# 10

# DIRECT TAXES LAW
## (INCOME TAX)

*G C Bharuka**

## I INTRODUCTION

IN 1921, Rowlatt J said: "In a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used."[1] This principle was being applied over a long time.[2] But, of late, various constitutional doctrines and principles enumerated by the Supreme Court under non-taxation statutory and constitutional settings have been very appropriately invoked and deployed in the development of tax jurisprudence. The application of these high principles to the comparatively rigid law of taxation gives a more reasonable, fair and human touch to the laws relating to the 'compulsory exaction of money by public authority for public purposes'.[3] This welcome jurisprudential development can be well noticed in the cases under review.

## II CLAIM OF DEDUCTION

In *Har Shankar* v. *Deputy Excise and Taxation Commissioner*,[4] the Supreme Court held that there is no fundmental right to do trade or business in intoxicants. It distinguished 'fee', 'excise duty' and 'licence fee'. 'Fee' is a charge for special services rendered to individuals by some governmental agency and such a charge has an element in it of a *quid pro quo*. 'Excise duty' is primarily a duty on the production or manufacture of goods produced or manufactured within the country. 'Licence fee' means the price or

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1 *Cape Brandy Syndicate* v. *Inland Revenue Commissioner*, (1921) 1 KB 64 at 71.

2 *Gursahai* v. *CIT*, AIR 1963 SC 1062 at 1064; *Banarasidas* v. *ITO*, AIR 1964 SC 1742 at 1744; *CIT* v. *Firm Muar*, AIR 1965 SC 1216 at 1221; CIT, *Patiala* v. *Shahzadanand & Sons*, AIR 1966 SC 1342 at 1347; *Janapada Sabha, Chhindwara* v. *Central Provinces Syndicate*, AIR 1971 SC 57 at 60; *Orissa State Warehousing Corporation* v. *CIT*, AIR 1999 SC 1338 at 1397; *Federation of A.P. Chamber of Commerce and Industry* v. *State of A.P.*, (2000) 6 SCC 550.

3 *Commissioner, Hindu Religious Endowments* v. *Sri Shrirur Math*, 1954 SCR 1005.

4 AIR 1975 SC 1121.

consideration which the government charges from the licensees for parting with its privileges and granting them to the licensees.

In *CIT* v. *Varas International Pvt. Ltd.*,[5] during the assessment years 1984-85 and 1985-86, the assessee imported spirit from outside the State of West Bengal. For enabling such import, the assessee, apart from paying the fee for privilege for carrying on business in country spirit, had also to pay fee under rule 6 of the West Bengal Excise (Manufacture of Country Spirit in Labelled and Capsulated Bottles) Rules, 1979 (in short, 'the Rules').

The assessee's claim for deduction of fee paid under rule 6 of the Rules was rejected by the Income-tax Officer (ITO) on the ground that section 43B of the Act is applicable. The assessee's appeal was dismissed by the commissioner holding that 'fee payable to the Government by whatever name is called is a duty" and hence, hit by section 45B. The appellate tribunal took the view that section 43B had included the word 'fee' after the assessment years in question and the same, therefore, could not be included within the provisions of that section for the purpose of rejecting the respondent's claim for deduction. The Revenue thereupon filed reference applications under section 256(1). The high court answered the reference in favour of the assessee holding that the amount paid by the assessee was really neither a duty nor a cess nor fee but was a price for the grant of a privilege. The Revenue moved the Supreme Court.

The Supreme Court held that the high court erred in holding that even an excise duty or other duty imposable by virtue of entry 51 of list II would be covered by the principle that the amount levied under that entry should also be treated as a price or consideration for the purposes of the grant of privilege with regard to the manufacture of alcohol. However, after so holding, the matter was remanded to the appellate tribunal for re-consideration on a pure question of law as to whether the levy under rule 6 of the Rules is a countervailing duty.[6]

It is submitted that the apex court, instead of remanding the matter, could have decided the said question of law itself as the factual foundation for answering the question was already laid down.[7] Further, whether the levy is a duty or countervailing duty would have no effect since either way, section 45B would have been applicable. This could have brought the two-decade old litigation to an end.

## III CLAIM FOR DEDUCTION OTHER THAN BY FILING A REVISED RETURN

The issue which came for consideration before the Supreme Court in

5 [2006] 284 ITR 80 (SC).

6 *Ibid*.

7 It is well-settled that a pure question of law can be raised before the Supreme Court for the first time. See, *Bhanwar Lal* v. *T.K.A. Abdul* Karim, 1993 Supp (1) SCC 626; *Babu* v. *State of Kerala*, (1999) 8 SCC 499).

*Goetze (India) Ltd.* v. *CIT*,[8] was whether an assessee can make a claim for deduction other than by filing a revised return. In this case, the assessee had filed the original return in November 1995 for the assessment year 1995-96. However, later on, it claimed certain deduction by way of a letter addressed to the assessing officer. The claim was rejected by him on the ground of non-filing of a revised return, which, in appeal before the commissioner of income-tax (appeals) was allowed. The income-tax appellate tribunal, in turn, allowed the Revenue's appeal which was sustained by the high court. The Supreme Court dismissed the appeal, signifying that the assessing authority has no power to entertain a new claim for deduction except on the basis of a revised return.

An argument was raised before the Supreme Court, that in view of the decision in *National Thermal Power Co. Ltd.* v. *CIT*,[9] it was open to the assessee to raise the points of law for the first time even before the appellate tribunal. The Supreme Court observed that this case has no relevance and the present case does not impinge on the power of the appellate tribunal under section 254 of the Act.

