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DIRECT TAXES LAW
(INCOME TAX)

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I INTRODUCTION

A REVIEW of the judgments arising out of the income tax disputes is clearly bringing out the impact of globalization, open economy and India's aggressive role in international trade and commerce. Disputes with various shades of fact situations relating to special deductions under section 80HHC for exports are a clear pointer in this direction.[1] The year under review witnessed the Supreme Court's interpretation of and adjudication on international contracts and double taxation avoidance treaties entered into by India with various countries in the context of OECD Model Convention, country-specific treaties, statutory provisions and the complex contracts entered into by the parties.[2] Questions are repeatedly arising on the concept of 'Permanent Establishment' of foreign enterprises in the Indian territories, business connections with such permanent establishments and doctrine of territorial nexus applicable to income tax laws of the respective jurisdictions. Though majority of the cases reviewed relate to traditional disputes with varying factual matrix, the judicial interpretations are setting new directions for better and effective national participation in international trade and commerce.

II BEST JUDGMENT ASSESSMENT

In *Kachwala Gems* v. *Joint Commissioner of Income Tax*,[3] the assessing officer had found that the books of account of the assessee were not correct and as such rejected the same. He then resorted to best judgment assessment under sections 145 (3) read with section 144 of the Act. The assessing

* Former Judge, High Courts of Patna and Karnataka.

1 *A.M. Moosa* v. *CIT, Trivandrum*, [2007] 294 ITR 1 (SC); *CIT* v. *Catapharma (India) P. Ltd.*, [2007] 292 ITR 641(SC); *CIT* v. *Lakshmi Machine Works*, [2007] 290 ITR 667 (SC); *CIT* v. *Baby Marine Exports*, [2007] 290 ITR 323 (SC); *CIT* v. *Shirke Construction Equipment Ltd.*, [2007] 291 ITR 380 (SC).

2 *CIT* v. *Hyundai Heavy Industries Company Limited.*, [2007] 291 ITR 482 (SC); *DIT International Tax* v. *Morgan Stanelly*, [2007] 292 ITR 416 (SC); *Ishikawajima-Harima Heavy Industries Ltd.* v. *Director of Income Tax*, [2007] 288 ITR 408 (SC).

3 (2007) 288 ITR 10(SC).

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officer estimated the gross profit of the assessee as 40%. On appeal to the CIT (appeals) and then to the tribunal the gross profit was reduced to 35% and then to 30%, respectively. The high court did not find any error with the order of the trial court.

The Supreme Court, agreeing with the high court, reiterated the well-settled principle governing the method of best judgment assessment. It held that:

> It is well settled that in a Best Judgment Assessment there is always a certain degree of guess work. No doubt the authorities concerned should try to make an honest and fair estimate of the income even in a best judgment assessment, and should not act totally arbitrarily, but there is necessarily some amount of guess work involved in a Best Judgment Assessment, and it is the assessee himself who is to blame as he did not submit proper account.

On facts, it was held that there was no arbitrariness on the part of income tax authorities in making best judgment assessment by ultimately estimating the gross profit of the assessee at 30%.

III DEDUCTION OF INTEREST

Section 36(1)(III), *inter alia*, provides that the amount of interest paid in respect of capital borrowed for the purposes of business shall be allowed as deduction in computing the income referred to in section 28 of the Act. In the context of these provisions, an issue of far reaching consequence had arisen before the apex court in the case of *S.A. Builders Ltd.* v. *CIT*[4] as to whether interest on funds borrowed by the assessee to give an interest-free loan to a sister concern can be allowed as a deduction under the said section.

The assessee, out of its cash credit accounts, had transferred Rs.82 lakhs to its subsidiary company without charging any interest. The assessing officer disallowed the proportionate interest which was chargeable from the subsidiary company. The disallowance was upheld by the income tax authorities, the tribunal and the high court.

According to the Supreme Court, the test to be applied for allowing deduction under section 36(1)(III) of the Act is to ascertain whether the assessee has lent the money without any interest as a measure of "commercial expediency". The court relied on its earlier judgment in *Madho Prasad Jatia* v. *CIT*[5] wherein it was held that the expression "for the purpose of business" occurring under the provisions was wider in scope than the expression "for the purpose of earning income, profit or gains". The same view has been taken in *CIT* v. *Malyalam Planatation*[6] and *CIT* v. *Birla Cotton Spinning and Weaving Mills. Ltd.*[7]

4 (2007) 288 ITR 1 (SC).
5 [1979]118 ITR 200 (SC).
6 [1964] 53 ITR 148 (SC).
7 [1971] 82 ITR 116 (SC).

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In the present case, it has been held that the decision relating to section 37 of the Act will also be applicable to section 36(1)(III) because in section 37 also, the expression used is "for the purpose of business". According to the Supreme Court, the decision relating to section 37 that the expression "for the purpose of business" includes expenditure voluntarily incurred for commercial expediency is immaterial if a third party also benefits thereby. It has further been held that the expression "commercial expediency" is an expression of wide import and includes such expenditure as a prudent businessman may incur for the purpose of business. The expenditure may not have been incurred under any legal obligation, but yet it is allowable as business expenditure if it was incurred on ground of commercial expediency. The Supreme Court has approved the view taken by the Delhi High Court in *CIT* v. *Dalmia Cement (P) Ltd.*[8] to the effect that once it is established that there was nexus between the expenditure and the purpose of the business (which need not necessarily be the business of the assessee itself), the revenue cannot justifiably put itself in the arm-chair of the businessman or in the position of the board of directors and assume the role to decide as to how much would reasonable expenditure be having regard to the circumstances of the case. No businessman can be compelled to maximize its profits.

Since on the facts of the present case, the tribunal and the high court had not approached the question of allowability of the interest from the point of view of commercial expediency, the apex court remanded the matter to the tribunal for fresh decision in accordance with the law laid down by it.

IV CO-OPERATIVE SOCIETIES SPECIAL DEDUCTION UNDER SECTION 80-P(2)

The Supreme Court in *CIT* v. *Nawanshahar Central Co-operative Bank Ltd.*[9] has reiterated the well-settled law that where a cooperative bank carrying on business of banking is statutorily required to place a part of its fund in approved securities, the income attributable to it is deductable under section 80P(2)(a)(i) of the Income Tax Act, 1961. The court followed its earlier judgments in *Bihar State Co-operative Bank Ltd.* v. *CIT*,[10] *CIT* v. *Karnataka State Co-operative Apex Bank*[11] and *CIT* v. *Ramanathapuram District Cooperative Central Bank Ltd*.[12]

V PENALTY

In *Virtual Soft Systems Ltd.* v. *CIT*[13] the following two questions of law

8 [2002] 254 ITR 377.
9 [2007] 289 ITR 6 (SC).
10 [1960] 39 ITR 114 (SC).
11 [2001] Supp (2) SCR 35.
12 [2001] 255 ITR 423 (SC).
13 [2007] 289 ITR (SC).

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of wide application fell for consideration before the Supreme Court:

1. Whether the Income Tax Appellate Tribunal was right in deleting the penalty imposed under section 271(1)(c) of the Income Tax Act, 1961 on the ground that the total income of the assessee has been assessed at a minus figure/loss?
2. Whether the Income Tax Appellate Tribunal was justified in holding that the judgment in *Prithipal Singh* case, [1990] 183 ITR 69 (P&H) and (2001) 249 ITR 670 will apply even after insertion of Explanation 4 to Section 271(1)(c)of the Income Tax Act 1961 with effect from April 1, 1976?

