement simpliciter or also as defined in Explanation 2 below Section 147.

The reasons leading to satisfaction under Section 147 must be duly recorded by the Assessing Officer bringing out clearly the "material" or the "insight", the link of reasoning connecting the material with the belief of escapement and also indicating the prima-facie estimate of escapement. The recording of reasons is the most important and fundamental jurisdictional necessity, in the absence of which the assessment itself will not survive. As such recorded reasons are the only basis for higher judicial authorities to ascertain the link between the material, the 'reason to believe' and the underlying reasoning, utmost care should be exercised to ensure:

(1) That the reasons are fully self-contained and bring out a clear existence of the fulfillment of requisite conditions and jurisdictional facts. Wherever necessary, after the end of four years from the Assessment Year, how there is requisite "failure" of the assessee must also be clearly brought out;

(2) That the existence of such reasons recorded in the file and on the order-sheet

(3) That proper approvals are taken whenever necessary;

(4) That mentioning of such reasons is duly made in the Assessment Order; and,

(5) That the reasons recorded must be **on the basis of**

Evidence/ 'material'.

In *Hindustan Lever Limited Vs. R.B. Wadkar, Asst. Commissioner of Income Tax, (2004) 268 ITR 332 (Bom),* a Division Bench has opined the followings with respect to recording of reasons which should form the unimpeachable code for the Assessing Officers:

- The reasons are required to be read as they were recorded by the Assessing Officer;
- No substitution or deletion is permissible;
- No additions can be made to those reasons;
- No inference can be allowed to be drawn on reasons not recorded;
- It is for the Assessing Officer to disclose and open his mind through reasons recorded by him;
- It is for the Assessing Officer to reach to the conclusion as to whether there was failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment for the concerned assessment year;
- The reasons recorded should be clear and unambiguous and should not suffer from any vagueness;
- The reasons recorded should be self explanatory and should not keep the assessee guessing for the reasons;
- Reasons provide the link between conclusion and evidence;

- The reasons must be based on evidence;
- The Assessing Officer, in the event of challenge to the reasons, must be able to justify the same based on material available on record;
- He must disclose in the reasons as to which fact or material was not disclosed by the assessee fully and truly necessary for assessment of that assessment year, so as to establish the vital link between the reasons and evidence;
- That vital link is the safeguard against arbitrary reopening of the concluded assessment;
- The reasons recorded by the Assessing Officer cannot be supplemented by filing an affidavit or making an oral submission;
- If the reasons were lacking in the material particulars, the same would get supplemented by the time the matter reaches to the court, on the strength of affidavit or oral submission advanced.

b) **Information :**

The Assessing officer may, on the basis of 'information' received from external sources, including that from the Audit, form the belief of escapement. The Assessing Officer, based on the information which comes to his notice subsequent to the earlier assessment, may issue notice for reassessment. "Information" means communication or reception of knowledge or intelligence. It includes knowledge obtained from investigation, study or instruction. To inform means to impart knowledge. A detail available in file before ITO does

not by its mere presence or availability become an item of information. It is transmuted into an item of information only, if and when its existence is realized and its implications are recognized. Whether a particular fact or material constitutes information has to be decided w.r.t the facts of that case and there cannot be a definite rule of universal application. **(Shiva Exports 28 SOT 512(Chd))**

It may not be out of place to mention, that in the modern era of user-friendly and searchable data of ALL relevant decisions available on softwares subscribed by the department, locating the decision is not a challenge (as it earlier used to be), but **reading** those which have gone against the Department, and integrating the import of the same as a guiding factor in our actions is the key challenge. The following case laws envisage what amounts to 'information' and may be used as a guide or relied upon by the Assessing Officer:

(a) In *Assistant Commissioner of Income Tax Vs. Dhariya Construction Co. (2010) 328 ITR 515*, the Supreme Court held that the Department sought reopening of the assessment based on the opinion given by the District Valuation Officer. The **opinion of the DVO per se is not** information for the purposes of reopening assessment under Section 147 of the Act. The Assessing Officer has to apply his mind to the information, if any, collected and must form a belief thereon.

(b) In *Income Tax Officer Vs. Saradbhai M. Lakshmi, (2000) 243 ITR 1*, the Supreme Court held that the decision of the High Court would constitute information and the initiation of reassessment proceeding on the basis of the decision of the High Court has been justified.

