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INCOME TAX

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I INTRODUCTION

DURING THE year under review, the nature of disputes under the Income Tax Act, 1961 (the Act) requiring adjudication has remained almost the same as in the past three years. By and large, the law on the subject tends to be settled. It only required application to different fact situations with a bit of pragmatic and cautious approach. Taking note of globalization and cross-border transactions, the courts are rightly giving importance to the doctrine of creative interpretation. This is essential to meet the challenges arising out of advancement in science and technology as also because of opening of the economy resulting in much more complex cross-border transactions. Another redeeming feature of current judicial approach is that it is trying to reconcile the equity and taxation to meet the ends of justice than to go just by literal construction.

II ASSSESSMENT

Block assessment – levy of surcharge

Article 271 of the Constitution of India empowers the Parliament to increase any of the duties or taxes levied by it by a surcharge for the purpose of the union and the whole proceeds of any such surcharge shall form part of the consolidated fund of India. Chapter XIV of the Act lays down a special procedure for assessment of such cases with a view to combat tax evasion by providing a simplified machinery for determining tax liability in such cases. Section 113 of the Act provides for levy of income tax at a flat rate of 60 per cent in the case of block assessment envisaged under chapter XIV of the Act. Resorting to its powers under article 271 of the Constitution of India, the Parliament had been levying surcharge on the tax levied in block assessment under various Finance Acts with varying rates. The Finance Act, 2001 prescribed the rate of 17 per cent for levy of surcharge in case of block assessment.

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In *CIT* v. *Rajiv Bhatara*,[1] block assessment was made pursuant to a search conducted on April 6, 2000. The question involved in this case was whether surcharge at the rate of 17 per cent prescribed by Finance Act, 2001 can be applied in relation to search conducted in the present case. Relying on its earlier judgment in *CIT* v. *Suresh N. Gupta*,[2] it was held that surcharge at the rate of 17 per cent was leviable in the present case. According to the court, the proviso added to section 113 by the Finance Act, 2002 w.e.f. 1.6.2002 clarifies that out of four dates, the date of search will be relevant for the applicability of the particular Finance Act, thereby giving it retrospective effect to the newly added proviso. The above judgment in *CIT* v. *Rajiv Bhatara*[3] was rendered on 19.02.2009. Curiously, shortly after the said decision, *i.e*. on 1.6.2009, another bench of the Supreme Court by doubting the correctness of the interpretation given in *CIT* v. *Suresh N. Gupta,*[4] had referred the matter to a larger bench by holding:

> Is the said proviso was introduced with effect from June 1, 2002, i.e., with prospective effect and by reason thereof, the tax chargeable under section 113 of the Income-tax Act is to be increased by surcharge levied by a Central Act, we are of the opinion that keeping in view the principles of law that the taxing statute should be strictly construed and a statute, ordinarily, should not be held to have retrospective effect, it is necessary that the matter be considered by a larger bench.

The aforesaid case is one more example requiring cutting edge information and tracking system at least in the apex court of the country for which both money and technology is available in abundance.

Block assessment – depreciation

In *E.K. Lingamurthy* v. *Settlement Commission (IT & WT)*,[5] the Supreme Court was called upon to consider the scope of section 155BB of chapter XIV-B of the Act in the context of undisclosed income as envisaged therein. The present case related to the block period commencing from 1.4.1986 to 11.10.1996 when the search took place. While making the block assessment, the settlement commission disallowed the application of the assessee for set up of carry forward losses and depreciation which had accrued in the period prior to the block period against the income returned/ assessed in such previous period. The assessee's stand before the Supreme Court was that there was a conceptual difference between current loses and carry forward loses. According to the assessee, explanation 1.1(a) to

1 (2009) 310 ITR 105 (SC).
2 (2008) 297 ITR 322 (SC).
3 *Supra* note 1.
4 *Supra* note 2.
5 (2009) 314 ITR 305 (SC).

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section 158BB did not rule out current year's losses or current year's depreciation. It only ruled out the brought forward loses or unabsolved depreciation under section 32(2). The submission was that this difference was lost sight of by the settlement commission in its impugned judgment. The Supreme Court again held that chapter XIV-B constituted a code by itself. Section 155BB provides for aggregation of income/loss of each previous year comprised in the block period. The block period assessment under chapter XIV-B was in addition to regular assessment.

Analyzing section 158BB (4) read with explanation (a) thereto, it was held that only brought forward losses of the past years under chapter VI and unabsorbed depreciation under section 32(2) were to be excluded while aggregating the total income or loss of each previous year in the block period but set off of the loss suffered in any of the previous year in the block period against the income assessed in other previous years in the block period was not prohibited. It was held that the settlement commission erred in disallowing the application of the assessee for set off of *inter se* losses and deprecation accruing in any of the previous years in the block period against the income returned/assessed in any other previous year in the block period. The judgment of the High Court as well as the settlement commission was, therefore, set aside and the matter was remitted to the settlement commission for fresh computation of the undisclosed income under section 158BB of the Act for the block period in question.

Passing of an order of assessment under the dictates of the commissioner

It is a cardinal principle of administrative law that an order passed by a statutory authority at the dictates of his superior or any external authority is a nullity in the eye of law because this amounts to abdication/surrender of discretion.[6] In *CIT* v. *Greenworld Corporation*,[7] the assessing officer accepted the return of income filed by the assessee at nil for the assessment years 1996-97 to 1999-2000 on the direction of the commissioner of income tax. Assessments for the years 2001-2002 and 2002-2003 were also completed on the same line. The successor commissioner, being of the opinion that the said assessment orders were prejudicial to the interest of the revenue, interfered under section 263 of the Act and directed for initiating re-assessment proceedings under section 148 of the Act. The tribunal, on appeal by the assessee, set aside the order of the commissioner. The revenue authority took the matter in appeal to the High Court and succeeded primarily on the ground that the assessment orders were based on uncalled for interference by the commissioner.