The facts giving rise to the above questions of law were that for the assessment year 1996-97, the assessee had filed a "Nil" return with a carry forward unabsorbed depreciation of Rs.15,53,487.72. After assessment, ultimately, the admissible carry forward loss was reduced to Rs.11,02,025/- based on the reduction of loss. The assessing officer levied a penalty of Rs.31,71,692/- under section 271(1)(c) of the Act as amended by Taxation Laws (Amendment) Act, 1975 and Finance Act, 2002 which came into force with effect from 01.04.1976 and 01.04.2003, respectively. For the present case, the amendment made by Finance Act, 2002 is material. Sub-clause (iii) of section 271(1)(c) and amendment to clause (a), Explanation 4 as it stood after amendment is as under:

> (iii) in the cases referred to in clause (c) in addition to tax, if any, payable by him, a sum which shall not be less than, but which shall not exceed three times, the amount of tax sought to be evaded by reason of the concealment of particulars of his income or the furnishing of inaccurate particulars of such income.
> Explanation 4: For the purposes of clause (iii) of this sub–section, the expression 'the amount of tax sought to be evaded'-,
> In any case where the amount of income in respect of which particulars have been concealed or inaccurate particulars have been furnished has the effect of reducing the loss declared in the return or converting that loss into income, means the tax that would have been chargeable on the income in respect of which particulars have been concealed or inaccurate particulars have been furnished had such income been the total income.

The provisions of section 271(1)(c)(iii) prior to 1.4.1976, and after its amendment by the Taxation Laws (Amendment) Act, 1975, with effect from 1.4.1976, the later provisions being applicable to the assessment year in question, are substantially the same except that in place of the word "income" in clause(iii) to clause(c) of section 271 prior to its amendment by the Taxation Laws (Amendment) Act, 1975, the expression "amount of tax sought to be evaded" have been substituted. Explanation 4 inserted for the purpose

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of clause(iii) where the expression "the amount of tax sought to be evaded" was inserted had in fact made no difference insofar as the main criteria, namely, absence of tax continued to exist, prior to or after 1.4.1976, changing only the measure or the scale as to the working of the penalty which earlier was with reference to the "income" and after the amendment related to the "tax sought to be evaded". The *sine qua non* which was there prior to or after the amendment on 1.4.1976, was the fact that there must be a positive income resulting in tax before any penalty could be levied continued to exist. The penalty imposed was in "addition to any tax". If there was no tax, no penalty could be levied. The return filed declaring loss and assessment made at a reduced loss did not warrant any levy of penalty within the meaning of section 271(1)(c)(iii) with or without explanation 4.

The Supreme Court, after examining the judgments of various high courts as also its own decision in *Elphinstone*[14] case, held that prior to the amendment made to section 271 by the Finance Act, 2002, which came into operation in April, 2003, no penalty for concealment could be imposed unless some tax was payable by the assessee. In other words, if no tax was payable by the assessee, then the question of imposition of penalty for concealment did not arise at all. That position was changed for the first time only by the amendment made by the Finance Act, 2002, with effect from 1.4.2003. It is only by this amendment that the hitherto inseverable inter connection between the liability to pay tax and the imposition of penalty was served for the first time.

For taking the above view, the Supreme Court was persuaded by the view taken by the majority of the high courts in India, namely, Punjab and Haryana, Kerala, Madras, Madhya Pradesh, Allahabad and Calcultta. The Supreme Court did not agree with the contrary view taken by the High Courts of Karnataka and Bombay.[15]

In doing so, the Supreme Court relied on the settled principle of precedence that where the predominant majority of the high court has taken a certain view of the interpretation of a certain provision, the Supreme Court would lean in favour of the predominant view. Similar view was taken in *CIT* v. *Podar Cement*,[16] *CIT* v. *P.J. Chemical Ltd.*[17] and *CIT* v. *Kerala State Industrial Development Corpn.*[18]

While taking the above view, the court also held that the amendments made to section 271 (1)(c) by the Finance Act, 2002 was neither

14 (1960) 40 ITR 142.

15 *Prithipal*, (1990) 183 ITR 69 (P&H) affirmed by Supreme Court in *CIT* v. *Prithipal Singh and Co.*, (2001) 249 ITR 670 (SC); *CIT* v. *Varindra and Co.*, (2001) 171 CTR 51 (P&H); *CIT* v. *N.Krishnan*, (1990) 240 ITR 47 (Ker); *Ramnath Goenka* v. *CIT*, (2003) 259 ITR 229 (Mad); *CIT* v. *Jabalpur Cooperative Milk Producers Union Ltd.*, (2005) 276 ITR 649 (MP); *CIT* v. *Zam Zam Tanners*, (2005) 279 ITR 197 (All); *CIT* v. *R.G. Sales Pvt. Ltd.*, (2005) 278 ITR 140 (Cal).

16 [1997] 226 ITR 625 (SC).

17 [1994] 210 ITR 830 (SC).

18 [1998] 233 ITR 197 (SC).

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retrospective nor declaratory in nature because the amendment does not make it to be so. It has further been held that retrospectivity has to be enacted specifically in the fiscal statute and it is more so in the case of penal provisions, otherwise it would be contradictory and derogatory to article 20(1) of the Constitution of India.

V CASH CREDITS

In the case of *CIT* v. *P. Mohanakala*,[19] the Supreme Court once again examined the true nature and scope of section 68 of the Act which reads as under:

> 68. Cash credits. – 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 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.

According to the Supreme Court, a bare reading of section 68 suggests that: (i) there has to be a credit of amounts in the books maintained by an assessee; (ii) such credit has to be a sum during the previous year; (iii) the assessee offers no explanation about the nature and source of such credit; (iv) in the opinion of the assessing officers, explanation offered by the assessee is not satisfactory, then the sum so credited may be charged to income tax as income of the assessee of that previous year.

According to the apex court, the expression "the assessee offered no explanation" means where the assessee offered no proper, reasonable and acceptable explanation as regards the sums found credited in the books maintained by the assessee. It has been emphasized that the opinion of the assessing officer for not accepting the explanation offered by the assessee as not satisfactory is required to be based on proper appreciation of the material and other attending circumstances available on record. The opinion of the assessing officer is required to be found objectively with reference to the material available on record. Application of mind is *sine qua non* for forming the opinion. In the present case, the income tax authorities having found that the explanation offered by the assessee was not acceptable for good and cogent reasons and the same view having found favour with the tribunal, it was, according to the Supreme Court, impermissible for the high court to record a finding of fact of its own in favour of the assessee by a re-appreciation of the material on record. The Supreme Court reversed the high court by relying on its earlier judgment in *Sumati Dayal* v. *CIT*[20] in which it was held as under:[21]

19 [2007] 291 ITR 278 (SC).
20 [1995] 214 ITR 801 (SC).
21 *Ibid.*

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> In all cases in which a receipt is sought to be taxed as income, the burden lies on the Department to prove that it is within the taxing provision and if a receipt is in the nature of income, the burden of proving that it is not taxable because it falls within exemption provided by the Act lies upon the assessee. But, in view of section 68 of the Act, 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 that 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 a case there is, prima facie, evidence against the assessee, viz., the receipt of money, and if he fails to rebut, the said evidence being unrebutted, can be used against him by holding that it was a receipt of an income nature.

VI DOCTRINE OF MERGER

Whether the order of assessment made under section 143(3) of the Act merges with the order of rectification passed under section 154 of the Act, thereby denuding the power of revision conferred on the commissioner of income tax (CIT) under section 263 of this Act was the question that fell for consideration before the Supreme Court in *CIT* v. *Ralson Industries Ltd.*[22]

In this case, the income tax officer (ITO), based on the return filed by the assessee, completed the assessment under section 143(3) of the Act. CIT initiated *suo motu* revisional proceeding under section 263 of the Act in respect of this said assessment order and excluded certain deductions granted by the ITO. Assessee preferred an appeal to the tribunal contending that in a rectification proceeding initiated by the ITO under section 154 of the Act, the deductions were found to be admissible. Therefore, according to the assessee, the CIT had no authority to initiate any proceedings under section 263 of the Act. The contention of the assessee was upheld both by the tribunal as well as by the high court.

Setting aside the judgment of the Madhya Pradesh High Court, the Supreme Court has held that when different jurisdictions are conferred upon different authorities to be exercised on different conditions, both may not be held to be overlapping with each other. Jurisdiction under section 154 of the Act is only to be exercised by him when there is an error apparent on the face of the record. It does not confer any power of review. An order of assessment may or may not be rectified. If an order of rectification is passed by the assessing authority, the rectified order shall be given effect to. However, only because an order of assessment has undergone rectification at the hands of the assessing officer, the same would not mean that the revisional authority shall be denuded of exercising its revisional jurisdiction.