(c) *In Ess Ess Kay Engineering Co. P. Limited Vs. Commissioner of Income Tax, (2001) 247 ITR 818*, the Supreme Court held that the Income Tax Officer is not precluded from reopening of the assessment of an earlier year on the basis of his finding of fact, made on the basis of the fresh materials in the course of assessment of the next assessment year.

(d) *In Dr. Lata Chouhan Vs. Income Tax Officer and another, (2010) 329 ITR 400 (MP),* the petitioner filed her return for the Assessment Year 1997 – 98. On 25-12-1999, a survey under Section 133A of the Act was conducted by the Department in the business premises of the petitioner. During the course of the survey, it was noticed that the petitioner had made substantial investment in construction of her hospital building. It was estimated by the ITO at Rs 27,70,000/- whereas the petitioner had disclosed only Rs. 3,65,310/-. A notice for reassessment was issued under Section 147. In the writ petition filed by the assessee, the High Court held that when survey was conducted in the premises, the department came into possession of material for proceeding to reopen the assessment. This fact was thus rightly made the basis for making reassessment. Once there existed a basis for forming a prima facie opinion for escaped income then it is sufficient ground to issue notice under Section 147. The Court cannot examine the adequacy or sufficiency of reasons on facts like an appellate court for deciding as to whether on such facts, notice would be issued or not unless the reasons are found to be totally perverse or absurd or against any provision of law. Such was not the case here.

The return was filed and hence notice under Section 147 could be issued on satisfying the requirement of Section147. The notice was thus valid.

(e) In case of *A Raman & Co 67 ITR 11(SC),* it is held that the word information means instruction or knowledge derived from external source or as to law relating to a matter bearing on the assessment. Similarly in the case of Kalyanji Mavji 102 ITR 287(SC) it has been held that information can come from external sources or even from material already on record and the *word information would include the true and correct state of law*. [Also see *287 ITR 282(Bom) Clagget Brachi & Co 100 ITR 46 (AP)].*

(f) Audit note is information P.*V.S beedies P Ltd- 237 ITR 13(SC*):

(g) A subsequent decision of Jurisdictional court will constitute information: *Novapan India 236 ITR 746(AP), Madras Fertilisers 122 ITR 139(Mad), Maharak Kumar kamal Singh 35 ITR 1(SC), A L A Firms 189 ITR 285(SC*)

If, somehow, the Assessing Officer feels that she has no "real material" on which a "reason to believe" can exist, the Assessing Officer may be well advised to gather further material by collecting information under Section 133(6) after seeking approval from the Appropriate Authority. This may be particularly required while dealing with remedial actions in cases of Audit Objections which are not accepted. Such information can strengthen either the reassessment proceedings (by ensuring proper existence and recording of "reason to

believe"), or the reply to the Audit, as the facts may turn out to be. When there is "escapement" but there is also challenge in forming a belief under Section 147, the Assessing Officer should endeavour to gather proper material as statutorily permissible before recording the reasons and issuance of notice. The Range Heads can and should ensure proper and legal basis for issuance of notice under Section 148 rather than hurriedly recording "some reasons".

c) **Failure to disclose fully and truly material facts necessary for assessment**

In case the earlier assessment is under Section 143(3)/147, the reopening beyond four years from the end of the Assessment Year is possible only if the escapement is on account of "failure of the assessee to disclose fully and truly all material facts necessary for his assessment". The following case laws are important in this regard:

(i) In *Deputy Commissioner of Income Tax Vs. Purolator India Limited, (2011) 11 ITR (Trib) 434 (Delhi),* it was held that where the assessee had claimed relief under Section 80HHC on the basis of audited accounts with accompanied return and such relief was allowed in regular assessment after considering the materials on record, there could be no justification for issuing notice under Section 148 after the four year time limit.