## IV ADVANCE TAX AND INTEREST THEREON

In *Kwality Biscuits Ltd.* v. *CIT*,[10] the Karnataka High Court held that interest is not leviable under sections 234B and 234C of the Act in the case of an assessee-company on the basis of book profits under section 115 since the entire exercise of computing income under section 115 can only be done at the end of the financial year, and the provisions of sctions 207, 208, 209 and 210 cannot be made applicable until and unless the accounts are audited and the balance-sheet prepared. In an appeal preferred by the department, the Supreme Court, in *CIT* v. *Kwality Biscuits Ltd.*,[11] merely affirmed the high court decision by stating: "The appeals are dismissed."

It is submitted that in view of the law laid down in *Kunhayammed* v. *State of Kerala*,[12] the decision of the Karnataka High Court has merged with the order of the Supreme Court and the legal propositions laid down by the High court have become the 'law declared' under article 141 of the Constitution of India without there being any discussion on the subject by the Supreme Court. In fact, there were divergent opinions of different high courts[13] on the

8 [2006] 284 ITR 323 (SC).
9 [1998] 229 ITR 383.
10 [2000] 243 ITR 519 (Karn).
11 [2006] 284 ITR 434 (SC).
12 (2000) 6 SCC 359.
13 The Gauhati High Court in *Assam Bengal Carriers Ltd.* v. *CIT*, [1999] 239 ITR 862, the Bombay High Court in *CIT* v. *Kotak Mahindra Finance Ltd.*, [2004] 265 ITR 119, the Madras High Court in *CIT* v. *Holiday Travels P. Ltd.*, [2003] 263 ITR 307 and the Punjab and Haryana High Court in *CIT* v. *Upper India Steel Manufacturing and Engineering Co. Ltd.*, [2005] 279 ITR 123 decided in favour of the Revenue, while the Madhya Pradesh High Court in *Itarsi Oils and Flours P. Ltd.* v. *CIT*, [2001] 250 ITR 686 and the Karnataka High Court in *Kwality Biscuits Ltd.* v. *CIT*, [2000] 243 ITR 519 decided in favour of the taxpayer.

question of law involved in the appeal. Therefore, it would have been better had the Supreme Court, before upholding the Karnataka High Court judgment and declaring the law, assigned reasons for affirmation.

Reasons are the soul of law.[14] The Supreme Court has been time and again, insisting for a reasoned order to be passed since: (a) aggrieved party can persuade before a higher forum that the reasons leading to the decision are erroneous; (b) the obligation to record reasons operates as a deterrent against possible arbitrary action.[15] Even an order of affirmation, it has been held, requires reasons for affirmation to be indicated.[16] However, though these principles apply even to high courts, the Supreme Court has held that it is not imperative for itself to assign reasons since its order is not subject to further appeal.[17]

This view, it is submitted, needs a review. The apex court, too, should adhere to the requirements of speaking orders while disposing of an appeal, even while affirming the orders of courts, tribunals and other authorities, for the reasons that: (i) the parties are entitled to know the reason which persuaded the apex court to pass a certain order; (ii) in view of article 141, it is necessary that the reasons for declaration of law in a particular manner be known; and, (iii) review[18] and curative[19] petitions are available against a decision of the Supreme Court, which remedies can be meaningfully employed by the aggrieved party only when reasons are known.

## V INTEREST ON REFUND

In *R.R. Holding P. Ltd.* v. *CIT*,[20] the Supreme Court has explained the basic requirements for the applicability of section 244(1A) of the Act. It declared that before section 244(1A) is applied, the following basic requirements must be fulfilled:

(a) there is a refund due;
(b) the whole or part of the refund referred to in section 244(1) is due as a result of any amount having been made after 31st March, 1975;
(c) the payment has been made pursuant to any order of assessment or penalty;
(d) such amount or any part thereof as paid is found in appeal or other proceedings under the Act to be in excess of the amount which such assessee is liable to pay as tax or penalty.

14 *K.I. Pavunny* v. *Asstt. Collector (HQ), Central Excise Collectorate*, (1997) 3 SCC 721, para 32.
15 *M/s Travancore Rayons Ltd.* v. *UOI*, AIR 1971 SC 862, para 11.
16 *Mangalore Ganesh Beedi Works* v. *CIT*, [2005] 273 ITR 56 (SC).
17 *State of Punjab* v. *Surinder Kumar*, (1992) 1 SCC 489.
18 Art. 137 of the Constitution of India read with Order XL, Rule 1 of the Supreme Court Rules, 1966.
19 *Rupa Ashok Hurra* v. *Ashok Hurra*, (2002) 4 SCC 388 read with Order XLVII, Rule 6 of the Supreme Court Rules, 1966.
20 [2006] 284 ITR 674 (SC).

In the present case, since the claim of the assessee made under section 244(1A) was not examined by the high court from the above perspective, the apex court remanded the case directing the high court to hear the matter afresh.

## VI INTEREST ON INTEREST ON REFUNDS

In the case of *Sandvik Asia Ltd.* v. *CIT*,[21] the Supreme Court has laid down the law of great general public importance touching upon the rights of the assessees to be compensated for delayed refunds and usual behavioural problem with the department for reasons more than one. The court, in the present case, found that the delay in refunding the amounts due to the assessee was ranging from 12 to 17 years. Under the statutory provisions under the Act, the assessees, as of statutory right, are entitled to get interest on the amounts refundable to them but there was no specific provision which provides for grant of interest on interest. But the apex court, by taking into consideration, the general principles has held that even if there is no provision for the payment of compensation, the same has to be paid on general principle that the assessee is entitled to compensation for deprivation of money due to him. The Supreme Court has held that the *Narendra Doshi's*[22] case was clearly a decision on the point at issue. It has approved the views taken by the High Court of Gujarat,[23] Delhi,[24] Madras,[25] Kerala[26] and an earlier decision of the Bombay High Court[27] and reversed the later decision of the Bombay High Court which was under appeal.[28]

## VII SPECIAL DEDUCTION ON EXPORTS

The question of law that fell for consideration before the Supreme Court in the case of *P.R. Prabhakar* v. *CIT*,[29] was whether commission and brokerage earned by the assessee for procuring export contracts for other exporters was exempt under section 80HHC of the Act on the ground that the same is also export profit.