22 [2007] 288 ITR 322 (SC).

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Such an interpretation, in Supreme Court's opinion, would run counter to the scheme of the Act. It has further been held that an order of assessment is subject to exercise of an order of a revisional jurisdiction under section 263 of this Act. The doctrine of merger in such a case will have no application.

Sub-section (2) of section 263 of the Act provides that the CIT shall not make any order of revision under sub-section (1) thereof after the expiry of two years from the end of the financial year in which the order sought to be revised was passed. In *CIT* v. *Agagendran Finance Ltd.*,[23] the assessee's returns under the head "Lease Equalization Fund" was accepted and completed in 1997 and 1998. However, the assessing officer initiated re-assessment proceedings in respect of some other items and passed orders on 28.3.2002. Thereafter, the CIT, by an order dated 29.3.2004, initiated revision proceedings only in relation to the said item "Lease Equalization Fund". The appellate tribunal held that the revision proceedings were barred by limitation as they were initiated more than four years after the original assessments with respect to items in which revision was initiated. This was affirmed by the high court.

The issue which arose for consideration before the Supreme Court was whether for the purpose of computing the period of limitation envisaged under sub-section (2) of section 263 of the Act, the date of order of assessment or that of re-assessment is to be taken into consideration. The court held that the present matter is not where the subject-matter of assessment and the subject-matter of re-assessment were the same. The tribunal's finding of fact that all the subsequent events were in respect of matters other than the allowance of "lease equalization fund" was taken note of in holding that the doctrine of merger in the fact situation has no application. The court, while affirming the order of high court, held that the CIT exercising his revisional jurisdiction reopened the order of assessment only in relation to lease equalization fund which being not the subject of the reassessment proceedings, the period of limitation provided for under sub-section (2) of section 263 of the Act would begin to run from the date of the order of assessment and not from the order of reassessment. The revisional jurisdiction having been invoked by the CIT beyond the period of limitation was without jurisdiction rendering the entire proceeding a nullity.

VII JUDICIAL DISCIPLINE

In *CIT* v. *Ralson Industries Ltd.*,[24] the Supreme Court also reiterated the principles of judicial discipline as enunciated by it *Bhopal Sugar Industries Ltd* v. *ITO.*,[25] *Dharam Chand Jain* v. *State of Bihar*[26] *and Morgan Securities & Credits Pvt. Ltd.* v. *Modi Paper Ltd.*[27] wherein it has held that

23 [2007] 293 ITR 1 (SC).
24 *Supra* note 22.
25 [1960] 40 ITR 618 (SC).
26 AIR 1976 SC 1433.
27 [2006] 14 SCALE 267.

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when an order is passed by a higher authority, the lower authority is bound by it keeping in view the principles of judicial discipline.

In *Bhopal Sugar Industries Ltd.* it has been held that if a subordinate tribunal refuses to carry out directions given to it by a superior tribunal in the exercise of its appellate powers, the result will be chaos in the administration of justice. It is, indeed very difficult to appreciate the process of reasoning by which the judicial commissioner while roundly condemning the respondent for refusing to carry out the directions of the superior tribunal, yet held that no manifest injustice resulted from such refusal. The order of the tribunal dated 22.4.1954, was not under challenge before the judicial commissioner. That order had become final and binding on the parties, and the respondent could not question it in any way. As a matter of fact, the CIT had made an application for a reference, which application was subsequently withdrawn. The judicial commissioner was not sitting in appeal over the tribunal and in the circumstances of this case, it was open to him to say that the order of the tribunal was wrong and, therefore, there was no injustice in disregarding that order. Such a view, the Supreme Court held, is destructive of one of the basic principles of the administration of justice.

VIII SPECIAL DEDUCTION UNDER SECTIONS 80HH AND 80-I

In *Joint Commissioner of Income Tax* v. *Mandideep Engineering and Pkg. India P. Limited*,[28] the issue which rose for consideration was whether sections 80HH and 80-I of the Income-tax Act, 1961, are independent of each other and therefore, whether a new industrial unit can claim deductions under both the sections on the gross total income independently or that deduction under section 80-I can be taken on the reduced balance after taking into account the benefit taken under section 80HH.

The Supreme Court took note of an earlier decision of the Madhya Pradesh High Court in *Tobacco Products P. Ltd.* v. *CIT*[29] which took the view that both the sections are independent and, therefore, the deductions could be claimed both under sections 80HH and 80-I on the gross total income. Subsequently, a special leave petition was dismissed by the apex court, consequent to which various high courts[30] followed the Madhya Pradesh High Court decision. The Supreme Court held that since the department had not preferred any special leave petitions against subsequent decisions of various high courts, it having accepted the view taken in those

28 [2007] 292 ITR 1 (SC).

29 [1998] 229 ITR 123 (MP).

30 *CIT* v. *Nima Specific Family Trust*, [2001] 248 ITR 29 (Bom); *CIT* v. *Chokshi Contracts P. Ltd.*, [2001] 251 ITR 587 (Raj); *CIT* v. *Amod Stamping*, [2005] 274 ITR 176 (Guj); *CIT* v. *Mittal Appliances P. Ltd.*, [2004] 270 ITR 65 (MP); *CIT* v. *Rochiram and Sons*, [2004] 271 ITR 444 (Raj); *CIT* v. *Prakash Chandra Basant Kumar*, [2005] 276 ITR 664 (MP); *CIT* v. *S.B. Oil Industries P. Ltd.*, [2005] 274 ITR 495 (P&H); *CIT* v. *SKG Engineering P. Ltd.*, [2005] 285 ITR 423 (Del); *CIT* v. *Lucky Laboratories Ltd.*, [2006] 284 ITR 435 (All).

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judgments now cannot be permitted to take a contrary view. Accordingly, the appeals were dismissed.

IX VOLUNTARY DISCLOSURE OF INCOME SCHEME

In *Tanna and Modi* v. *CIT,*[31] the issue which arose for consideration before the apex court was whether a partnership firm and its partners are to be treated differently for the purposes of immunity from certain penal actions under the Voluntary Disclosure of Income Scheme, 1997 in the same manner as they are treated differently for the purposes of income tax and other taxation laws.

In this case, a search was conducted at the premises of the firm though the search warrant was issued in the name of one of the partners and not the firm name. The firm filed a voluntary disclosure suppressing the fact of search and seizure. This disclosure was accepted. Later on, when it was found that there was an earlier search and seizure, the acceptance was rejected. This was challenged which eventually reached the apex court.

In the above premise, the court held that for the purpose of the application of the provisions of the Income-tax Act, and the Voluntary Disclosure of Income Scheme, 1997 a firm and its partner may have to be treated differently as a partner of a firm may have income other than his share of profits from the firm. However, it is one thing to say that for the purpose of invoking the provisions of the Indian Income-tax Act and other taxation laws, a firm and its partners are treated to be separate entities but while construing a statute involving immunity from certain penal actions, the provisions thereof should not ordinarily be judged on the touchstone of the provisions of the 1961 Act only because the 1997 scheme has a direct nexus therewith. It is one thing to say that when a firm has concealed income, each partner need not make a declaration but it would be another thing to say that when a search has been made on the premises of the firm and the books of account of the firm are inspected on the strength of a search warrant issued in the name of one of the partners thereof, a declaration can be made by the firm so as to cover the loopholes. It was reiterated that a firm is the conglomeration of its partners, and is not a juristic person. In the instant case, the purported disclosure made by the firm relates to the same amount which has been disclosed by the partner. Even the source of income was found to be the same. As the income of a firm *vis-a-vis* its partners have a direct co-relation, while construing a statute granting immunity, it should not be construed in such a manner so as to frustrate its object.

It was also reiterated by the Supreme Court that clarificatory circulars issued by the Central Board of Direct Taxes may also be taken into consideration for the purpose of construction of the statute.

31 [2007] 292 ITR 209 (SC).

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X AVOIDANCE OF DOUBLE TAXATION

Globalization has led to spreading of many economic and commercial activities across the countries having their own tax legislations applicable to transactions carried on in their respective jurisdictions. Section 90 of the Act, *inter alia*, provides that the central government may enter into an agreement with the government of any country outside India for the avoidance of double taxation of income under the Act and under the corresponding law in force in that country.