(ii) In *Kalyan Ala Barot Vs. M.H. Rathod, (2010) 328 ITR 521 (Guj),* the High Court dismissed the writ petition holding that in consequence of and with a view to give effect to the finding contained in the order made by the Commissioner (Appeals) in appeal for assessment

year 1984-85, the Assessing Officer has issued notice under Section 148 for assessing the income which was excluded from the total income of the petitioner for the Assessment Year 1984-85, to assess such income for the Assessment Year 1983-84. Thus, the case fell within the ambit of provisions of Section 150 as well as Section 153(3)(ii) read with *Explanation* 2 to Section 153 of the Act and as such, there was no infirmity in the action of the Assessing Officer in initiating reassessment proceedings, the same being in consonance with the provisions of law and within the prescribed time limit.

iii) In *Hindustan Petroleum Corporation Limited Vs. Deputy Commissioner of Income Tax, (2010) 328 ITR 534 (Bom),* the High Court held that where the assessee had claimed relief under Section 80-IA on the income attributable to a generator used as a captive power plant, with all the particulars of such claim, reopening of assessment to withdraw the claim after four year time in such cases, where there was full and true disclosure, was not justified.

iv) In *Smt. Raj Rani Gulati Vs. Union of India and another, (2010) 329 ITR 370 (All),* the High Court held that under proviso to Section 147 of the Act, notice under Section 148 of the Act can be issued beyond the period of four years only in a situation where there is failure on the part of the assessee to disclose all material facts necessary for the assessment. Unless such case is made out, no notice beyond the period of four years can be issued. The Court has gone through the findings recorded

by the assessing authority in the assessment order. The findings recorded by the assessing authority in the assessment order revealed that the assessee had furnished complete details relating to the sale of 16,000 equity shares of M/s Viraj Credit Capital Limited through M/s J.R.D. Stock Brokers (P) Limited, Dariyaganj, New Delhi and on the basis of the material furnished, the assessing authority had also made necessary enquiry and therefore, the Court was of the view that there was no failure on the part of the assessee to disclose fully and truly the material in respect of equity shares of M/s Viraj Credit Capital Limited through M/s JRD Stock Brokers (P) Limited, Dariyaganj, New Delhi and therefore, the limitation available for initiation of proceeding was only four years. In the present case, the notice issued under Section 148 was beyond four years, and thus, barred by limitation.

d) **Validity of Notice**

The following case laws clearly bring out the issues in this regard:

i) In *Commissioner of Income Tax Vs. Rajesh Jhaveri Stock Brokers (P) Limited,* (2007) 291 ITR 500, the Supreme Court held that failure of the officer to make regular assessment under Section 143 will not render the Assessing Officer powerless to initiate reassessment proceedings.

ii) In *Commissioner of Income Tax Vs. Chandrasekar Balagopal*, (2010) 328 ITR 619 (Kar) the assessee during the previous year, relevant for the assessment

year 2000-01, received an income of Rs. 3.9 crore under restrictive covenant from a Japanese company which took over the business of an Indian company of which the assessee was the Managing Director. The assessee initially treated the receipt from the foreign company as his income and paid advance tax of Rs 63,94,000/-. Later, the assessee paid a further amount of Rs. 5 lakhs towards self assessed tax. The taxes so paid were in addition to the tax deducted at source in the assessee's account amounting to Rs. 63,347/- Even though such huge amount was paid by the assessee towards advance tax and self assessed tax, while filing the return for the assessment year 2000-01 on 31-08-2000, the assessee returned an income of only Rs 17,79,850/- and claimed refund of the taxes paid on the receipt of the aforesaid money from the foreign company. The Assessing Officer re-opened the assessment and completed the reassessment under Section 147 including the amount received from the foreign company as income. According to the Tribunal, there was no processing of return under Section 143(1)(a) the Assessing Officer was barred from making a reassessment of income escaping assessment under Section 147. On appeal, the High Court held that the reassessment proceedings were valid. By virtue of Explanation 2 to Section 147, if the Assessing Officer in the course of scrutiny of the return finds that the assessee has *"understated the income or has claimed excessive loss, deduction, allowance or other relief, in the return"* the Assessing Officer is free to initiate income

escaping assessment under Section 147, no matter the assessment based on original return is not completed either through proceedings under Section 143(1)(a) or through regular assessment under Section 143(3) of the Act. **Thus, income escaping assessment can, possibly, be made based on the return filed by the assessee, pending for assessment also**.

e) **Objection to Reassessment**

An assessee may raise objection on the issue of notice for reassessment. The Assessing Officer is to take note of objections and to dispose of his objection before reassessment. In *GKN Driveshafts (India) Limited Vs. ITO,* (2003) 259 ITR19 (SC), the Supreme Court held that the Court saw no justifiable reason to interfere with the order under challenge. **However, the Court clarified that - when a notice under Section 148 of the Act is issued, the proper course of action for the noticee is to file return and if he so desires, to seek reasons for issuing notices**;

The following points may be noted with respect to supply of copy of reasons

(1) The Assessing Officer is bound to furnish reasons within a reasonable time;

(2) On receipt of reasons, the noticee is entitled to file objections to issuance of notice; and,

(3) The Assessing Officer is bound to dispose of the same by passing a speaking order.