The Supreme Court, on a detailed examination of the facts arising from the records and the respective statutory provisions of the Act, found the

6 See *Commissioner of Police* v. *Goverdhandas*, AIR 1952 SC 16; *Purtabpur Co. Ltd.* v. *Cane Commissioner of Bihar*, AIR 1969 SC 48; *Orient Paper Mills* v. *Union of India*, AIR 1970 SC 1498; *State of U.P.* v. *Maharaja Dharmender Prasad Singh,* AIR 1989 SC 997; *Anirudh Singhji Jadeja* v. *State of Gujarat*, AIR 1995 SC 2390.

7 (2009) 314 ITR 81 (SC).

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order of the commissioner directing re-opening of the assessment under purported exercise of *suo motu* revisional powers under section 263 of the Act to be erroneous because it was hit by the principle of change of opinion.

The Supreme Court, despite having found the re-assessment proceedings to be bad in law on the jurisdictional issues, curiously exercised its constitutional jurisdiction under article 142 of the Constitution and directed re-assessment in order to do complete justice. It did so because the assessment orders were passed by the assessing officers on the dictates of the higher authority and, as such, without jurisdiction and a nullity. This was so done because the facts as found were too revealing and clearly involved manipulations leading to gross abuses in passing the original assessment orders.

Valuation of stock

In *V.K.J. Builders and Contractors P. Ltd.* v. *CIT*,[8] the assessee, a civil contractor, on alleged suppression of work in progress and consequential increase in the value of closing stock, opted for the *Kar Vivad Samadhan Scheme*, 1998 and paid tax on the basis of the resultant increased amount of income. Subsequently, the assessee moved a rectification application under section 154 of the Act to give consequential effect to the opening stock of the financial year next to the year under consideration. Both the assessing officer and the commissioner (Appeals) rejected the application. On second appeal, the tribunal directed the AO to modify the opening stock of the next following year. Though the High Court reversed the same, the Supreme Court restored the order of the tribunal based on the fundamental principle of accountancy that the closing stock of the earlier year has to form the opening stock of the next accounting year. Understandably, increase in closing stock results in increase in profit of the current year. In a way, a part of the expenses of the current year are being treated as part of the closing stock and not attributable to the revenue of the current year. Obviously, those expenses not recognized in the previous year are to be recognised as cost attributable to next year's revenue and thus have to be included in the opening stock of the next year. This adjustment would have the effect of reducing the profit of the next year.

In *Mepco Industries Ltd.* v. *Commissioner of Income Tax*,[9] the assessee received power subsidy for two years, which it initially offered as a revenue receipt in its return of income. Later, it filed a petition for revision under section 264 of the Act claiming that the subsidy received may be treated as capital receipt. The commissioner of income tax granted the relief as sought by the appellant. However, the CIT sought to pass an order of rectification under section 154. Applying the *ratio* of subsequent decision of the

8 (2009) 318 ITR 204 (SC).
9 (2009) 319 ITR 208 (SC).

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Supreme Court in *Sahney Steel and Press Works Ltd.*,[10] CIT held that the subsidy was given to the assessee company after it commenced its production and hence the subsidy received was to be treated as revenue receipt. Both the single bench and the division bench of the High Court rejected the writ petition filed by the assessee. On appeal by special leave, the Supreme Court, while reiterating the scope of section 154, held that it was not permissible to invoke rectification under section 154 merely on the basis of a change of opinion of the CIT. The rectifiable mistake must exist and the same must be apparent from the record. It must be a patent mistake which is obvious and whose discovery is not dependent on elaborate arguments.[11] The Supreme Court also pointed out that there is no straight jacket principle of distinguishing a capital receipt from a revenue receipt and it depends upon the circumstances of each case. In case of subsidy, it would depend on the terms of each subsidy scheme.

In *Assam State Text Book Production and Publication Corporation Ltd.* v. *CIT,*[12] the Supreme Court dealt with the issue whether the assessee, a government company whose main object was to do research, printing and publishing of textbooks for school students as per the norms prescribed and approved by the education department of the state, could be termed as an "educational institution" in terms of section 10(22) of the Act and claim exemption thereunder. The assessing officer held a negative view on the matter while the appellate tribunal held that the assessee was entitled to the benefit of exemption. On appeal, the High Court held that it was not so exempt, particularly since the assessee did not solely impart education and its income during the relevant years was only from publishing and sale of text books. Reversing the decision of the High Court, the Supreme Court, referring to the decisions in *CIT* v. *Rajasthan State Text Book Board*[13] and *Secondary Board of Education* v. *ITO*,[14] held that it should be treated as educational institution for the purpose of exemption under section 10(22). It is a government company controlled by the state of Assam. The CBDT had granted similar exemption by letter dated 19.8.1975 to the Tamil Nadu text books society which performed activities similar to those of the assessee. The central government had by letter dated 9.7.1973, stated that all state controlled educational committees/boards had been constituted to implement the educational policy of the states and, consequently, they should be treated as educational institutions.

Rectification of mistakes

Section 154 of the Act empowers an income-tax authority to amend any order passed under the Act with a view to rectify any mistake apparent on

10 (1997) 228 ITR 253 (SC).
11 *Deva Metal Powders (p) Ltd.* v. *Commissioner, Trade Tax, Uttar Pradesh* (2008) (2) SCC 439.
12 (2009) 319 ITR 317 (SC).
13 (2000) 244 ITR 667 (Raj).
14 (1972) 86 ITR 408 (Orissa).

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the face of the record. The Supreme Court in *Deva Metal Powders (P) Ltd.* v. *Commissioner, Trade Tax, Uttar Pradesh*,[15] has held that a rectifiable mistake must exist and the same must be apparent from the record. It must be a patent mistake, which is obvious and whose discovery is not dependant on elaborate arguments. The Supreme Court also held in *Commissioner of Central Excise, Calcutta* v. *A.S.C.U. Ltd.*,[16] that decision on debatable point of law cannot be treated as mistake apparent from the record.