The facts in brief which led to the raising of the above question is that the assessee carried on business of export of its own products as also procuring export contracts for other exporters on commission. During the assessment year 1990-91, he derived substantial income by way of commission

21 [2006] 280 ITR 643 (SC).
22 [2002] 254 ITR 606 (SC).
23 *D.J. Works* v. *Deputy CIT*, [1992] 195 ITR 227 (Guj); *Chimanlal S. Patel* v. *CIT*, [1994] 210 ITR 419 (Guj).
24 *CIT* v. *Goodyear India Ltd.*, [2001] 249 ITR 527 (Del).
25 *CIT* v. *Needle Industries Pvt. Ltd.*, [1998] 233 ITR 370 (Mad).
26 *CIT* v. *Ambat Echukutty Menon*, [1988] 173 ITR 581 (Ker).
27 *Suresh B. Jain* v. *P.K.P. Nair*, [1992] 194 ITR 148 (Bom).
28 *Sandvik Asia Ltd.* v. *CIT*, [2004] 267 ITR 78 (Bom).
29 [2006] 284 ITR 548 (SC).

on procuring export contracts for other exporters but sustained loss as an exporter of his own goods. He claimed deduction under section 80HHC on the commission so earned but the same was disallowed by the assessing officer as well as the first appellate authority. But the claim was held sustainable by the appellate tribunal. The high court, on a reference made to it, held against the assessee.

The Supreme Court found the claim of the assessee sustainable by taking the view that the income derived by way of commission and/or brokerage is impliedly covered by the provisions of section 80HHC though *ex facie*, a plain reading of the provisions does not admit of any such deduction on commissions earned on procuring export contractors for other exporters. The Supreme Court, for giving an extended meaning to the expression 'export profit', relied on some of the well-settled canons of interpretation of statutes. It took into consideration a subsequent amendment to section 80 HHC, which became operative from April 1, 1992 which had added a clause (baa) to the *Explanation* at the end of sub-section (4A) providing therein that 90% of the commission is not to be regarded as profits derived from export business. Form this, it has been inferred that but for the amendment of 1992, the commission earned formed part of the export business. The Supreme Court also took into consideration the fact that section 80 HHC was intended to provide incentive to export houses; therefore, though exemption provisions are to be construed strictly as regard their applicability thereof to the case of the assessee but once it is found that it is applicable, the same are required to be interpreted liberally.[30]

A rather simpler question relating to interpretation of section 80HHC had fallen for consideration before the Supreme Court in the case of *CIT* v. *B.Mohanchandran Nair*.[31] The question was whether the loss suffered in the export of trading goods can be adjusted against the profits (positive figure) obtained from the export of goods manufactured by the assessee himself. Following its earlier decision in the case *A.P.C.A. Laboratory Ltd.* v. *Deputy CIT*,[32] the Supreme Court held that a plain reading of section 80HHC makes it clear that in arriving at the profits earned from export of both self-manufactured goods and trading goods, the profit and losses in both the trades have to be taken into consideration. If, after such adjustments, there is a positive profit, the assessee would be entitled to deduction under section 80HHC(1). But if there is a loss, he will not be entitled to any deduction.

In *Income-tax Officer* v. *Induflex Products P. Ltd.*,[33] the assessee had declared that its profits out of export of trading goods were "negative', ie., it incurred loss and claimed benefit of section 80HHC. The assessing officer

30 *Tata Iron and Steel Co. Ltd.* v. *State of Jharkhand*, (2005) 4 SCC 272; *Government of India* v. *Indian Tobacco Association*, (2005) 7 SCC 396; *Commissioner of Excise Tax* v. *Hira Cement*, 2006 (2) JT 369 (SC).
31 [2006] 285 ITR 226 (SC).
32 [2004] 266 ITR 521 (SC).
33 [2006] 280 ITR 1 (SC).

allowed the deduction which, by exercising the *suo motu* revisional powers, under section 263, was disallowed by the commissioner of income-tax. The appellate tribunal allowed the deduction which was upheld by the high court. The Revenue preferred appeal before the Supreme Court.

The court took note of its earlier decision in *IPCA Laboratory Ltd.* v. *Deputy CIT*[34] and held that the term 'profit' implies positive profit which has to be arrived at after taking into consideration only the profit earned from export of both self-manufactured goods and the trading goods and the profit and losses in both the trades have to be taken into consideration. In the event it is found that a loss has occurred, sub-section (3) of section 80HHC will have no application. On facts, the court found that it is not clear whether the appellant had shown any positive profit or not and therefore, remitted the matter to the high court for fresh consideration on this ground.

## VIII PENALTY FOR LATE FILING OF RETURNS

In the case of *Amichand Pyarelel* v. *Inspecting Asstt. CIT*,[35] the Supreme Court has dealt with various situations under which an assessee can be subjected to penalty under section 271(1) of the Act for belated filing of returns. Interpreting the provisions contained therein, the Supreme Court has held that under this provision, in essence, three situations are contemplated in which penalty can be imposed. These are: (i) where the assessee has, without reasonable cause, failed to furnish the return or total income which he was required to furnish under sub-section (1) of section 139; (ii) or, where the assessee has, without reasonable cause, failed to furnish the return of total income which he was required to furnish by notice given under sub-section (2) of section 139 or section 148; and, (iii) or, where the assessee has, without reasonable cause, failed to furnish it within the time allowed in the manner required by sub-section (1) of section 139.