In exercise of its powers under section 90, the Government of India entered into an agreement with Korea called the Convention for Avoidance of Double Taxation (CADT). Article 7 of this convention fell for consideration before the Supreme Court in *CIT* v. *Hyundai Heavy Industries Company Limited*.[32]

Under section 4 of the Act, it is the total income of every "person" which is taxable. A foreign company which is not wholly controlled or managed in India is a non-resident so far as its residential status is concerned. Section 5(ii) of the Act lays down that as far as non-resident assessee is concerned, the scope and total income of assessee is confined to income which accrues or arises in India and which income is received or deemed to be received by such foreign country. Therefore, it is clear that under the Act, the taxable unit is a foreign company and not its branch or its permanent establishment in India. A non-resident assessee may have several incomes accruing or arising in India or outside India but so far as taxability under section 5(ii) of the Act is concerned, it is restricted to income which accrues or arises or deemed to accrue or arise in India. The scope of this deeming fiction is mentioned in section 9 of the Act. Therefore, the income accruing or arising in India to a foreign enterprise can only be such income which is attributable to its business carried out in India. This business could be carried out through its branch to some other form of its persons in India such as office, project sites, factory, sales outlet etc. These have come to be known as permanent establishments of foreign enterprises (PE). It is of importance to note that though under the Act, the taxable entity is the foreign general enterprise (for short GE), it will be liable to tax only in respect of income which accrues or arises to that foreign GE in India.

The Income Tax Act does not provide for taxation of the permanent establishment of a foreign enterprise. In the case before the Supreme Court, the Korean company M/s Hyundai Heavy Company Limited which is a non-resident foreign company incorporated in Korea, had entered into an agreement with Oil & Natural Gas Company (ONGC) for designing, fabrication, hook-up and commissioning of South Vassein filled central complex facilities in Bombay High on 12.03.1985. The contract was in two parts, one for fabrication of the platform and other for installation and

32 [2007] 291 ITR 482 (SC).

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commissioning of the said platform. After the fabricated platform was delivered by the assessee to the agents of ONGC in Korea, it established a permanent establishment in India for commissioning of the said platform and earned service charges for the same.

The question of law which fell for consideration before the Supreme Court was as to what are the profits reasonably attributable to the assessee's permanent establishment in India according to the department since there was one intricated contract of fabrication as well as commission of the platform. The department was of the view that all the receipts of the assessee including that of fabrication of the platform are liable to be taxed under the Act.

The Supreme Court, relying on article 7 of the CADT, negatived the contention of the department and held that only so much of the profits having economic nexus with the permanent establishment in India would be taxable under the Act and not the profits of the assessee attributable to the Korean operations.

Article 7(i) of the CADT lays down that the profits of enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through the permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state but only so much as is attributable to that permanent establishment.

The Supreme Court has held that on reading article 7 of CADT, it is clear that the said article is based on OECD Model Convention. Paragraph one of article 7 states that the business profits of an enterprise of a contracting state may not be taxed by the other contracting state unless the enterprise carries on its business in the other contracting state through its permanent establishment. The said paragraph one further lays down that only so much of the profits attributable to the permanent establishment is taxable. This paragraph further lays down that the attributable profit can be determined by the apportionment of the total profits of the assessee to its various parts or on the basis of an assumption that the permanent establishment is distinct and separate enterprise having its own profits and distinct from the GE.

After settling the law as noticed above on facts, it was held that no taxability can arise in the present case as the sales were directly billed to ONGC. Further, there was no allegation by the revenue that the price at which billing was done for supply included any element for services rendered by the permanent establishment.

Another such agreement under section 90 of the Act has been entered into by the Government of India with the United States of America called the Double Taxation Avoidance Agreement. In the context of the conventions or agreements for avoidance of double taxation, quite often the clear understanding of the concept of Permanent Establishment (PE) becomes imperative because most of such agreements define the expression PE. Article 5 of the Tax Avoidance Agreement defines PE to be a fixed place of

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business through which the business of an enterprise is wholly or partly carried on.

In the case of *DIT International Tax* v. *Morgan Stanelly*,[33] the respondent before the Supreme Court was a multi-national enterprise. This company had outsourced some of its internal activities to another company, namely, Morgan Stanelly Advantages Services Pvt. Ltd. (MSAS) which had to carry on the said activity as the back office of the respondent. MSAS had a fixed place of business in Mumbai from where it was carrying on the back office operations for the respondent.

It was on the basis of the above facts that a question arose before the Supreme Court as to whether MSAS can be treated as a PE of the respondent bringing into the tax net to the extent of such activities entrusted to MSAD. The Supreme Court, on a close examination of article 5(i) of the Tax Avoidance Agreement, held that the back office functions do not specify the requirements for holding it to be a PE. It has been held that on a reading of the agreement, it is clear that MSAD in India was only engaged in supporting the front office functions of the respondent undertaken by it and in providing IT enabled services as also reconciliation of accounts. The Supreme Court opined that in order to decide whether a PE stood constituted, one has to undertake what is called a functional and factual analysis of each of the activities to be undertaken by an establishment. The court has also noticed that MSAS cannot be treated as an agency PE in India because it had no authority to enter into or conclude any contract on behalf of the respondent. Admittedly, the contracts were being entered into in the United States and were also concluded or executed only in that country.

The Supreme Court further clarified that the definition of PE as set out in section 902(f)(iii)(a) should be understood in the sense in which it has been defined under the respective Tax Avoidance Agreement. It further held that keeping in view article 5(2)(l) of the Double Taxation Avoidance Agreement and section 92-B read with section 92-C of the Act and the rules framed thereunder, MSAS could be a service PE in India in respect of the services to be performed by deputationists deployed by the respondent.

Certain important issues pertaining to interplay and interpretation of Double Taxation Avoidance Agreement, provisions of the Act and contract for turnkey project had arisen in the case of *Ishikawajima-Harima Heavy Industries Ltd.* v. *Director of Income Tax*.[34]

The appellant in this case was a non-resident company incorporated in Japan. The company along with five other enterprises formed a consortium. The consortium so formed entered into an agreement with Petronet LNG Limited (Petronet). The contract envisaged a turnkey project. The role and responsibility of each member of the consortium was specified separately. Each of the members of the consortium was to receive separate payments.

33 [2007] 292 ITR 416 (SC).
34 [2007] 288 ITR 408 (SC).

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The contract, *inter alia*, involved (i) off-shore supplies and services, as well as, (ii) on-shore supplies and services.

The liability of the appellant to pay tax in India being doubtful, an application was filed by the same before the Authority for Advance Rulings (Income Tax) in terms of section 245Q(i) of the Act. Precisely, the question raised was whether the amounts received by the applicant from Petronet for off-shore supplies of equipment, materials, etc. as also the related services are liable to tax in India under the provisions of the Act and Indo-Japan treaty. The authority answered the question in affirmative i.e., against the appellant. The matter was brought in appeal to the Supreme Court.

On a close analysis of the contract, the court has found that though the contract is termed as a turnkey contract to be executed by the five members of consortium in the manner specified, that by itself is not of much significance. The court found that the off-shore supplies and services were made by the office of the appellant which is in Japan that is outside the territorial jurisdiction of India. The permanent establishment of the appellant in India had no role to play in such supplies and services. Therefore, in respect of these transactions, it cannot be said that there was any 'business connection' with permanent establishment in India to attach any liability by applying section 9 of the Act.

The most important part of the judgment having bearing on international law pertaining to tax jurisprudence is its declaration of territorial nexus doctrine. It has been held that income arising out of operations in more than one jurisdiction would have territorial nexus with each of the jurisdictions on actual basis.

XI REFERENCE TO HIGH COURT

In *Commissioner of Agricultural Income Tax* v. *M.N. Moni*,[35] it was found by the Supreme Court that the high court has interfered with the finding of facts found by the tribunal on cogent materials. Setting aside the impugned order of the high court, the Supreme Court has laid down principles for reference to the high court. It has been held that in cases of reference, only a question of law can be answered. Where the determination of an issue depends upon appreciation of evidence or materials resulting ascertainment of basic facts without application of law, the issue raises a mere question of fact. An inference from certain facts is also a question of fact. A conclusion based on appreciation of facts does not give rise to any question of law. If a finding of facts is arrived at by the tribunal after improperly rejecting evidence, a question of law arises. Where the tribunal acts on material partly relevant and partly irrelevant, a question of law arises because it is impossible to say to what extent the mind of the tribunal was affected by the irrelevant material used by it in arriving at the finding.