In *Mepco Industries* v. *CIT*,[17] a question arose whether it was open to the CIT to rectify his own order under section 154 of the Act on the basis of a later judgment of the Supreme Court in *Sahney Steel and Press Works Ltd.* v. *CIT*.[18] The appellant-assessee had preferred revision petitions under section 264 of the Act before the CIT claiming relief that the electricity subsidy received by it from the Government of India may be treated as capital receipt. The same was granted *vide* order dated 30.04.1997 by the CIT. However, subsequently, rectification proceedings were taken by the CIT as, according to him, there was a mistake apparent on the face of the record. In the rectification proceedings, the CIT, by placing reliance on the decision of the Supreme Court in *Sahney Steel and Press Works Ltd.* v. *CIT*,[19] held that the power tariff subsidy was given to the assessee-company after it had commenced its production and hence the subsidy received by the appellant had to be treated as revenue receipt. Writ petition as also the writ appeal thereafter before the High Court failed.

The Supreme Court, in appeal, held that examination of nature of the subsidy cannot be undertaken under section 154 of the Act. Since the rectification order was passed in view of a later judgment of the Supreme Court in *Sahney Steel and Press Works Ltd.* v. *CIT*,[20] it held that the present case was a classic illustration of change of opinion. While so holding, the court took note of earlier judgment passed by Calcutta High Court in *Jiyajeerao Cotton Mills Ltd.* v. *ITO*,[21] wherein it was held that since there was conflict of opinion on computation of profits of priority industry for granting tax relief which conflict was resolved by the Supreme Court later on for the subsequent assessment year 1967-68, such subsequent decision of the Supreme Court did not obliterate the conflict of opinion prior to it. Rectification under section 154 was not permissible on debatable issue.

III BUSINESS EXPENDITURE

Scope of the 'provision'

In *Rotork Controls India P. Ltd.* v. *CIT*[22] and analogous cases, a short

15 (2008) 2 SCC 439.
16 (2003) 1515 ELT 481.
17 *Supra* note 9.
18 *Supra* note 10.
19 *Ibid.*
20 *Ibid.*
21 (1981) 130 ITR 710 (Cal).
22 (2009) 314 ITR 62 (SC).

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but important question of law pertaining to allowing of provisions made for meeting contingent liabilities as revenue expenditure under section 37 read with section 40A of the Act had fallen for consideration. In the cases before the Supreme Court, the assessees were manufacturers of sophisticated electronic goods. The manufacturing history revealed that some of the goods sold were found to be defective and required to be replaced free of charge as per the warranty executed by the manufacturers. Accordingly, in the books of accounts maintained by the assessee, appropriate provision was made. Right from the assessment year 1983-84, claim for this allowance under the provision against warranty was allowed. For the assessment year 1991-92, the assessee claimed deduction of net provision of Rs.5,18,554 but the assessing officer disallowed the claim on the ground that it was merely a contingent liability. The decision was upheld by the CIT (Appeals) but reversed by the tribunal. The High Court, on appeal by the revenue, reversed the order of the tribunal by holding that no obligation was cast on the date of sale and, consequently, there was no accrued liability.

The Supreme Court found that the goods manufactured and sold by the assessee were sophisticated goods and statistical data indicated that every year some of these were defective. The court inferred that the warranty given to the customers was an integral part of the sale price and as such, the provisions made against warranty had to be allowed.

On an analysis of its earlier judgments,[23] the Supreme Court has held that if the historical trend indicates that a larger number of sophisticated goods were being manufactured in the past and the facts show that the defects existed in some of the items manufactured and sold, then the provision made for warranty in respect of such sophisticated goods would be entitled to deduction from the gross receipts under section 37 of the Act. So far as the permissible quantum of provision is concerned, the court has held that it can be measured only by using a substantial degree of estimation. According to the court, a provision is recognized when (a) an enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision can be recognized.

Interest on borrowed capital

Under section 36(1)(iii) of the Act, interest on borrowed capital for the purposes of business is a deductible expenditure where the assessee is dealing in shares. In *CIT* v. *Ashini Lease Finance P. Ltd.*,[24] the assessee had borrowed funds from one Torrent group for purchase of equity shares of AEC. The total investment made by the assessee was Rs.22,59,969 but after

23 *Indian Molasses Co.* v. *Commissioner of Income-Tax West Bengal* (1959) 37 ITR 66 (SC); *Metal Box Company of India* (1969) 73 ITR 53 (SC); *Bharat Earth Movers*, (2000) 245 ITR 428 (SC).

24 (2009) 309 ITR 230 (SC).

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acquiring those shares, the same were sold at Rs.63,57,925. Incidentally, the said AEC was taken over by the said Torrent group itself. Under these circumstances, the issue for consideration before the apex court was whether the assessee was entitled to deduct the interest on the borrowed funds under section 36(1)(iii) of the Act as interest on moneys borrowed for the purpose of business. Though the assessing officer disallowed the interest, the same was deleted on appeal by the CIT (Appeals) which stood affirmed by the tribunal. The High Court declined to interfere on the ground that no substantial question of law arose.

The Supreme Court noted that the record indicated, *prima facie*, that the assessee-company had acquired the shares of AEC through finances arranged mainly from the Torrent group (sister companies) along with two other companies only to enable the Torrent group to acquire and take over the business of AEC. It further observed that the High Court lost sight of certain facts which, if proved and established, would indicate circular trading entered into solely with the idea of evading tax. The apex court, therefore, held that the High Court was not justified in holding that the tribunal in allowing the deduction had taken a decision on facts and that there was no substantial question of law for determination by the High Court. The matter was remanded to the High Court for a decision in accordance with law.

Permissibility of deduction

Section 43B (a) of the Act, as stood on 1.4.1989, *inter alia* provided that any sum payable by the assessee by way of "tax, duty, cess or fee, by whatever name called, under any law for the time being in force" shall be allowed in the previous year in which such sum is actually paid by the assessee notwithstanding the accrual of higher liability in respect of the same in such previous year.

In *CIT* v. *McDowell and Co. Ltd. (No.1)*,[25] the assessee, during the assessment year 1988-89, had sold India-made foreign liquor (IMFL). In respect of such sales, he had made provisions for excise duty on wastage of liquor in transit. The assessee debited the customers' account for the said sum and credited to the unpaid amount on the bottling fee account. A bank guarantee had been furnished by the assessee in respect of that amount. The question was whether the department could apply the provisions of section 43B of the Act and add that amount to the income of the assessee. On a reference, the High Court held that on facts, section 43B had no application. The appeal filed by the department was negatived by the Supreme Court affirming the view of the High Court and addressed three aspects arising out of the disputes, namely (i) whether the bottling fee paid to the excise department fell within the category of levies enumerated under clause (a) of section 43B; (ii) whether furnishing of bank guarantee can be equated

25 (2009) 314 ITR 167 (SC).