Despite the above provisions, the appellant-assessee took the plea that since he has paid interest on late filing of return, he cannot be subjected to penalty under section 271 of the Act. The court found that the assessee had admittedly failed to file the return either within the time specified in the statute for doing so or within the extended period of time. Admittedly, returns were filed beyond the extended period for filing the return. It was held that interest on the amount due and penalty are two different and distinct concepts. Interest is accretion on the capital whereas the penalty is a punishment, imposed on the wrong-doer. The Supreme Court, by distinguishing its earlier judgment in *CIT* v. *M. Chandrashekhar*[36] which was a case of filing return under section 139(1) and relying on its judgment

34 [2004] 266 ITR 521.
35 [2006] 285 ITR 546 (SC).
36 [1985] 151 ITR 433 (SC).

in *Pradeep Lamps Workers* case[37] (which was a case of filing return under section 139(4)) upheld the penalty imposed on the assessee in the present case.

## IX BUSINESS LOSS DUE TO ILLEGAL ACTIVITIES

It is well-settled that the taint of illegality of the business cannot detract from the losses being taken into account for computation of the amount which can be subjected to tax as 'profits' under section 10(1) of the Act. The tax collector cannot be heard to say that he will bring the gross receipts to tax without deducting such losses. He can only tax profits of a trade or business. For the purpose of section 10(1), the losses which have actually been incurred in carrying on a particular illegal business must be deducted before the true figure relating to profits which have to be brought to tax can be computed or determined.[38]

The above issue arose before the Supreme Court in *Dr. T.A. Qureshi* v. *CIT*,[39] in respect of a medical practitioner claiming deduction of the value of heroin seized from his gross income. The assessee, while filing his return for the assessment year 1986-87, claimed that since heroin seized from him formed part of his stock-in-trade, hence, its loss on account of seizure is an allowable deduction while computing his profits and gains of business/profession. The assessing officer's order rejecting the claim was upheld by the first appellate authority. Appellate Tribunal eventually reversed the orders of the authorities below and held that the assessee is entitled to claim the deduction as a business loss. The high court, however, placing reliance on *Explanation* to section 37 of the Act, set aside the order of the tribunal.

The appellant-assessee contended that section 37 of the Act had no application since it relates to business expenditure whereas the issue related to one of business loss. Agreeing with the assessee and placing reliance of its earlier decision in *CIT* v. *Piara Singh*,[40] the Supreme Court held that business losses are allowable on ordinary commercial principles in computing profits. Though assessee was committing a highly immoral act in illegally manufacturing and selling heroin, yet once it is found that heroin seized formed part of the stock-in-trade of the assessee, it follows that the seizure and confiscation of such stock-in-trade has to be allowed as a business loss.[41]

37 [2001] 249 ITR 797 (SC).

38 *CIT* v. *S.C. Kothari*, [1971] 82 ITR 794 (SC); for further discussion, see Kanga, Palkhivala and Vyas, *The Law and Practice of Income Tax* 674 (9th ed.).

39 [2006] 287 ITR 547 (SC).

40 1980 Supp SCC 166.

41 The court also took note of its earlier decision in *CIT* v. *S.N.A.S.A. Annamalai Chettiar*, [1972] 86 ITR 607, wherein it was held that loss of stock-in-trade has to be considered as a trading loss.

## X DEPRECIATION

The issue which arose for consideration of the Supreme Court in *CIT* v. *Hoogly Mills Co. Ltd.*[42] was whether depreciation is allowable in respect of liability on account of gratuity taken over by the assessee in course of purchase of an undertaking. The respondent-assessee had purchased an undertaking and by the same agreement had also taken over the accrued and future gratuity liability of the vendor, amounting to Rs. 3.5 crores. It claimed depreciation on the said amount on the ground that it was a capital expenditure. The CIT (appeals) as well as the appellate tribunal allowed the assessee's claim and their orders were upheld by the high court. The Revenue moved the Supreme Court.

The Revenue contended that the gratuity liability is revenue expenditure. The Supreme Court rejected the contention and held that such liability, *qua* the vendor, was revenue expenditure allowable as such in the year in which it was accrued. But *qua* the vendee, in view of the fact that the same agreement of sale of the undertaking also mentioned takeover of the accrued and future gratuity liability, the entire amount of consideration including the gratuity liability of Rs. 3.5 crores is a capital expenditure because it is an expenditure incurred for acquiring an asset of an enduring nature. However, having held so, the court then rejected the assessee's claim for depreciation on the ground that gratuity liability taken over by the respondent does not fall under any of the categories specified in section 32. The court took note of section 32 of the Act which states that depreciation is allowable only in respect of buildings, machinery, plant or furniture, being tangible assets, and know-how, patents, copyrights, trade marks, licences, franchises or other business or commercial rights of similar nature being intangible assets.

It is submitted that gratuity liability taken over by the assessee was either a part of capital expenditure on acquisition of capital assets or a revenue expenditure. In the former case, it was entitled to depreciation under section 37 or else, in the latter case, as a deduction under section 37 of the Act.