In *IOT Infrastructure and Energy Services Limited Vs. Assistant Commissioner of Income Tax and another*, (2010) 329 ITR 547 (Bom), the notice for reopening the

assessment was issued on 16-03-2009 and the reasons in support of the notice were dated 18-06-2009. On 18-12-2009, the assessee lodged its objections to the reopening of the assessment, stating that a copy of the letter dated 18-06-2009 had been handed over only on 16-12-2009. The order of assessment was passed on 23-12-2009. In the writ petition filed by the assessee, the High Court held that there was absolutely no reason or justification for the Assessing Officer **not to deal with the objections filed by the assessee to the reopening of the assessment, particularly in view of the binding principle of law laid down by the Supreme Court in that regard**. The order of reassessment was therefore set aside. The High Court directed the Assessing Officer to pass a fresh order on the objections raised by the assessee to the proposed reassessment in accordance with the law.

f) **Change of opinion:**

One important controversy is the doctrine of "change of opinion" which should always remain paramount in the mind of the Assessing Officer while proceeding to reopen an assessment. This is so because, by the time, if at all, the assessment based on 'mere change of opinion' is held to be so, the time to gather further information might expire, and the revenue may be lost forever. In simple words, the doctrine, as propounded in various Decisions, is that the same or the successor Assessing Officer cannot, in the absence of any new material or "insight", suddenly and baselessly change his position vis-à-vis an allowance/relief granted in previous assessment, unless it is patently so, in which case also the re-opening may have a doubtful life. Such a changed opinion,

in the absence of any material newly discovered or brought, would not be construed as "reason to believe", and thus, would fail the judicial test. The key points to be noted and to be accordingly highlighted while recording the reasons are:

i) An earlier "stand/opinion" based on mistake of law or a mistake of fact is no "valid opinion", and hence a new "opinion" based on correct facts/law can still be a good basis for formation of a valid belief of escapement. But such facts must be clearly stated and brought out in the reasons recorded;

ii) Even if the earlier stand is one of the permissible legal stands, but the same was taken without weighing pros and cons of possible stands or without demonstrable application of mind, and in a subsequent opportunity (say, in the subsequent Assessment Year) the contrary view is taken by the Assessing Officer after weighing pros and cons and after due application of mind, the "new opinion" can, possibly, lead to formation of a "reason to believe";

iii) An allowance, wholly uncalled for and not at all allowable, if granted, would be a valid ground for re-opening;

iv) The "newly acquired knowledge" of a binding decision or discovery of patently (factually or legally) non-admissible claim granted in original assessment can also, thus form a valid basis;

v) While recording the reasons or in preparation to formation of the belief, the Assessing Officer should always remain conscious to so marshal the facts (if need be, by resorting to Section 133(6)) and to so adopt the reasoning as to avoid the conclusion or even allegation of having "a mere change of opinion"

The following case laws discussed would demonstrate what would amount to 'change of opinion' which bars reassessment.

(1) In *Deputy Commissioner of Income Tax Vs. Manak Shoes Co. P. Limited*, (2011) 11 ITR (Trib) 673 (Del), the Tribunal held that where regular assessment had been made under Section 143(3) allowing depreciation of factory building, plant and machinery, and reassessment proceedings were initiated on the ground that depreciation was not admissible since the assessee had no manufacturing activity during the year, the Tribunal found that the matter had been examined during the assessment stage and that there was no fresh information to justify a different inference and notice under Section 148. Though action was initiated within the four year time limit, it was found that it was based on **mere change of opinion** and reassessment proceedings was, therefore, not justified.