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with actual payment; and, (iii) the concept of "tax" under the constitutional scheme.

Relying upon its earlier judgments,[26] the Supreme Court held that under the excise laws, the "licence fee" or "fixed fee" relating to potable liquors/ intoxicant means the price or consideration which the government charges to the licences. There is no fundamental right in doing trade in intoxicants. It is a consideration for acquiring the exclusive privilege granted to the licensee. As such, it is neither fee nor tax.

It was further held that the furnishing of bank guarantee cannot be equated with actual payment which requires that money must flow from the assessee to the public exchequer as required under section 43B. The "bank guarantee" is only a guarantee for payment on some happening and that cannot be taken as "actual payment" as required under section 43B of the Act for allowing deduction in computation of income. The apex court further explained that the "tax", "duty", "cess" or "fee" constituting a class denotes to various kind of impost depending on the purpose for which they are levied. This power can be exercised in any of its manifestation only under law authorizing levy and collection of tax as envisaged under article 265 which uses the only expression that no "tax" shall be levied and collected except authorized by law. The law laid down in this case has been followed by the Supreme Court.[27]

Loss on account of foreign exchange fluctuations

In *CIT* v. *Woodward Governor India P. Ltd.*,[28] the Supreme Court, affirming the decision of the High Court, held that where the assessee was following the mercantile system of accounting, the additional liability arising on account of fluctuation in the rate of foreign exchange in respect of loans taken for revenue purposes on the date of balance sheet was an item of expenditure under section 37(1) of the Act. In such cases, the assessee would be entitled to deduction for income tax purposes. The Supreme Court rejected the contention of the department that the word "depreciation" in section 37(1) connotes "what is paid out" and that which has gone irretrievably. It further held that the quantum of deduction permitted under various heads under sections 30 to 43C from the income, profits and gains of a business would differ according to the system of accounting adopted by the assessee which can be either cash basis or mercantile system. Under the mercantile system of accounting, what is due is brought into credit

26 See *State of Bombay* v. *F.N.Balsara*, AIR 1951 SC 318; *Harshankar* v. *Deputy Excise and Taxation Commissioner,* AIR 1975 SC 1121; and *State of U.P.* v. *Shivpath Rai*, AIR 1994 SC 813.

27 See *CIT* v. *McDowell and Co. Ltd. (No. 2)* (2009) 314 ITR 174 (SC); *CIT* v. *McDowell and Co. Ltd. (No. 3)* (2009) 314 ITR 177 (SC); *CIT* v. *McDowell and Co. Ltd. (No. 4)* (2009) 314 ITR 180 (SC); *CIT* v. *McDowell and Co. Ltd. (No. 5)* (2009) 314 ITR 185 (SC); *CIT* v. *Udaipur Distillery Co. Ltd.* (2009) 314 ITR 188 (SC).

28 (2009) 312 ITR 254 (SC).

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before it is actually received; it brings into debit an expenditure for which a legal liability has been incurred before it is actually dispersed. Therefore, the expression "expenditure" as used in section 37 may, where mercantile system of accounting was followed, cover an amount which is really a loss even though the said amount has not gone out from the pocket of the assessee. While arriving at the above conclusion, the Supreme Court also referred to AS-11 (Accounting Standard – 11) which deals with effect of foreign exchange fluctuations. Para 9 of AS-11 states that exchange differences arising on foreign currency transactions of revenue nature have to be recognized as income or expenditure in the period in which they arise. Para 7(a) states that on each balance-sheet date monetary items, denominated in a foreign currency should be reported using the closing rate.

Another issue decided by the apex court in this case related to adjustment of actual cost of imported asset acquired in foreign currency on account of fluctuation in the rate of exchange at each balance-sheet date, pending actual payment of the varied liability under section 43A of the Act, as it existed prior to its amendment *vide* the Finance Act, 2002. It was held that the unamended section 43A required adjustment to be made to the cost of fixed assets with reference to the prevailing exchange rate as at the end of the accounting year irrespective of whether the payment for the asset was made or not. It was held that the amendment to section 43A with effect from 1.4.2003 was amendatory and not clarificatory and would have application only from financial year 2003-04, ruling out the stand of the department that the same was clarificatory and will have retrospective effect. It is to be noted that under the pre-amended section 43A, any fall or increase in rate of exchange will have an impact on the capital cost of the asset, ultimately effecting the cost of asset for the purposes of depreciation. Any increase in cost of asset would result in allowability of higher depreciation for the year.

IV DEDUCTION OF TAX AT SOURCE

Usance interest

In *Vijay Ship Breaking Corporation* v. *CIT*,[29] the question for consideration was whether the assessee was bound to deduct TDS under section 195(1) of the Act in respect of usance interest paid for purchase of vessel for ship breaking. The Supreme Court, while relying upon the e*xplanation* (2)[30] to section 10(15)(iv)(c), which was added by an amendment to the Act on 18.9.2003 with retrospective effect from 1.4.1983, held that usance interest had been exempted from payment of

29 (2009) 314 ITR 309 (SC).

30 *Explanation 2*.- For the removal of doubts, it is hereby declared that the usance interest payable outside India by an undertaking engaged in the business of ship-breaking in respect of purchase of a ship from outside India shall be deemed to be the interest payable on a debt incurred in a foreign country in respect of the purchase outside India."

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income tax, if paid, in respect of ship breaking activity. Though the amendment had come into force after the pronouncement of the High Court judgment, it did apply to the facts of the case because of the retrospectivity attached to e*xplanation* (2).

Payments made abroad

The purpose of the provisions for deduction of tax at source (TDS) in chapter XVII-B of the Act is to see that from the sum which is chargeable under section 4 for the levy and collection of income tax, the payer should deduct the tax thereon at the rates in force, if the amount is to be paid to a non-resident. In *CIT* v. *Eli Lilly and Co. (India) P. Ltd.*,[31] the question was whether the TDS provisions in chapter XVII-B were applicable to payments/ remuneration made abroad in foreign currency by a foreign company/head office to its employees against services rendered by such employees in India.