## XI BUSINESS EXPENDITURE

The Central Board of Direct Taxes had issued a circular on 6.10.1952 stating that the interest on sticky loans which are entered in the suspense account need not be included in the assessee's assessable income provided the ITO was satisfied that there was no real probability of the loans being repaid. This circular was withdrawn in June 1978 in view of the decision of the Kerala High Court in *State Bank of Travancore* v. *CIT*.[43] However, the principle was re-introduced by another circular issued on 9.10.1984 with effect from 1979-80.

42 [2006] 287 ITR 333.
43 [1977] 110 ITR 336 (Ker).

The Supreme Court in *State Bank of Travancore* v. *CIT*,[44] held that carrying certain amounts which had accrued as interest without treating it as a bad debt or irrecoverable interest but keeping it in suspense account would be repugnant to section 36(1)(vii) read with section 36(2) of the Act. It held that where the mercantile system of accounting was followed and loans had not been written off, the amounts accrued on the loans were income assessable to tax. However, the minority opinion expressed by Tulzapurkar J was that the interest could not be brought to tax irrespective of the method of accounting followed, provided the assessee was able to establish to the satisfaction of the taxing authority that the loans had in fact become sticky during the concerned year by producing proper material. The minority view was found favour with the bench of three judges in a subsequence case of *UCO Bank* v. *CIT*, where the Supreme Court was of the view that the judges in *State Bank of Travancore* did not have the occasion to consider the 1984 circular.

Similar question arose before the Supreme Court in *Mercantile Bank Ltd.* v. *CIT*.[45] The issue was whether the assessee-bank is liable to be taxed under the Act in respect of the interest on doubtful advances credited to the suspense account for the assessment year 1978-79. The high court had held in favour of the Revenue. The Supreme Court, while taking note of the circular of 1984 as also its earlier decision in *UCO Bank,* held that the assessment year in question should have been dealt with by the department in accordance with the 1952 circular under which the interest on doubtful loans could not have been brought to tax.

Another question which arose for consideration of the Supreme Court in the above case related to the interpretation of section 40A(5). The employer, under section 40A(5), is entitled to deduction towards expenses or payments to an employee or former employee. Two separate limits, however, are provided for this purpose – (i) deduction at the rate of Rs. 5,000 per month as long as the employee was in employment; (ii) deduction upto the limit of Rs. 60,000 when the employee retires. The issue is which limit would apply when the employee ceased to be in employment during the previous year.

The Calcutta High Court in *Hindustan Motors Limited* v. *CIT*[46] opined that for the period that an employee remains in service, he is to be treated as an employee and all payments made to him as an employee would be allowed as deduction within the permissible monthly limits. After such period, when he retires, payments made to him as a former employee again ought to be deductible within the limit. Any other construction, it held, would make one or the other part of the section nugatory. The Bombay High Court, however, in *CIT* v. *Mercantile Bank Ltd.*[47] took a contrary view on the ground that the status of an 'employee' on the last date of the relevant previous year would

44 [1986] 158 ITR 102.
45 [2006] 283 ITR (SC).
46 [1985] 156 ITR 223.
47 [1999] 237 ITR 676.

have to be seen for fixing the limit of deduction and there were no separate limits prescribed by section 40A(5).

Agreeing with the conclusion of the Bombay High Court and overruling the Calcutta High Court decision, the Supreme Court held that section 40A(5)(c)(ii) speaks of "an amount" which indicates that the employer is only entitled to deduction of one amount. It noted that clause (c)(ii) speaks of an employee as being not only one who is in employment, but also one who ceases to be in employment. The court held that only one limit is prescribed in deduction on account of salary whether paid to an employee in service or a retired employee in any previous year.

## XII EXEMPTION OF INCOME OF A STATE FROM UNION TAXATION

In *Adityapur Industrial Area Development Authority* v. *Union of India*,[48] the issue was whether the income of the appellant-assessee would come within the scope of the exemption benefit under article 289 of the Constitution of India. Prior to the Finance Act, 2002, sub-section (20A) of section 20 of the Act provided that any income of any authority constituted in India by or under any law enacted either for the purpose of dealing with and satisfying the need for housing accommodation or for the purpose of planning, development or improvement of cities, towns and villages, or for both shall not be included while computing total income of a previous year of any person. This sub-section was omitted in 2002 and an Explanation defining 'local authority' for the purposes of section 10(20) was inserted. In view of this statutory development, the high court held that the appellant-authority could not claim any benefit under the above provisions after 1.4.2003. It further held that the income of the appellant could not be said to be the income of the state so as to be exempt from Union taxation under article 289 of the Constitution of India.

The appellant-authority preferred an appeal. The Supreme Court, having regard to the provisions of the Bihar Industrial Area Development Authority Act, 1974 (under which the appellant-authority was constituted), particularly section 17, held that the income of the appellant is its own income and not that of the state government. It also held that the appellant does not carry on any trade or business within the contemplation of clause (2) of article 289.

While dealing with the scope of articles 285 and 289, the court adopted the view of Basu[49] that the two articles are analogous to each other inasmuch as while article 285 exempts Union property from state taxation, article 289 exempts the state property from taxation. It further held that while any property of the Union is immune from state taxation under article 285(1), income derived by the state from business, as distinguished from governmental purposes, shall not have exemption from Union taxation unless Parliament declares such trade or business as incidental to the ordinary functions of government of the state.

48 [2006] 283 ITR 97 (SC).
49 Basu, *Commentary on the Constitution of India*, 50 (6th ed., vol. L).