35 [2007] 291 ITR 387 (SC).

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It has further been held that even after reference is made by the trial court directly or on the basis of direction given by the high court, it is open to the high court not to answer the reference if no question of law is involved.

XII VALUATION OF CLOSING STOCK

It is a well-established law of accounting that the closing stock should be valued at the cost or market price whichever is lower as at the close of the accounting year, cost being the actual cost of the closing stock or the average cost of the stock purchased. The assessee is not bound to value all items of stock in trade in similar manner i.e., either all of them at cost or all at market value. Each item can be considered separately and lower of cost or market value taken for each of them. If there is no demand in local or foreign markets for certain goods, the assessee may be justified in valuing them at 'NIL'. Closing stock of a year is the opening stock of the next year and, therefore, the valuation placed by the assessee upon his closing stock should be adopted by him as the valuation of the opening stock of the next year. The above rule of taking the stock at cost or market value whichever is lower is obviously intended to be in favour of the trader and enables him to distribute his loss more evenly.

As per Accounting Standard 2 'Valuation of Inventories' issued by the Council of Institute of Chartered Accountants of India:

> Inventory should be valued at the lower of cost and net realizable value. The practice is consistent with the view that the assets should not be carried in excess of amounts expected to be realized from their sale or use.
> The cost of inventory comprises all cost of purchase, cost of conversion and other cost incurred in bringing the inventories to their present location and condition. Cost of items not ordinarily interchangeable should be assigned by specific identification of their individual cost while in other cases cost should be assigned using the FIFO (First in First out) or the weighted average cost formula whichever reflects the fairest possible approximation of cost incurred in bringing the item of inventory to their present location and condition.
> Net realizable value is the estimated selling price in the ordinary course of business less the estimated cost of completion and the estimated cost necessary to make the sale.
> Estimates of the net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realize. Estimates of net realizable value also take into consideration the purpose for which the inventory is held.

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In *CIT* v. *Hindustan Zinc Ltd.*,[36] the assessee had, in the past, been valuing the closing stock of zinc concentrate at weighted average cost. At the relevant time i.e., assessment year 1996-97, the domestic consumption of the stock was not possible due to low metal content and high impurity level of silica. Thus, the domestic market value was in fact 'NIL'. There were no domestic buyers. Since domestic consumption of the accumulated stock was not possible the assessee decided to explore the possibilities of exporting the accumulated stock. The assessee-company took the decision in consultation with the government to export the accumulated quantity of zinc concentrate. With the permission of the government, the assessee decided to price "zinc concentrate" for the purpose of sale by adopting what is called as the London Metallic Exchange Price (LME price). Thus, the stock was held for the purpose of export and the international market value expected to be realized was the LME price which was lower than the weighted average cost by Rs. 27.08 crores. The assessee accordingly valued the stock at the LME price. It is to be noted that the goods were actually exported out of India in the subsequent years.

The assessing officer noted that there was no export of zinc concentrate and the auditor's report categorically stated that decrease in the value of inventory by abovesaid amount was not in accordance with the accounting policy of the company and if the inventory would have been valued at the domestic price, company's profit would have been higher by abovesaid amount. Therefore, he added the said amount back as income. This was upheld by CIT (Appeals) but reversed by the tribunal. The department appealed but the high court found that no substantial question of law arose. Thus, the matter reached the Supreme Court.

The issue which arose for consideration before the apex court was whether the assessee was right in writing down the inventory (zinc concentrate) below the cost price by estimating its net realisable value at the LME price and not by estimating its net realizable value at the domestic price. The court held that the present case is a case of reduction of prospective profits and therefore, allowed the department's appeal. The court relied upon its earlier decision in *CIT* v. *British Paints India Ltd.*[37] wherein it was held that if the fall in the price has the effect of merely reducing the prospective profits, there would be no justification to discard the valuation at cost.

It is submitted that while reaching the above decision, there seems to be an error in appreciating the fact that the assessee had been valuing it at weighted average cost and not at net realizable value at the domestic price. Rather than being a case of reduction in prospective profit, it is submitted that it seems to be a case of anticipated loss. Whether the assessee sells the goods in domestic market or international market, incurring of loss seems

36 [2007] 291 ITR 391 (SC).
37 [1991] 188 ITR 44 (SC).

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inevitable.

Even if one assumes that the domestic price was lower than the cost but higher than the LME and looks into the aspect of valuation of closing stock at domestic market value rather than the international market value, it is submitted that one needs to look into the purpose for which the stock is held as on the date of the balance sheet. Undeniably, the goods in this case were held for international sale; therefore, the LME price should have been taken as the value the closing stock keeping in view of the above-stated settled accounting principles.

The court was pleased to place reliance on the auditor's report to reach the above conclusion. It is submitted that the auditor has a duty to disclose any changes in accounting policy and its effect on the company's profit. This disclosure in the present case seems to have been misread by the assessing officer who held that an addition is required to be made to the assessee's income in view of the said report, which has been upheld by the apex court.

XIII REVISION UNDER SECTION 263

Section 263 of the Act empowers the commissioner to initiate a *suo motu* revisional proceeding if he considers that the order passed by the assessing officer is "erroneous insofar as it is prejudicial to the interest of the revenue."

In *CIT* v. *Max India Ltd.*,[38] the question before the Supreme Court was that in a case where there are two possible views of a statutory provision, and the assessing officer adopts a view which is favourable to the assessee, can it then empower the commissioner to exercise his powers of revision under section 263 of the Act merely because it is "prejudicial to the interest of the revenue".

The present question fell for consideration before the court because at the relevant time two views were found possible of the word 'profits' in the proviso to section 80 HHC(3) of the Act. This was amended eleven times. The mechanics of the section became so complex over the years that two views were inherently possible. As of fact, different views were existing on the day the commissioner had passed the impugned order.

The Supreme Court following its earlier judgment in *Malabar Industrial Co. Ltd.* v. *CIT*[39] has held that the phrase "prejudicial to the interest of revenue" under section 263 has to be read in conjunction with the expression "erroneous" order passed by the assessing officer. Every loss of revenue as a consequence of an order of the assessing officer cannot be treated as prejudicial to the interest of revenue. For example, when an income tax office (ITO) adopted one of the courses permissible in law and has resulted in loss of revenue; or where two views are possible and the ITO

38 [2007] 295 ITR 282 (SC).
39 [2000] 243 ITR 83.

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has taken one view with which the commissioner does not agree, it cannot be treated as erroneous order prejudicial to the interest of revenue, unless the view taken by the ITO is unsustainable in law.

It is submitted that apart from the above reason, it is also well established that where a taxing statute admits of two possible interpretations, then the one which favours the taxpayer has to be adopted. This rule of interpretation which has been reiterated by the Supreme Court in catena of cases[40] binds even the commissioners while exercising quasi-judicial powers. Therefore, in such cases, the initiation of section 263 proceedings will be without jurisdiction.

XIV CHARITABLE PURPOSE

In *CIT* v. *Gujarat Maritime Board*[41] the question involved was whether the respondent board was entitled to be registered as a charitable trust under section 12-A of the Act.

The board is a statutory authority constituted under section 3(2) of the Gujarat Maritime Board Act, 1981.

Before 13.11.2002, the board was registered as 'local authority' as defined under section 3(31) of the General Clauses Act, 1897, which is a very wide definition. Prior to 2002, the board was availing of exemption as 'local authority' under section 10(20) of the 1961 Act. Accordingly, prior to 2002, the income of the board was not exigible to income tax under section 10(20) of the Act.

By the Finance Act, 2002, an explanation was added in section 10(20) by which 'local authority' was defined. It gave a restricted meaning to the words 'local authority'. By reason of the said explanation, the expression 'local authority' was confined to *panchayats*, municipality, municipal committee, district board and cantonment board. Thus, the maritime board did not come within the definition of the expression 'local authority'.