The assessee was a joint venture company between a Netherland and an Indian company (the assessee) engaged in manufacturing and selling pharmaceutical products in India. The foreign partner had appointed four expatriates to the assessee in India. The assessee paid only part of the total remuneration and rest was paid by the foreign company though the total remuneration was only on account of services rendered in India. No work was performed by the expatriates for the foreign company. In such circumstances, since the assessee failed to deduct TDS on such part of remuneration which was paid by the foreign partner abroad, the assessing officer treated the assessee as a defaulter and levied interest under section 201(1A). The appellate tribunal and the High Court, however, held that the assessee was not under a statutory obligation to deduct tax at source on the home salary paid by the foreign partner under section 192 as it was not paid in India.

In appeal, the Supreme Court, while reversing the judgment of the High Court, held that the payment of home salary abroad by the foreign company to the employees had a connection with their rendition of services in India and, therefore, such payment constituted income which was deemed to accrue or arise to the recipient in India earned in India. Therefore, the assessee was under an obligation to deduct tax at source even on the remuneration paid to the expatriates by the foreign company abroad. The apex court further held that the Act is an integrated code in which one cannot segregate the computation machinery from the collection and recovery machinery.

V DEPRECIATION

Meaning of "actually allowed"

Deductions by way of depreciation allowance have been specifically

31 (2009) 312 ITR 225 (SC).

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recognized and dealt with in sections 32, 34 and 43(6) of the Act. Section 32 prescribes two methods for computation of depreciation. As per section 32(1)(i), in the case of ocean-going ships, depreciation is allowed year after year at the fixed percentage of the original cost of the asset. This is called "straight line" method. In the case of non-ocean going ships, buildings, machinery, plant and furniture, clause (ii) of section 32(1) provides that the prescribed percentage of depreciation is to be computed on the basis of "written down value" of the asset. This is known as the "written down value" method. The definition of "written down value" is to be found in section 43(6) of the Act which is to the following effect:

> In the case of assets acquired in the previous year, the actual cost to the assessee,
>
> In the case of assets acquired before the previous year, the actual cost to the assessee less all depreciations(s) actually allowed under the Act.

In *CIT* v. *Doom Doma India Ltd.*,[32] the Supreme Court was required to construe the meaning of the words 'actually allowed' in the context of section 43(6)(b) of the Act. In the case of *Madeva Upendra Sinai* v. *Union of India*,[33] the Supreme Court had earlier held that the words 'actually allowed' in section 43(6) (b) would mean the amount of depreciation actually taken into account or granted and given effect to, *i.e.* debited by the income tax officer against the incomes of the business in computing the taxable income of the assessee. In *Doom Doma India Ltd.,* the assessee was engaged in the business of growing and manufacturing of tea. As per the provision of section 10(1) of the Act read with rule 8 of the Income Tax Rules, 1962, only 40 per cent of the business income derived from sale of tea grown and manufactured in India by the assessee was liable to income tax under the Act. It was accordingly held that in such cases, only proportionate depreciation is required to be taken into account because that could be the only depreciation which can be said to be "actually allowed."

Balancing charge

The interplay of sub-sections (1) and (2) of section 41 of the Act in the context of "balancing charge" was the subject matter of interpretation before the Supreme Court in *Nectar Beverages P. Ltd.* v. *Deputy CIT*.[34] In the lead matter, the assessee who was manufacturer of soft drinks, purchased bottles and crates, the cost of each item of which was less than Rs.5,000/-, and therefore, as provided under the *proviso* to section 32(1)(ii) of the Act, 100 per cent depreciation was allowed on the cost of such

32 (2009) 310 ITR 392 (SC).
33 (1975) 98 ITR 209 (SC).
34 (2009) 314 ITR 314 (SC).

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bottles/crates. When the bottles and crates got worn out, those were sold by the assessee and proceeds thereon were shown as "miscellaneous income" in the subsequent year. Though during the year under consideration, section 41(2) which *inter alia* dealt with profit of sale on depreciable assets (that is balancing charge) stood deleted, the department sought to tax Rs.50,850/- on the plea that sale proceeds in question can still be treated as business income of the assessee under section 41(1) of the Act.

Prior to 1.4.1988, each of sub-sections (1) to (4) of section 41 of the Act dealt with a different and distinct circumstance. Sub-section (1) dealt with recoupment of trading liability, sub-section (2) dealt with balancing charge, sub-section (3) specifically dealt with balancing charge in respect of assets relating to scientific research and sub-section (4) dealt with recovery of bad debts. Therefore, one cannot read recoupment under one sub-section into another. Prior to 1.4.1988, both sub-section (1) and sub-section (2) of section 41 existed in the statute book. Section 41(2) specifically brought to tax the balancing charge as a deemed income under the Act. The necessity to keep section 41(2) as a provision in addition to section 41(1) arose from the fact that in its very nature depreciation is neither a loss, nor an expenditure, nor a trading liability referred to in section 41(1).

On the above factual and legal premise, the Supreme Court has held that for the assessment years 1990-91 to 1998-99 (when section 41(2) stood deleted) in relation to an item of any depreciable asset which did not exceed Rs. 5,000 in cost for which 100 per cent depreciation had been allowed under section 32(1)(ii), the department is not entitled to tax the sale proceeds of that asset as business income under section 41(1).

VI HIGH COURT – APPEAL UNDER SECTION 260A – FRAMING OF SUBSTANTIAL QUESTION OF LAW

Section 260A of the Income-Tax Act, as inserted by Finance (No. 2) Act, 1998, reads as under:

> 260A. Appeal to High Court.- (1) An appeal shall lie to the High Court from every order passed in appeal by the Appellate Tribunal, if the High Court, is satisfied that the case involves a substantial question of law.

In *Shreyans Industries Ltd.* v. *CIT*,[35] the assessee, which ran a paper mill, applied to the pollution control board and the forest department to allow it to discharge its effluent from its mill to the village tallewal drain. The forest department agreed to provide land for an open drain to be constructed by the assessee for carrying its effluent to tallewal subject to

35 (2009) 314 ITR 302 (SC).