(2) In *Consolidated and Finvest Limited Vs. Asst. Commissioner of Income Tax,* (2006) 281 ITR 394 (Delhi), the High Court held that the doctrine of change of opinion could not be a basis for reopening completed assessments and would be applicable only to situations where the Assessing Officer had applied his mind (in earlier assessment) and taken conscious decision on a particular matter in issue, and it would have no application, where the order of assessment did not address itself to the aspect

which was the basis for re-opening of the assessment. The High Court further held that mere production of books of account or other evidence from which the Assessing Officer could have, with due diligence, discovered the material evidence does not necessarily amount to a disclosure within the meaning of the proviso to Section 147 of the Act.

(3) In *Jai Hotels Co. Limited Vs. Asst. DIT,* (2009) 24 DTR 37 (Del), the Delhi High Court has held that there being no new material in the hands of the Revenue leading to view that there was reason to believe that income had escaped assessment, the case is a classic instance of a change of opinion. The High Court further observed that when copies of statement of income, trading account, profit and loss account, audit report etc., were appended to the return filed by the assessee, taking resort to Section 147/148 was unwarranted as it constituted a change of opinion, since the material acted upon had been made available along with return of income.

(4) In *Satnam Overseas vs. Addl. Commissioner of Income Tax*, (2010) 329 ITR 237 (Delhi), the High Court held that the only reason which has been given seeking reopening of the assessment for the years 1997-98 and 1998-99 is that suppression of sales has taken place on account of the fact that when average price of

the closing stock is multiplied with the quantity of the sales in the year then the value of the sales would be at a higher figure, than declared by the assessee. Clearly, there is no new material which is alleged to have come to the notice of the Assessing Officer which has caused him to seek reopening of the assessment. Admittedly, the reasons given for seeking reopening of the assessment contains the expression 'perusal of the case record reveals' clearly showing that it is on the basis of the same assessment record as was filed by the assessee, during the relevant assessment years and also scrutinised by the Assessing Officer before passing the orders under Section 143(3). Further, the new logic, rationale and opinion which has been formed by the Assessing Officer for seeking reopening of the assessment is nothing but a change of opinion and a new approach to the existing facts and material which the Assessing Officer could well have done during the regular assessment proceedings of the relevant assessment years.

(5) In *Commissioner of Income Tax Vs. Eicher Limited,* (2007) 294 ITR 310 (Del), the High Court has taken a view that since the facts and materials were before the Assessing Officer at the time of framing of the original assessment, and later a different view was taken by him or his successor on the same facts, it clearly amounted to a change of opinion, which would not form the basis for permitting

the Assessing Officer or his successor to re-open the assessment of the assessee. The Honorable High Court further observed that if the entire material had been placed by the assessee before the Assessing Officer at the time when the original assessment was made and the Assessing Officer applied his mind to that material and accepted the view canvassed by the assessee, then merely because he did not express this in the assessment order, that by itself would not give him a ground to conclude that income had escaped assessment and, therefore, the assessment needed to be reopened. The assessee had no control over the way an assessment order is drafted.

(6) In *Commissioner of Income* Tax *Vs. Kelvinator of India Limited*, (2010) 320 ITR 561, the Supreme Court observed that post 01-04-1989, the power to reopen is much wider. However, **one needs to give a schematic interpretation to the words 'reason to believe' failing which, Section 147 would give arbitrary powers to the Assessing Officer to reopen the assessments on the basis of 'mere change of opinion' which cannot be per se reason to reopen.** The conceptual difference between the power to review and power to reassess is to be kept in mind. The Assessing Officer has no power to review; he has the power to reassess. But reassessment has to be based on the fulfillment

of certain pre conditions and if the concept of 'change of opinion' is removed, in the garb of re-opening the assessment, review would take place. **One must treat the concept of 'change of opinion' as an in-built test to check abuse of power by the Assessing officer.** Hence, after 01-08-1989, the Assessing Officer has power to reopen, provided there is 'tangible material' to come to the conclusion that there is escapement of income from assessment. Reasons must have a link with the formation of the belief.