Applying these principles, the court concluded that the benefit conferred by section 10(20A) of the Act on the assessee has not only been expressly taken away but even an Explanation to section 10(20) enumerating the 'local authorities' which do not cover the assessee has been inserted. The court also took note of the well-settled law that a corporation having the attributes of a company must be held to be distinct from the central government and not eligible for exemption from taxation under article 285.[50]

## XIII EXPENDITURE RELATING TO ISSUANCE OF BONUS SHARES

There have been conflicting opinions on the question as to whether the expenditure incurred in connection with the issuance of bonus shares is a capital expenditure or revenue expenditure. The Bombay[51] and Calcutta[52] High Courts have taken such expenditure to be revenue expenditure whereas Gujarat[53] and Andhra Pradesh[54] High Courts have held such expenditure to be capital expenditure

The Supreme Court has given quietus to the controversy in the case of *CIT* v. *General Insurance Corporation*[55] while dealing with a matter arising from the Bombay High Court. The assessing officer has disallowed the expenditure of the assessee incurred towards increase of its authorized share capital and the issue of bonus shares as revenue expenditure for the assessment year 1991-92. In appeal, the CIT (appeals) allowed expenditure towards issue of bonus shares as revenue expenditure but disallowed the expenditure towards increase in authorized share capital. The tribunal, on an appeal by the Revenue, upheld the decision, which was affirmed by the high court in an appeal under section 260A of the Act.

The Supreme Court, in an appeal preferred by the Revenue, took note of the conflicting opinions of different high courts. Placing reliance on its earlier decision in *Empire Jute Co. Ltd.* v. *CIT*,[55a] it held that if the expenditure is made once and for all with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, then there is a good reason for

50 *Food Corporation of India* v. *Municipal Committee, Jalalabad,* (1999) 6 SCC 74; *Board of Trustees for the Visakhapatnam Port Trust* v. *State of AP,* (1999) 6 SCC 78; *Municipal Commissioner of Dum Dum Municipality* v. *Indian Tourism Development Corporation,* (1995) 5 SCC 251; *Central Warehousing Corporation* v. *Municipal Corporation,* (1994) Supp (3) SCC 316; *Western Coalfields Ltd.* v. *Special Area Development Authority,* AIR 1982 SC 697.

51 *Bombay Burmah Trading Corporation Ltd.* v. *CIT,* [1984] 145 ITR 793 (Bom); *Richardson Hindustan Ltd.* v. *CIT,* [1988] 169 ITR 516 (Bom).

52 *Wood Craft Products Ltd.* v. *CIT,* [1993] 204 ITR 545.

53 *Ahmedabad Manufacturing and Calico P. Ltd.* v. *CIT,* [1986] 162 ITR 800; *CIT* v. *Mihir Textiles Ltd.,* [1994] 210 ITR 358; *CIT* v. *Ajit Mills Ltd.,* [1994] 210 ITR 658.

54 *Vazie Sultan Tobacco Co. Ltd.* v. *CIT,* [1990] 184 ITR 70; *Vazir Sultan Tobacco Co. Ltd.,* [1988] 174 ITR 689.

55 [2006] 286 ITR 232 (SC).

55a (1980) 4 SCC 25.

treating such an expenditure as properly attributable not to revenue but to capital. To consider the effect of issuance of bonus shares, the court gathered support from observations in *CIT* v. *Dalmia Investment Co. Ltd.*[56] wherein it was held that floating capital used in the company which formerly consisted of subscribed capital and the reserves now become the subscribed capital. The conversion of the reserves into capital did not involve the release of the profits to the shareholder; the money remains where it was, that is to say, employed in the business. In this view of the matter, the Supreme Court held as under:[57]

> The issue of bonus shares by capitalization of reserves is merely a reallocation of company's funds. There is no inflow of fresh funds or increase in the capital employed, which remains the same. If that be so, then it cannot be held that the Company has acquired a benefit or advantage of enduring nature. The total funds available with the company will remain the same and the issue of bonus shares will not result in any change in the capital structure of the company. Issue of bonus shares does not result in the expansion of capital base of the company.

The court finally upheld the views of the Bombay and Calcutta High Courts to the effect that the expenditure on issuance of bonus shares is revenue expenditure. The contrary judgments of the Gujarat and Andhra Pradesh High Courts were overruled as not laying down the correct law.

## XIV APPOINTMENT OF A SPECIAL AUDITOR UNDER SECTION 142(2A)

Section 142(2A) of the Act permits, subject to conditions laid therein, for appointment of a special auditor in view of nature and complexity of the accounts of the assessee. Though no express provision for hearing is provided, the Calcutta[58] and the Kerala[59] High Courts have taken a view that before issuance of a direction under section 142(2A), it is necessary to comply with the principles of natural justice. However, the Bombay[60] and Delhi[61] High Courts have held to the contrary.

The interpretation and application of section 142(2A) of the Act fell for consideration of the Supreme Court in *Rajesh Kumar* v. *Deputy CIT*.[62] A raid

56 [1964] 52 ITR 567.
57 [2006] 286 ITR 232 at 240 (SC).
58 *Peerless General Finance and Investment Co. Ltd.* v. *Deputy CIT*, [1999] 236 ITR 671 (Cal); *West Bengal State Co-op. Bank Ltd.* v. *Joint CIT*, [2004] 267 ITR 345 (Cal); *Joint CIT* v. *I.T.C. Ltd.*, [1999] 239 ITR 921 (Cal)
59 *Muthoottu Mini Kuries* v. *Deputy CIT*, [2001] 250 ITR 455 (Ker).
60 *Atlas Copco. (India) Ltd.* v. *V.S. Samuel, Asst. CIT*, [2006] 283 ITR 56 (Bom).
61 *Yum Restaurants India P. Ltd.* v. *CIT*, [2005] 278 ITR 401 (Del); *Gurunanak Enterprises* v. *CIT*, [2003] 259 ITR 637 (Del).
62 [2006] 287 ITR 91 (SC).

was conducted in the premises of the appellants whereupon some documents including their books of account and hard disk of the computer were seized. A notice under section 158BBC was issued requiring the appellants to submit a return of undisclosed income for the block period of ten years. During the proceedings, the deputy commissioner, with the previous approval of the commissioner but without granting any opportunity of hearing to the appellants, appointed a special auditor having regard to the nature and complexity of accounts maintained in two sets of books. This appointment was challenged before the high court. Upon dismissal of the writ petition, the appellants moved the Supreme Court, *inter alia*, on the ground of failure to adhere to the principles of natural justice and non-application of mind.