Under the circumstances, the Gujarat Maritime Board made an application to the commissioner for registering it (the board) as a "charitable institution" as defined under section 2(15) of the Income tax Act, 1961. Accordingly, it claimed exemption as charitable institution in respect of income derived from its property/business under section 11 of the 1961 Act. This was denied by the department. The board then filed an appeal to the tribunal which was allowed. The high court and now the Supreme Court affirmed the decision of the tribunal holding that the board is a charitable institution.

"Charitable purpose" has been defined under section 2(15) of the Act to include relief to the poor, education, medical relief and advancement of any

40 *Express Mill* v. *Municipal Committee*, AIR 1958 SC 341 (344); *C A Abraham* v. *ITO, Kottayam*, AIR 1961 SC 609 (612); *Petron Engineering Corporation Pvt. Ltd.* v. *CBDT*, AIR 1989 SC 501 (506).

41 [2007] 295 ITR 561 (SC).

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other object of general public utility Applying the test laid down by the Supreme Court in its earlier decision in *Andhra Pradesh Road State Transport Corporation*,[42] the court has found that the Gujarat Maritime Board is established for the predominant purpose of development of minor ports within the state of Gujarat, the management and control of the board is essentially with the state government and there is no profit motive, as indicated by the provisions of section 73,74, and 75 of the 1981 Act. The income earned by the board is deployed for the development of minor ports in the State of Gujarat. Accordingly, it has been held that the board is entitled to be registered as a "charitable trust" under section 12A of the Act and thus, its income is exempt under section 11(1) thereof.

XV DEPRECIATION

Section 32 of the Act provides for the deduction of depreciation of buildings, machinery, plant or furniture owned by the assessee and used for the purpose of *business or profession.* Sub-section (iv) of section 32, *inter alia*, provides that such deduction shall also be allowed in respect of the building solely used for the purpose of residence of persons employed in business whose chargeable "salary" is Rs. 10,000/- or less.

In *G.K. Choksi and Co.* v. *CIT*[43] the question was whether the assessee being a chartered accountants' firm would be entitled to deduction under section 32(iv) which refers to only "business" excluding the word "profession" though the opening paragraph of section 32(1) speaks of both "business or profession".

On a close analysis of section 32(1) and the legislative scheme envisaged therein the Supreme Court has held that it is not possible to construe that the word 'business" in section 32(1)(iv) would include "profession" as well.

Applying the grammatical rule of construction, which did not lead to any absurdity or inconsistency, the court has held that Parliament has clearly used the words "business", "profession" or both as and when it intended to do so without leaving any scope of ambiguity. It has been held that Parliament was conscious of the fact that the "business" and "profession" are conceptually different and they cannot be used interchangeably.

It may be of interest to note here that though in *Barendra Prasad Ray*[44] pertaining to section 9(1) of the Act, the court has held that keeping in view the wide import of the word 'business', the expression "business connection" will include "profession connection" as well. In the case under review, the court has distinguished *Barendra Prasad Ray* by holding that the decision was rendered on the peculiar facts and circumstances of the case and has to be restricted to the situation prevailing therein.

42 [20071986] 159 ITR 1 (SC).
43 [2007] 295 ITR 376 (SC).
44 (1981) 2 SCC 693.

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One has to always remember that decision making process is a complex mental exercise which is quite often heavily loaded with personalized perceptions and as such can hardly be assessed on the golden scale of global objectivity.

XVI ALLOWANCE UNDER SECTION 32AB

In the case of *S.A. Builders Ltd.* v. *CIT*,[45] the Supreme Court agreed with the holding of the tribunal and the high court that the appellant, being involved in civil construction and not in manufacturing activity, is not entitled to the benefit under section 32AB. The earlier judgment of the Supreme Court in *CIT* v. *N.C. Budharaja and Co.*[46] was relied upon by the tribunal and the high court to reach this conclusion. The Supreme Court held that the deduction under section 32AB is not automatic; it is subject to various conditions laid down in the provisions. Whether the assessee fulfilled those conditions for claiming the deduction or not required examination into facts which were not on record.

XVII RECTIFICATION OF MISTAKES

In *Honda Siel Power Products Ltd.* v. *CIT*,[47] the assessee had taken a loan in foreign exchange for import of machinery. On account of fluctuation in the foreign exchange rate, the liability of the assessee to repay the loan in terms of Indian rupee went up. The assessee enhanced the figure of written down value of the block of assets and claimed depreciation accordingly. The assessing officer held that revision in the actual cost was not permissible but on appeal, the commissioner (appeals) held that the claim was admissible. On appeal, the appellate tribunal held that the revision was not permissible unless actual payment had been made by the assessee, since under section 43A actual payment was a condition precedent for availing of the benefit. The assessee moved the appellate tribunal for rectification of its order, pointing out that the earlier order of a coordinate bench of the tribunal in which it was held that the enhanced depreciation was admissible even on notional increase in the cost of the asset had been cited before the tribunal, but the tribunal had inadvertently not considered the submission of the assessee to that effect. The appellate tribunal allowed the rectification application of the assessee stating that the judgment of the coordinate bench of the tribunal had escaped its attention. The department preferred an appeal to the high court and the high court set aside the order of the tribunal holding that the power to rectify any mistake was not equivalent to a power to review or recall the order sought to be rectified.

45 (2007) 289 ITR 26 (SC).
46 [1993] 204 ITR 412 (SC).
47 [2007] 295 ITR 466 (SC).

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On the above facts, the Supreme Court has considered the scope of power of rectification conferred on the tribunal under section 254(a) of the Act. The expression "rectification of mistake apparent from the record" occurs in section 154 as well as in section 254(2) of the Act. According to the Supreme Court, the purpose behind the enactment of section 254(2) is based on the fundamental principle that no party appearing before the tribunal, be it an assessee or the department, should suffer on account of any mistake committed by the tribunal. This fundamental principle has nothing to do with the inherent powers of the tribunal. In the present case, the tribunal in its order dated 10.9.2003, allowing the rectification application has given a finding that *Samtel Color Ltd.*[48] was cited before it by the assessee but through oversight it had missed out the said judgment while dismissing the appeal filed by the assessee on the question of admissibility/ allowability of the claim of the assessee for enhanced depreciation under section 43A. One of the important reasons for giving the power of rectification to the tribunal is to see that no prejudice is caused to either of the parties appearing before it by its decision based on a mistake apparent on the record.

For the above reasons the judgment of the high court was set aside and the order of the tribunal allowing rectification was restored.

XVIII KAR VIVADH SAMADHAN SCHEME

In *State, CBI* v. *Shashi Balasubramaniam*,[49] the Supreme Court was called upon to decide whether the Kar Vivad Samadhan Scheme, 1998 is applicable in relation to public servants.

Parliament enacted the Finance (No. 2) Act, 1998. Chapter IV of the said Act provides for the scheme under consideration. The scheme, *inter alia*, provides for remissions in respect of tax arrears under the central fiscal legislation as also immunity from prosecution and imposition of penalty in certain cases.

In the present case, the respondents were officers concerning foreign trade and as such were public servants. They were found accused of facilitating private company to import dutiable goods as exempted. Accordingly, a first information report was lodged on 2.3.1995 for commission of offences under sections 120B, 420 and 271 of the Indian Penal Code and section 13(2) of the Prevention of Corruption Act, 1988 and section 138 of the Customs Act, 1962.

The company and its two directors, much before filing of the chargesheet against them, filed declarations under the scheme. They also filed application for quashing their prosecution which was allowed. Thereafter, the

48 Tribunal's order dated 10.12.2001 passed in *DCIT, Spl. Range 5, New Delhi* v. *Samtel Color Limited.*

49 [2007] 289 ITR 8 (SC).

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respondents also filed similar application before the high court, which was eventually allowed.

On appeal by the state, the Supreme Court has held that in clear stipulation contained under the scheme, the immunity clauses contained therein will not be applicable to public servants. The reason is obvious. Section 95 of the scheme clearly spells out that the provisions of the scheme shall not apply to any person in respect of whom prosecution for offences under chapter IX (dealing with public servants) of the Indian Penal Code and/ or Prevention of Corruption Act, 1988 have been instituted.