4) **Other Important Decisions:**

a) The fact that ITO could have found out true position by further probing did not exonerate assessee from making disclosure truly. *Indo Aden salt Mfg & trading Co 159 ITR 624(SC), Electro steel casting 264 ITR 410(cal), Shri Krishna P Ltd 211 ITR 538 (SC).*

b) It is duty of assessee to make true and full disclosure of material facts. It is for the Assessing Officer to decide what inference of fact or law can be drawn there from and the law does not require assessee to state that the conclusion could reasonably be drawn from primary facts. If there were some reasonable grounds for thinking that there had been any no disclosure as regards any primary facts which could have material bearing on question of under assessment, that would be sufficient to give jurisdiction. *Calcutta Discount Co 41 ITR 191(SC)***.** Material disclosed should be by itself complete enough and part/vague disclosure would not amount to full & true disclosure 221 ITR 538(SC).

c) The fact that only an Intimation was passed under Section 143(1)(a) is irrelevant because what is material is whether the Assessing Officer had proper "reasons to believe" that income had escaped assessment**.** *Prashant S Joshi(Bom), Pirojsha Godrej Foundation ITAT(Mum).*

d) Block Assessment can be reopened under Section 148 as held in *Peerchand Ratanlal Baid 322 ITR 544(Gau)* which has been passed after considering *Cargo clearing agency* 307 ITR 1(Guj) which is against revenue. Also see *Western India Brakes 87 ITD 607(Mum)* and Mangal Singh (HUF)) 42 DTR 58 (Del.)(Trib.) which are also against revenue.

e) Reassessment order passed without considering the objections lodged by the assessee is not sustainable. But Assessing Officer was directed to consider the objections filed by the assessee and pass fresh orders after hearing the assessee. *IOT Infrastructure & Energy Services Ltd* 233 CTR 175 (Bom.)

5) **Recent Decisions**

Though there are decisions pouring in practically daily for and against the revenue on the issue of reopening and validity thereof, and guidance would need to be always sought before proceeding to reopen, the following recent decisions are worth noting:

(i) *211 Taxmann 447 (Guj.) – Gala Gymkhana (P) Ltd. Vs. ACIT:* Where Assessing Officer seeks details from assessee-club as to number of its members and assessee in addition informs about total membership fees it has received and Assessing Officer without

expressing any opinion on membership fees passed its order not imposing any tax thereupon, it cannot be said that Assessing Officer had expressed its opinion on membership fees; and, therefore, membership fees can be taxed subsequently by re-opening assessment.

(iii) The important full bench decision of Delhi HC on the issue of "change of opinion" in *CIT vs. Usha International Limited* [2012] 25 taxmann.com 200 (Delhi) (FB): Reassessment proceedings will be invalid in case an issue or query is raised and answered by assessee in original assessment proceedings and Assessing Officer does not make any addition in assessment order.

6) **Reopening of Assessment as a consequence of Audit Objections:**

This has become a very potent issue for discussion since with advent of RTI Act an assessee can now collect information from the Auditor as well as the Assessing Officer to find out:

(i) That the reopening is on the basis of an Audit Objection.

(ii) That the Assessing Officer has actually accepted or not accepted the objection.

Moreover, in many instances it has been seen that the Assessing Officer himself mentions that his "reason to believe" is based on Audit Objections raised in a particular case.

The issues that arise in this regard are as under:

(1) Where an objection has not been accepted by the Assessing Officer but notice under Section 148 has been issued as a remedial measure in view of the Board's Instruction No. 9/2006 date 07.11.2006. In this regard, the High Court of Gujarat in the case of Adani Exports Vs. DCIT [240 ITR 224] and Cadila Healthcare Pvt Ltd in SCA No. 15566 of 2011 has held that when the Assessing Officer did not accept the objection, he could not have a reason to believe. The aforesaid decisions have been accepted by the Department since no further SLP has been preferred. Thus, clearly, reopening is not a remedial action available when the Audit Objection is not acceptable.