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certain conditions. One of the conditions was that the assessee would transfer 4.063 hectares of non-forest land in favour of the forest department. The question was whether the sum of Rs.70,79,862/- incurred by the assessee on the construction of open drain of about 14 kilometers for disposal of its effluents would be revenue expenditure. According to the department, it was capital expenditure but on appeal, the commissioner (Appeals) as also the appellate tribunal held that the expenditure was incurred on revenue account. The High Court, on appeal under section 260A, reversed the concurrent finding of the commissioner (Appeals) and tribunal without framing any substantial question of law.

On appeal preferred by the assessee, the Supreme Court set aside the judgment of the High Court holding that framing of a proper substantial question of law was a mandatory requirement under section 260A of the Act. It observed that the provisions of section 260A were very similar to section 100, CPC, 1908. It held that without framing or reframing of such a question, the High Court could not have reversed the concurrent finding given by the commissioner of income-tax (Appeals) as well as by the tribunal.

VII INTEREST UNDER SECTION 234A

A short but important question of law concerning every tax payer under the Act has been answered by the Supreme Court in *CIT* v. *Pranoy Roy*.[36] In this case, the assessee was required to file his return of income for the assessment year 1995-96 by 31.10.1995. But it was filed on 29.9.1996, *i.e.* after a delay of about 11 months. However, the due tax was paid on 25.9.1995, *i.e.* before date due for filing the return. Though the returned income was accepted while making assessment, interest was charged under section 234A of the Act on the ground that the tax paid could not be reduced from the tax due on assessment. The order was challenged before the High Court by a writ jurisdiction which was allowed.[37] On appeal by the revenue, the Supreme Court held that where the tax due had already been paid which was not less than the tax payable on the accepted returned income, the question of levy of interest did not arise. The judgment of the High Court was thus upheld.

VIII INTERPRETATION OF STATUTES – RETROSPECTIVE OPERATION

Prior to the Finance Act, 2003, the second proviso to section 43B of the Act restricted the deduction in respect of any sum payable by an employer by way of contribution to provide fund/superannuation fund or any

36 (2009) 309 ITR 231 (SC).
37 See *Dr. Pranoy Roy* v. *CIT* (2002) 254 ITR 775 (Del).

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other fund for the welfare of employees, unless it stood paid within the specified due date. According to the second proviso, the payment made by the employer towards contribution to provident fund or any other welfare fund was allowable as deduction, if paid before the date for filing the return of income and necessary evidence of such payment was enclosed with the return of income. In other words, if contribution stood paid after the date for filing of the return, it was not allowed. In view of the hardship faced by the employers, the government introduced the Finance Act, 2003 by which the second proviso was deleted with effect from 1.4.2004.

The question which arose for consideration before the Supreme Court in *CIT* v. *Alom Extrusions Ltd.*,[38] was whether the omission (deletion) of the aforesaid second proviso by the Finance Act, 2003 operated with effect from 4.1.2004 or operated retrospectively with effect from 4.1.1988. The Supreme Court held that the amendment was curative in nature and hence, it would apply retrospectively with effect from 4.1.1988. Reliance was placed on an earlier decision in *Allied Motors P. Ltd.* v. *CIT*,[39] wherein it was held that when a proviso was inserted to remedy unintended consequences and to make the section workable, a proviso which supplies an obvious omission in the section and which proviso was required to be read into the section to give the section a reasonable interpretation, it could be read as retrospective in operation, particularly to give effect to the section as a whole.[40] Before concluding, the apex court took note of the following observations made in *CIT* v. *J.H. Gotla*:[41]

> … we should find out the intention from the language used by the Legislature and if strict literal construction leads to an absurd result, i.e., a result not intended to be subserved by the object of the legislation found in the manner indicated before, then if another construction is possible apart from the strict literal construction, then that construction should be preferred to the strict literal construction. Though equity and taxation are often strangers, attempts should be made that these do not remain always so and if a construction results in equity rather than in injustice, then such construction should be preferred to the literal construction.

IX LEAVE TRAVEL CONCESSIONS

In *CIT* v. *Larsen and Toubro Ltd.*,[42] the Supreme Court held that an employer was not under any statutory obligation under the Act to collect

38 (2009) 319 ITR 306 (SC).
39 (1997) 224 ITR 677 (SC).
40 It was held in *Allied Motors P. Ltd.* (*ibid*) that the first proviso to sec. 43B of the Act was curative in nature and hence, retrospective in operation with effect from April 1, 1988.
41 (1985) 156 ITR 323 (SC).
42 (2009) 313 ITR 1 (SC).

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evidence to show that the employee had actually utilized the amount paid towards leave travel concession or the conveyance allowance under section 10(5) of the Act. It noted that the beneficiary of exemption under section 10(5) was an individual employee. There was no circular of the central board for direct taxes requiring the employer to collect and examine the supporting evidence to the declaration to be submitted by an employee.

X PENALTY UNDER SECTION 271(1)(C)

The issue which arose for consideration before the Supreme Court in *CIT* v. *R.M.P. Plasto P. Ltd.*[43] was whether penalty can be levied under section 271(1)(c) of the Act on the ground that there was loss assessed in the year under consideration in view of the fact that there was positive income which was reduced to nil only after allowing set off of carried forward losses of earlier years. The Gujarat High Court had held that penalty was not leviable. In an appeal by the department, the Supreme Court, relying upon its larger bench decision in *CIT* v. *Gold Coin Health Food P. Ltd.*,[44] allowed the appeal and held that where in the year under consideration, there was positive income of the assessee and the loss was reduced to nil only after set-off of carried forward losses of earlier years, penalty for concealment of income can be imposed under section 271(1)(c) of the Act.