It has been conclusively held that an immunity under the scheme is granted only in respect of offences purported to have been committed under direct or indirect tax enactments but it cannot be granted in respect of offences under the Prevention of Corruption Act.

It is submitted that respondents, who were public servants, had neither filed any declaration under the scheme nor could they have at all filed the same. It is so because of the reason that they were not liable to pay any duty. In this view of the matter, there was no occasion for them to seek any immunity from prosecution under the scheme because filing of declaration and its acceptance is a *sina qua non* for seeking the aforesaid immunities.

XIX BLOCK ASSESSMENT

The Supreme Court, in *Manish Maheshwari* v. *Asst. CIT*[50] (heard along with *Indore Construction P. Ltd.* v. *CIT*) has finally settled the law that for sustaining the proceeding initiated under section 15BC against third parties for block assessment, the conditions precedent contained therein must be strictly complied with. The court has held the provisions contained in chapter XIV-B of the Act to be drastic in nature with draconian consequences.

The court held that the condition precedent for invoking a block assessment is that a search has been conducted under section 132, or documents or assets have been requisitioned under section 132A. The said provision would apply in the case of any person in respect of whom search has been carried out under section 132A or documents or assets have been requisitioned under section 132A. section 158BD, however, provides for taking recourse to a block assessment in terms of section 158BC in respect of any other person, the conditions precedent wherefor are: (i) satisfaction must be recorded by the assessing officer that any undisclosed income belongs to any person, other than the person with respect to whom search was made under section 132 of the Act; (ii) the books of account or other documents or assets seized or requisitioned had been handed over to the assessing officer having jurisdiction over such other person; and (iii) the assessing officer has proceeded under section 158BC against such other persons.

50 [2007] 289 ITR 341 (SC).

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The conditions precedent for invoking the provisions of section 158BD, thus, are required to be satisfied before the provisions of the said chapter are applied in relation to any person other than the person whose premises had been searched or whose documents and other assets had been requisitioned under section 132A of the Act.

It has further been held that:

> No proceeding under section 158BC had been initiated. There is, thus, a patent non-application of mind. A prescribed form had been utilized. Even the status of the assessee had not been specified. It had only been mentioned that the search was conducted in the month of November 1995. No other information had been furnished. The provisions contained in Chapter XIV-B are drastic in nature. It has draconian consequences. Such a proceeding can be initiated, it would bear repetition to state, only if a raid is conducted. When the provisions are attracted, legal presumptions are raised against the assessee. The burden shifts on the assessee. Audited accounts for a period of ten years may have to be reopened.

The preponderant view of the high court's in taking such a view has been accepted now by the Supreme Court after citing a passage from the decision of the Gujarat High Court in *Khandubhai Vasanji Desai* v. *Deputy CIT*.[51] The decision in *CIT* v. *Ms. Pushpa Rani*[52] was found to be inapplicable as no valid search warrant had been found to have been issued. The decisions specifically approved by the Supreme Court are *Rushil Industries Ltd.* v. *Harsh Prakash*,[53] *Priya Blue Industries P. Ltd.* v. *Joint CIT*,[54] *Premjibhai and Sons* v. *Joint CIT*,[55] *CIT* v. *Deep Arts*,[56] *CIT* v. *Don Bosco Card Centre*[57] and *CIT* v. *Smt. Maya Chotrani*.[58]

XX SPECIAL DEDUCTION ON EXPORTS UNDER SECTION 80HHC

In *A.M. Moosa* v. *CIT, Trivandrum*,[59] the Supreme Court once again reiterated the already well settled principle that the profit as contemplated under section 80 HHC(1) and section 80 HHC(3) means positive profit

51 [1999] 236 ITR 73.
52 [2007] 289 ITR 328 (Del).
53 [2001] 251 ITR 608 (Guj).
54 [2001] 251 ITR 615 (Guj).
55 [2001] 251 ITR 625 (Guj).
56 [2005] 274 ITR 571 (Ker).
57 [2007] 289 ITR 329 (Ker).
58 [2007] 288 ITR 175 (MP).
59 [2007] 294 ITR 1 (SC).

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arrived after taking into consideration the losses, if any. The court took note of its earlier decision in *IPCA Laboratory Ltd.* v. *CIT*[60] and *ITO* v. *Induflex Products (P) Ltd.*[61] and held that no deduction would be allowed under section 80 HHC(1) if the sum of profits from export business of trading goods and manufactured goods is in negative. In arriving at the figure of profit, in the case where business includes export of both self manufactured and trading goods as covered by section 80 HHC(3)(c), the profits and losses from both the trades have to be taken into account and the deduction would be allowed only in case the final figure is positive.

In *CIT* v. *Catapharma (India) P. Ltd.*[62] and *CIT* v. *Lakshmi Machine Works*,[63] the question which arose for consideration was whether sales tax and excise duty form part of the total turnover for the purpose of section 80HHC. It was held that the tax under the Act is a tax on income, profits and gains. It is not a charge on gross receipts. The word 'total turnover' in section 80HHC has to be read as part of the formula which sought to segregate the 'export profits' from the 'business profits'. The business profit has to be divided in the ratio of export turnover to total turnover so as to arrive at the export profits for the purpose of claiming deduction under section 80 HHC(1). Like receipts in the nature of rent, commission, brokerage, interest etc. which have no nexus with the activity of export and are, therefore, acceptedly not included in the business profits for the purpose of deduction, the sales tax and excise duty recovered from the buyers also do not have any nexus with the activity of export. Excise duty and sales tax are indirect taxes collected on behalf of the government and therefore if made relatable to exports the formula under section 80 HHC would become unworkable. A schematic interpretation has to be given to the word 'total turnover' in the formula. It cannot be interpreted with reference to the definition of the word 'turnover' in other laws or as defined in accounting principles. The aim of the formula is to disallow a part of the concession which is not related to export. In view of the above contentions, it was finally held that excise duty and sales tax cannot form part of the 'total turnover' under section 80 HHC(3).

In this case, it is to be specifically noted that the business profit which stands to be segregated does not include sales tax or excise duty collected since these taxes are paid to the government and consequently deducted in arriving at the figure of business profit. Also, sales tax and excise duty are not leviable on export goods in many cases and thus are not part of the export turnover. Thus, if we include these indirect taxes collected on behalf of the government in the total turnover, we will arrive at a distorted figure of export profits and the whole purpose of the section would remain unaccomplished.

60 [2004] 266 ITR 521.
61 [2006] 280 ITR 1.
62 [2007] 292 ITR 641 (SC).
63 [2007] 290 ITR 667 (SC).

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The controversy which arose in *CIT* v. *Baby Marine Exports*[64] was regarding the premium paid by the export house to the supporting manufacturer in respect of which a certificate was issued by the export house as to the inclusion of the premium in the profits for the purpose of deduction under section 80 HHC(1A) in the hands of the supporting manufacturer. In this case, the supporting manufacturer was paid a premium of 2.25% on the F.O.B. value as per the terms of the agreement by the export house and such premium was claimed as deduction under section 80 HHC(1A) by the supporting manufacturer. The Supreme Court, upheld the views of the appellate tribunal and that of the high court that the export house premium was nothing but an integral part of sale price realized by the assessee. The premium cannot be considered as commission or brokerage as a person could not earn brokerage or commission for himself. And that since the sales were to the export house the provisions of sub-section (1) of section 80 HHC did not apply to the case of the assessee. Only the provision of sub section (1A) of section 80 HHC applied. Thus, on a plain interpretation of section 80 HHC(1A), the assessee was entitled to claim deduction in respect of the premium amount received from the export house in computing the total income. The requirement of realizing the sale proceeds of the goods or merchandise in convertible foreign exchange is applicable only to the export house and a claim for deduction under section 80 HHC(1) and not to a supporting manufacturer as contained expressly in section 80 HHC(2)(a).