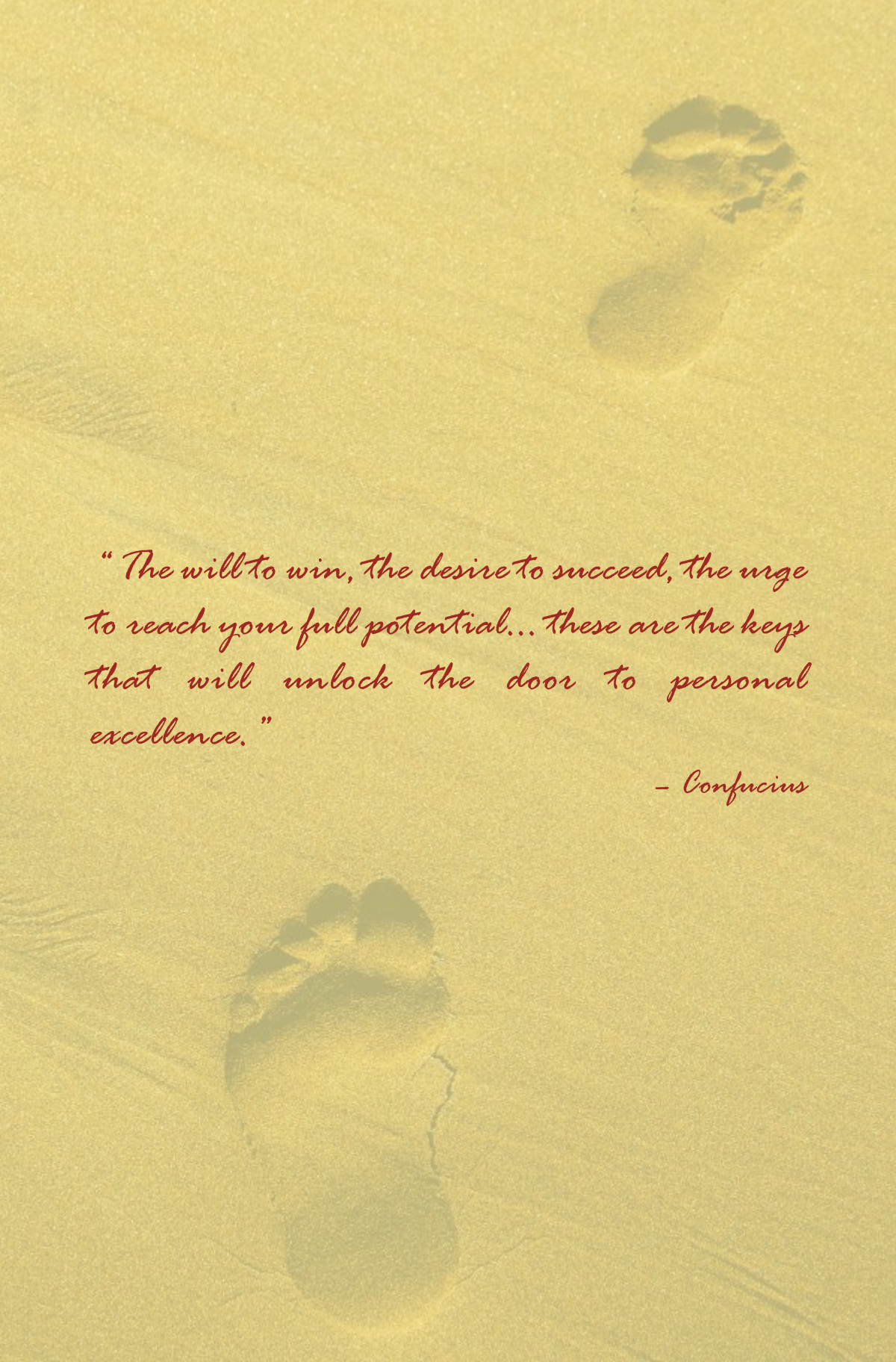
(2) Where an objection has been accepted it has been held in many instances that re-opening under Section 147 is not on the basis of a reason to believe formed by the Assessing Officer. Thus, following measures should be taken by the Assessing Officer, if, at all, remedial measure under Section 147 is required to be taken in response to an Audit Objection:-

(a) He should clearly mention in the reason recorded that the belief is owing to facts, information or evidence in his possession. Mention of Audit Objection should be obviously avoided.

(b) He may gather further information to verify the Audit Objection under Section 133(6) and form the reasons to believe on the basis of such new information gathered.

7) Conclusion:

The Assessing Officer and Range Head should seek guidance from recent decision before embarking on reassessment proceedings. If proper care is taken, and if proper actions available to the Department are taken to gather/collect/collate information and evidences, and are properly marshalled into the proper recording of reasons, and due care is taken to strictly follow all procedural aspects/time-frames, there is no reason why the re-opened assessments, in genuine cases, would not be upheld. Further, a reason to believe that income has escaped assessment need not necessarily lead to the same conclusion after the assessee has been allowed opportunity to represent the facts and law and the same has been found contrary to the reasons recorded.



"The will to win, the desire to succeed, the urge to reach your full potential... these are the keys that will unlock the door to personal excellence."

– Confucius

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