The Court noticed that following factors are relevant for invoking section 142(2A): (i) the nature of accounts; (ii) complexity of the accounts; and, (iii) the interests of the Revenue. Tracing the various provisions relating to assessment and inquiry, the court noticed that section 136 raises a legal fiction that a proceeding under the Act shall be a judicial proceeding. The court held that when a statutory power is exercised by the assessing authority in exercise of its quasi-judicial function which is detrimental to the assessee, the same is not and cannot be administrative in nature. The prejudice of the assessee, if an order is passed under section 142(2A), is apparent on the face of the statutory provision. The decision in *State of Orissa* v. *Miss Dr. Binapani Devi*[63] was taken note of which is an authority for the proposition that when by reason of an action on the part of a statutory authority, civil consequences ensue and the principles of natural justice are required to be followed. To appreciate the scope and application of section 142(2A), the court referred to its earlier decision in *Swadeshi Cotton Mills Co. Ltd.* v. *CIT*.[64] The Supreme Court also took note of the well-settled law that the thin demarcated line between an administrative order and quasi-judicial order now stands obliterated.[65]

On the issue of section 142(2A), the court held that the factors enumerated therein are not exhaustive. Once it is held that the assessee suffers civil consequences and any order passed by it would be prejudicial to him, principles of natural justice must be held to be implicit. Having said so, the court then laid down the law as under:[65a]

> The hearing given, however, need not be elaborate. The notice issued may only contain briefly the issues which the assessing officer thinks to be necessary. The reasons assigned therefor need not be detailed

63 AIR 1967 SC 1269.
64 [1988] 171 ITR 634 at 637 (SC).
65 *A.K. Kraipak* v. *Union of India*, (1969) 2 SCC 262; *Chandra Bhawan Boarding and Lodging* v. *State of Mysore*, AIR 1970 SC 2042; *S.L. Kapoor* v. *Jagmohan*, AIR 1981 SC 136.
65a *Supra* note 62, *ibid*.

> ones. But, that would not mean that the principles of justice are not required to be complied with. Only because certain consequences would ensue if the principles of natural justice are required to be complied with, the same by itself would not mean that the court would not insist on complying with the fundamental principles of law. If the principles of natural justice are to be excluded, the Parliament could have said so expressly. The hearing given is only in terms of Section 142(3) which is limited only to the findings of the special auditor. The order of assessment would be based upon the findings of the special auditor subject of course to its acceptance by the assessing officer. Even at that stage the assessee cannot put forward a case that power under Section 142 (2a) of the Act had wrongly been exercised and he has unnecessarily been saddled with a heavy expenditure. An appeal against the order of assessment, as noticed hereinbefore, would not serve any real purpose as the appellate authority would not go into such a question since the direction issued under section 142 (2a) of the Act is not an appellate order.

In the above view, the decisions of the Calcutta and Kerala High Courts were upheld and those of Bombay and Delhi High Courts were overruled.

## XV PRESUMPTION AS TO POSSESSION UPON SEARCH UNDER SECTION 132

The provision relating to search and seizure is contained in section 132 of the Act. sub-section (4A) thereof raises certain presumptions with respect to books of accounts, money, jewellery, etc. as regards ownership. The words employed in the section are "may be presumed".

In *P.R. Metrani* v. *CIT*,[66] a search was conducted in the residential and business premises of the appellant and certain documents were seized. During assessment for the year 1981-82, assessment for the construction of a commercial complex was made, the investment for which was declared. The assessing authority valued the cost of the building at a rate higher than what was declared based on the presumptions in terms of section 132(4A) of the Act. This was confirmed by the commissioner (appeals) with a slight modification. The appellate tribunal, however, relying upon the decision of the Allahabad High Court in case of *Pushkar Narain Sarraf* v. *CIT*,[67] held that the presumptions under section 132(4A) are confined to the framing of the order under section 132(5) only and not available for framing the regular assessment. However, it referred, *inter alia*, to the said question of law for the opinion of the high court, which answered the same in favour of the Revenue. The appellant thus filed appeals.

66 [2006] 287 ITR 209 (SC).
67 [1990] 183 ITR 388.

The apex court took note of the decisions of the Allahabad High Court in *Pushkar Narain Sarraf*[68] and the High Court of Delhi in *Daya Chand* v. *CIT*[69] which held that presumption under section 132(4A) is for a limited purpose and the contrary view taken by the Karnataka High Court in the impugned judgment was not right.

Analyzing its scope, the court held that section 132 is a code in itself. It provides for the conditions upon which and the circumstances in which the warrants of authorization can be issued. The section considered as a whole, shows that it has its own procedure for search, seizure, determination of the point in dispute, quantum to be retained and also the quantum of the tax and interest on the undisclosed income. The proceedings under section 132(5),[70] the court held, are of a quasi-judicial nature. The section has to be strictly construed since search and seizure is a serious invasion into the privacy of a citizen.