XI SPEAKING ORDER

In *Speed Lines Pvt Ltd.* v. *CIT*,[45] the assessee had filed a petition for special leave to the Supreme Court against the order of the Delhi High Court which had dismissed the appeal filed by the assessee under section 260A of the Act. The Supreme Court granted leave and remanded the matter for fresh consideration solely on the ground that the order of the High Court was non-speaking. There is no doubt that it is incumbent upon the judicial or quasi-judicial courts/tribunals to pass speaking orders containing reasons. The question of larger interest and consequence still remains as to whether the High Courts, while disposing of the matters coming before them at the stage of preliminary hearing or admission, should pass reasoned orders which would necessarily consume a considerable judicial time. Even if such a requirement may be considered to be imperative, should the orders contain detailed reasons or the requirement of procedure can be said to be satisfied if some minimal reasons are assigned in support of the order. This becomes more important since in second appeals filed before the High Court under section 100 of the CPC or some other special statutes, the

43 (2009) 313 ITR 397 (SC).
44 (2008) 304 ITR 308 (SC).
45 (2009) 316 ITR 102 (SC).

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High Courts have been empowered to entertain appeals only on the question of law. Necessarily, law has to be the same in respect of all such statutory appeals. The High Courts are already overburdened with cases. Therefore, a proper balance has to be struck between reasonably fair orders and elaborate orders with reasons. The matrix for weighing the quantum of reasons cannot be the same for statutory tribunals, subordinate courts and the High Courts.

XII SPECIAL DEDUCTION – SECTIONS 80HH, 80HHC, 80I AND 81B

Chapter VIA of the Act provides for deductions to be made in computing total income. It contains section 80A providing deductions under various situations and subject to varying conditions. The object underlying sections 80HH (1) contained chapter VIA of the Act is to encourage setting up of new industrial undertakings in the backward areas. This section stipulates that where gross total income of an assessee includes any profits and gains derived from an industrial undertaking to which the section applies, then there shall be allowed in computing the total income of the assessee a deduction from such profits and gains of an amount equal to 20 per cent thereof. Under sub-section (2) of section 80HH, certain conditions are required to be satisfied before an industrial undertaking can claim the benefit of deduction under section 80HH(1).

In *CIT* v. *R. Pratap*,[46] the assessee, which was a processor of cashew kernels, had outsourced some of the activities to its sister concerns. The assessee did not given any particulars regarding the activity undertaken by it, the activity outsourced by it to sister concerns and whether those concerns were located in or outside backward areas. The appellate tribunal and the High Court held that the assessee was entitled to the allowance under section 80HH of the Act. In appeal preferred by the department, the Supreme Court noted that there wass complete absence of details regarding the process undertaken by the assessee and its sister concerns. In this view of the matter, the court held that the assessee was not entitled to the deduction under section 80HH.

In *Janatha Cashew Exporting Co.* v. *CIT*,[47] the assessee claimed relief under section 80HHC on both direct exports and exports made through export houses. The assessing officer excluded the sales to export houses from the export turnover. Having lost before the CIT (Appeal), the assessee went to the tribunal. The tribunal remanded the matter to the assessing officer for considering whether the assessee would be eligible for relief as a supporting manufacturer on the basis of disclaimer certificate issued by the export houses as provided under section 80HHC(3) of the Act. The

46 (2009) 310 ITR 405 (SC).
47 (2009) 309 ITR 440 (SC).

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decision of the tribunal was, however, set aside by the High Court which took the view that since section 80HHC(1) read with section 80HHC(3) provided for computation and deduction of profit on direct exports only, the assessee was not entitled to claim deduction in respect of export-sales made through export houses. On appeal, the Supreme Court set aside the judgment of the High Court and remanded the matter to the assessing officer by holding that under section 80HHC(3), if the assessee was a supporting manufacturer, then, on his producing disclaimer certificate from the export house, the assessee became entitled to the deduction claimed.

The law laid down by the Supreme Court is apparent on the face of the statutory provisions, but still the High Court failed to notice the same leading to avoidable litigation resulting in wasteful expenses and burdening the docket of the Supreme Court.

In *CIT* v. *B. Suresh*,[48] the question for consideration before the Supreme Court was whether the foreign exchange earned by transferring right of exploitation of films outside India by way of lease was admissible for deduction under section 80HHC. The department had denied such deduction on the ground that there was neither any "sale" nor was film rights "goods/ merchandise." The tribunal, however, held that the assessee was entitled to such deduction. This was upheld by the High Court. In an appeal preferred by the department, the Supreme Court observed that the basic requirement of section 80HHC was earning in foreign exchange and retention of profits for export business. Noting that the difference between sale and service was getting blurred with globalization and cross-border transaction, it observed that one has to change the thinking regarding concepts like 'goods', 'merchandise' and 'articles'. The assessee had bought rights of various decoders and had recorded movies on beta-cam tapes which were transferred as telecasting rights to Star T.V. for five years (it has a limited life). In these circumstances, it was held that such "rights" fell in the category of articles of trade and commerce, hence, merchandise. As to whether the transfer of said rights by way of lease would attract section 80HHC, the apex court held that under rules 9A and 9B, the word "lease" was included in the meaning of the word "sale."

The aforesaid decision highlights the importance of creative interpretation of the statutes. The Supreme Court in *Suresh Jindal* v. *BSES Rajdhani Power Ltd.*[49] had held that creative interpretation demands that with the advancement of science and technology, the court should read the provisions of a statute in such a manner so as to give effect thereto.

As already stated above, sub-section (1) of section 80HH, *inter alia,* provides that where the gross total income of an assessee includes any profits and gains derived from an industrial undertaking to which the section applies, a deduction shall be allowed in computing the total income of the

48 (2009) 313 ITR 149 (SC).
49 (2008) 1 SCC 341, para 45.

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assessee for such profits and gains of an amount equal to twenty per cent thereof. However, section 80HH(2) sets out conditions for grant of such deduction, namely that the industrial undertaking must be involved in the activity of "manufacturing or producing articles". The interpretation of the word "production" was in issue before the Supreme Court in *Vijay Ship Breaking Corporation* v. *CIT*[50] and *India Cine Agencies* v. *CIT*.[51]

In *India Cine Agencies,*[52] the assessee was engaged in conversion of jumbo roles of photographic films into small flats and roles in the desired sizes. The assessee's contention was that the same amounted to manufacture/production, as the case may be, entitling the assessee to special deduction, which was not acceptable to the revenue. Similarly, in *Vijay Ship Breaking Corporation,*[53] the assessee was engaged in ship breaking activity. A question arose whether such an activity resulting in various articles amounted to production of such articles for the purposes of special deduction. The Gujarat High Court had negatived the contention of the assessee thereby declining the deduction.