The twin question involved in the case of *CIT* v. *Shirke Construction Equipment Ltd.*[65] were squarely covered by the earlier judgments of the Supreme Court rendered in *ITO* v. *Induflux Products P. Ltd.*[66] and *IPCA Laboratory Ltd.* v. *Deputy CIT.*[67]

It has been held that:

(i) Section 80AB of the Act specifying that profits are those as determined for the purpose of the Act, will apply for determining profits from export business of the deduction under section 80HHC.

(ii) In determining business profits for deduction under section 80HHC, the unabsorbed business losses of earlier years should be set off.

XXI INSURANCE BUSINESS – SECTION 44

Section 44 of the Act provides for a special mode in which the assessee carrying no business, *inter alia*, in general insurance should be assessed. In

64 [2007] 290 ITR 323 (SC).
65 [2007] 291 ITR 380 (SC).
66 [2006] 280 ITR 1 (SC).
67 [2004] 266 ITR 521 (SC).

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CIT v. *Oriental Fire and General Insurance Co. Ltd.*,[68] the issue relating to interpretation of section 44 came up for consideration before the Supreme Court. The issue was whether provisions of taxation by way of 'reserve for bad and doubtful debts' could be added to the balance of profits disclosed in the annual accounts of the assessee insurance company. Though the assessing officer was of the view that it could be added back, both the tribunal and the high court held otherwise.

The apex court, while noting its earlier decisions,[69] reiterated the special status of insurance companies with respect to computation of tax as under:

> Insurance companies in view of the provisions of the said Act [Insurance Act, 1938], however, are dealt with also under the 1961 Act differently. Section 44 thereof, as noticed hereinbefore, begins with a non obstante clause. The jurisdiction of the Income-tax Officer in passing the orders of assessment is limited. Keeping in view the fact that the business carried out by the assessee is not governed by the ordinary principles applicable to business computation as laid down in section 10 of the 1961 Act, the insurance companies do not compute their profits annually in the manner laid thereunder.

The Supreme Court held that provision for income-tax being not an expenditure, the assessing officer could not have exercised his jurisdiction in relation thereto. The court held that section 44 of the Act provides for a *non-obstante* clause and prevails over other provisions. Even 'bad and doubtful claims' is not an expenditure and not relevant for computing the profits.

XXII OFFENCE BY COMPANY

In *Madhumilan Syntex Ltd.* v. *Union of India*,[70] the CIT, Bhopal granted sanction to prosecute appellants under section 279 of the Act observing therein that the assessee had committed default under section 194C in paying TDS to the credit of the central government. Accordingly, a complaint was filed in the court of an Additional Chief Judicial Magistrate (Economic Crime), Indore. An application under section 254 of the Code of Criminal Procedure for discharge was dismissed by the trial court and subsequently affirmed by the high court.

The assessee contended that the case was one of only delayed payment of TDS and not one of non-collection or non-payment of TDS. It was also

68 [2007] 291 ITR 370 (SC).

69 *Life Insurance Corporation of India* v. *CIT*, [1964] 51 ITR 773 (SC); *Pandyan Insurance Co. Ltd.* v. *CIT*, [1965] 55 ITR 716 (SC); *CIT* v. *Calcutta Hospital and Nursing Home Benefits Association Ltd.*, [1965] 57 ITR 313 (SC).

70 [2007] 290 ITR 199 (SC).

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contended that the company is not a natural person and hence, cannot be punished. On the issue of offence with regard to delayed payment of TDS, the court, after taking note of section 276B of the Act held that wherever a company is required to deduct tax at source and to pay it to the account of the central government, failure on the part of the company in deducting or in paying such amount is an offence under the Act and has been made punishable. It, therefore, cannot be said that the prosecution against a company or its directors in default of deducting or paying tax is not envisaged by the Act.

On the issue of prosecution of company, the court took note of its earlier decision in *Standard Chartered Bank* v. *Directorate of Enforcement*[71] and held that:

> It is no doubt true that Company is not a natural person but 'legal' or 'juristic' person. That, however, does not mean that Company is not liable to prosecution under the Act. 'Corporate criminal liability' is not unknown to law. The law is well settled on the point and it is not necessary to discuss it in detail. We may only refer to a recent decision of the Constitution Bench of this Court in Standard Chartered Bank & Ors. v. Directorate of Enforcement & Ors., 2005 (4) SCC 530: 2005 (5) JT 267. In Standard Chartered Bank, it was contended on behalf of the Company that when a statute fixes criminal liability on corporate bodies and also provides for imposition of substantive sentence, it could not apply to persons other than natural persons and Companies and Corporations cannot be covered by the Act. The majority, however, repelled the contention holding that juristic person is also subject to criminal liability under the relevant law. Only thing is that in case of substantive sentence, the order is not enforceable and juristic person cannot be ordered to suffer imprisonment. Other consequences, however, would ensue, e.g. payment of fine etc.

The court reiterated that civil and criminal proceedings are separate and independent and one cannot abate or defeat the other. Even during the pendency of a civil suit, the jurisdiction of a criminal court would not be ousted in case the accused has committed any offence.

XXIII TAX DEDUCTED AT SOURCE (TDS)

In *Hindustan Coca Cola Beverage P. Ltd.* v. *CIT*,[72] the assessee entered into an agreement with M/s Pradeep Oil Corporation for use of their premises for receipt, storage and dispatch of goods belonging to the

71 (2005) 4 SCC 530.
72 [2007] 293 ITR 226 (SC).

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assessee, towards which it paid warehousing charges on which TDS under section 194C of the Act at 2 per cent was deducted and paid to the department. The assessing officer, however, declared the appellant-company to be an "assessee in default" by taking the warehousing charges as 'rent' thereby attracting TDS at 20 per cent. An appeal before the CIT (Appeals) failed. In appeal, the tribunal too rejected the assessee's contention *vide* an order dated12.7.2002. The high court, *vide* an order dated 21.5.2004 dismissed the appeal preferred by the assessee against the tribunal's order.

The assessee then moved an application for rectification of tribunal's order dated 12.7.2002 before the tribunal for pressing its alternative contention that the warehouser has been assessed on its income and the tax due has been recovered from it by the department and therefore, no further tax could have been collected from the assessee-appellant. This application was allowed by the tribunal holding that there was a mistake apparent on the face of record and therefore, constituted a rectifiable mistake under section 254(2) of the Act. It recalled its earlier order dated 12.7.2002 on this limited aspect. The department did not challenge the order of recall. Upon rehearing of the appeal on this limited issue, the tribunal held that there can be no recovery of tax alleged to be in default once again from the appellant considering that Pradeep Oil Corporation had already paid taxes on the amount received from the appellant.

In an appeal preferred by the department, the high court set aside the tribunal's order on the ground that order of the tribunal dated 12.7.2002 had attained finality since the appeal filed against the same by the assessee was dismissed by the high court on 21.5.2004. The high court opined that the tribunal's order dated 12.7.2002 got itself merged into the order passed by the high court on 21.5.2004.

The Supreme Court, however, did not agree with the high court's viewpoint and set aside its order. It noticed that the tribunal's order to reopen the matter for further hearing was not challenged by the department and therefore, the high court erred in interfering with the tribunal's order.

The court also took note of a circular dated 29.1.1997 issued by Central Board of Direct Taxes which declared that no demand visualized under section 201(1) of the Act should be enforced after the tax deductor has satisfied the officer-in-charge of TDS that taxes due have been paid by the deductee-assessee. This circular, in the court's view, put an end to the controversy.

XXIV SEARCH AND SEIZURE

In *Director-General of Income-tax* v. *Diamondstar Exports Ltd.*,[73] the issue was whether the high court could have directed payment of interest on

73 [2007] 293 ITR 438 (SC).

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certain jewellery and ornaments belonging to the respondents which had been seized by the appellants on 12.1.2001.

Upon a finding that the search and seizure order to be invalid and illegal, the high court had directed the appellants to forthwith return the gold, diamond, jewellery and ornaments seized with interest at the rate of 8 per cent per annum on the value of jewellery, etc. which was quantified at Rs. 84 lakhs from the date of seizure till payment.

The Supreme Court, without going into the question of payability of interest on the value of goods found by the court to have been illegally seized, directed payment of costs of Rs. 75,000 in full and final settlement of claim towards the quantum of interest.

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