Tracing the history of sub-section (4A), the court observed that before its insertion by the Taxation Laws (Amendment) Act, 1975 w.e.f. 1.10.1975, the onus of proving that the books of account, etc. found in the possession or control of a person in the course of a search belonged to that person was on the Revenue. The purpose of inserting the sub-section was to raise a presumption to the contrary to enable the assessing authority to make a provisional adjudication within the time frame prescribed under section 132. However, it was noticed that the use of the words "may be presumed" in the sub-section makes the presumption a rebuttable one. Such presumption would not be available for the purpose of framing a regular assessment under section 143. The court observed that the legislature has clearly spelt out wherever it intended to continue the presumption. section 132 being a complete code in itself cannot intrude into any other provision of the Act. Similarly, other provisions of the Act cannot interfere with the scheme or the working of section 132 or its provisions.

In a nutshell, the Supreme Court laid down the law as under:[70a]

> Presumption under Section 132(4A) is available only in regard to the proceedings for search and seizure and for the purpose of retaining the assets under Section 132(5) and their application under Section 132B. It is not available for any other proceeding, except where it is provided that the presumption under Section 132(4A) would be available.

On facts, the Supreme Court directed the assessing authority to frame the assessment in accordance with law.

68 *Ibid.*
69 [2001] 250 ITR 327.
70 As it existed till 31.5.2002.
70a *Supra* note 66, *ibid.*

## XVI COMPUTATION OF PERQUISITES

In *Arun Kumar* v. *Union of India*,[71] the appellants before the Supreme Court challenged the validity of rule 3 of the Income-tax Rules, 1962, as amended by the Income-tax (Twenty-second) Amendment Rules, 1962, which amended the method of computing the valuation of perquisites under section 17(2) of the Act. According to the appellants, amended rule 3 was inconsistent with the parent Act and also *ultra vires* article 14.

The Supreme Court, on a detailed examination of the scheme and provisions of the Act, did not find any conflict between the Act and the rules. Further, the order to examine the challenge on the ground of discrimination, reiterated the principles governing challenges based on article 14 of the Constitution. It has been held that: "It is no doubt true that Article 14 guarantees equality before the law and confers equal protection of laws. It is also true that it prohibits the State from denying persons or class of persons equal treatment provided they are equals and are similarly situated. But, it is equally well established that Article 14 seeks to prevent or prohibit a person or class of persons from being singled out from others situated similarly. If two persons or two classes are not similarly situated or circumstanced, they cannot be treated similarly. To put it differently, Article 14 prohibits dissimilar treatment to similarly situated persons, but does not prohibit classification of persons not similarly situated, provided such classification is based on intelligible differentia and is otherwise legal, valid and permissible."

Applying the said principles, the apex court rejected the plea of discrimination and held that, "distinction sought to be made by the rule making authority between employees of the Central Government as well as State Governments and other employees ie., employees of Companies, Corporations and other Undertakings is reasonable classification based on intelligible differentia. It has also rational nexus to the object sought to be achieved. Rule 3 takes into account service conditions of employees of Government vis-a-vis employees of Corporations, Companies and other Undertakings and prescribes method of calculating value of all perquisites. Such a provision, in our considered opinion, cannot be held ultra vires Article 14 of the Constitution."

## XVI PRE-EMPTIVE PURCHASE OF IMMOVEABLE PROPERTY

In the case of *Krishnaswamy* v. *Union of India*,[72] the appellant had entered into an agreement of sale dated 16.7.1987 for purchase of certain immovable properties with the owner thereof and paid part consideration. As required under chapter XX-C of the Act, he filed his statement in Form 37-I before the appropriate authority seeking permission for registration. The

71 [2006] 286 ITR 89 (SC).
72 [2006] 281 ITR 305 (SC).

authority passed an order on 18.12.1987 for pre-emptive purchase of the property, the reasons wherefore were recorded separately. Appellant challenged the said order by filing a writ petition before the Karnataka High Court to quash the same on various grounds. The high court, vide its order dated 7.1.1988, stayed the order of purchase which was subsequently modified on 13.1.1988 staying only the delivery of possession under section 269UE of the Act. Subsequently, on 1.8.1991, the interim order was vacated with a direction that the owner shall deliver the possession of the property to the Income-tax Officer who shall be paid the amount due to him. The department has allowed to bring the property to public auction. It was made clear that delivery of possession and payment of amount shall be subject to the ultimate result of the petition. Pursuant to the said order, delivery of possession was given by the owner to the income-tax department on 27.8.1991 and he accepted the sale consideration. The property was auctioned by the department on 26.3.1992 and the highest bidder was put in possession.

During the pendency of the said writ petition, a constitution bench of the apex court by its judgment rendered on 17.11.1992 upheld the validity of chapter XX-C of the Act in *C.B. Gautam* v. *Union of India*.[73] While doing so, the court, however, held that before an order for compulsory purchase is made under section 269UE, the intending purchaser and the intending seller must be given an opportunity of showing cause against the order of compulsory purchase being made by the appropriate authority. But it was, *inter alia*, clarified that the order of the court will not upset the completed transactions and where the properties are put to public auction and are purchased by third parties.

The writ petition was taken up by the high court for hearing after *C.B. Gautam* and was dismissed. The plea taken before the Supreme Court was that the case of the appellant was still governed by the decision in *C.B. Gautam's* case in view of the interim order passed by the high court that the same was subject to the result of the petitions. It was also pleaded that on the facts of the case, the principle of *lis pendens* was clearly applicable. The pleas of the appellant were rejected by the court holding that the requirement relating to hearing read into section 269UD by the Supreme Court in *C.B. Gautam* will not apply to transactions which have become final or transactions where the department has already auctioned the required property and as such, there cannot be any interference.

7 3 [1993] 199 ITR 530 (SC).