In both the above cases, the Supreme Court, relying on its earlier judgments[54] and referring to dictionaries[55] and law *lexicons*[56] for ascertaining the meaning of the word "production", held that the activities carried out by them amounted to "production" and, therefore, special deduction was admissible. The court also held that the word "production" had a wider connotation than the word "manufacture". While every manufacture can be categorized as production, every production may not amount to manufacture. The court accepted the assessee's stand that the goods produced of need not necessarily be a new product in the commercial sense. It added that the legislature had disjunctively used the two words of qualification "manufacture or production". Therefore, the word "production" cannot derive its colour from the word "manufacture". Even otherwise, the word "produce" was defined as something which was brought forth or yielded either naturally or as a result of effort and word. The court noted with emphasis that the word "new" was not used in the definition of the word "produce". It may be noted here that in *Webster's New International Dictionary*, the word "produce" means "something that is brought forth either naturally or as a result of effort and work; a result produced". Similarly, according to *Black's Law Dictionary*, the meaning of the word "produce" is to "bring into view or notice; to bring to surface."

50 (2009) 314 ITR 309 (SC).
51 (2009) 308 ITR 98 (SC).
52 *Ibid*.
53 *Supra* note 50.
54 *CIT* v. *Budharaja & Co.* (1993) 204 ITR 412 (SC); *CIT* v. *Sesagoa Ltd.* (2004) 271 ITR 331 (SC).
55 *Black's Law Dictionary*, 5th ed.; *Webster's New International Dictionary*.
56 R.P. Sethi, *Words and Phrases*, 2nd ed.; P. Ramanatha Iyer, *Advanced Law Lexicon*.

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In *Liberty India* v. *CIT*,[57] an important question of law came for the consideration of the apex court was whether profit from the Duty Entitlement Passbook Scheme (DEPB) and the Duty Drawback Scheme could be said to be profit derived from the business of the industrial undertaking eligible for deduction under section 80-IB of the Income Tax Act, 1961?" In this case, the appellant owned a small scale industrial undertaking engaged in manufacturing of fabrics out of yarns and also various textiles items such as cushion covers, pillow covers, *etc.* out of fabrics/yarn purchased from the market. During the relevant assessment year 2001-02, the appellant claimed deduction under section 80-IB of the Act on the increased profit of Rs.22,70,056/- as the profit of the industrial undertaking on account of DEPB and duty drawback credited to the profit and loss account. The assessing office denied deduction under section 80-IB on the ground that the said two benefits constituted export incentives and that they did not represent profits derived from industrial undertaking. The order of the assessing office was reversed by the CIT (Appeals) who took the view that the assessee was entitled to a deduction under section 80-IB on the ground that duty drawback received by the appellant was inextricably linked to the production costs of the goods manufactured by the assessee. On appeal by the revenue, the tribunal, by placing reliance on the judgment of the Delhi High Court, in *CIT* v. *Ritesh Industries Limited*,[58] held that the amount in question received by the assessee was not an income derived from the business of industrial undertaking so as to entitle the assessee to deduction under section 80-IB. The appeal filed before the High Court also failed.

The Supreme Court, on a detailed examination of the special deductions envisaged under sections 80-AB, 80-I, 80-IA and 80-IB, has held that chapter VI-A of the Act which provides for incentives in the form of tax deductions essentially belong to the category of "profit linked incentives." It was further held that sections 80-IB/80-IA, contained in chapter VI-A, were a code by themselves as they contained both substantive as well as procedural provisions. According to Supreme Court, DEPB/Duty drawback were incentives which flow from the schemes framed by the central government under section 75 of the Customs Act, 1962. Incentive profits were not profits derived from business of the industrial undertaking. Rather, they belonged to the category of ancillary profits of such undertaking. Profits derived by way of incentives such as DEPB/Duty drawback did not fall within the expression "profits derived from industrial undertaking" under section 80-IB of the Act.

57 (2009) 317 ITR 218 (SC).
58 (2005) 274 ITR 324 (Del).

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The Supreme Court affirmed the decisions of the Punjab and Haryana High Court in *Liberty India* v. *CIT*[59] and *CIT* v. *Lakhwinder Singh*,[60] as also of the Delhi High Court in *CIT* v. *Ritesh Industries* and of the Madras High Court in *Shakti Footwear* v. *CIT (No.2)*.[61]

XIII POWER OF TRIBUNAL UNDER SECTION 254

The power of the tribunal to take back the benefit conferred by the assessing office or to enhance the assessment came for consideration before the Supreme Court in *Mcorp Global P. Ltd.* v. *CIT*.[62] In this case, the assessee bought 5,46,000 soft drink bottles directly from the manufacturer and then leased them to Coolade, a manufacturer of beverages under a lease dated 15.02.1991. It then claimed depreciation on the said bottles to the tune of Rs.18,04,572/-. The assessing officer, finding that only 42,000 bottles were actually received by Coolade till 31.3.1991, restricted the depreciation only to such number and disallowed the rest. In appeal, CIT (Appeals) remanded the matter to the assessing officer after formulating the "user test." On remand, the assessing officer found that all 5,46,000 bottles stood paid for before 31.3.1991 and therefore, allowed 100 per cent depreciation. Meanwhile, the remand order of CIT (Appeals) was challenged before the tribunal which held that since the lease was not renewed and the bottles were not returned on expiry, the transaction in question was only a financial arrangement and not a lease and disallowed the depreciation. The High Court affirmed the decision of the tribunal.

On appeal, the Supreme Court, while relying upon *Hukumchand Mills Ltd.* v. *CIT*,[63] held that under section 254(1), the tribunal had no power to take back the benefit conferred by the assessing officer or enhance the assessment. Since the assessing officer had granted depreciation in respect of 42,000 bottles that benefit could not be withdrawn. The court observed that if depreciation was to be granted for 42,000 bottles under the transaction dated 15.2.1991, it cannot be said that 42,000 bottles came within the lease dated 15.2.1991 and the balance came within the so-called financial arrangement. It was further noted that the assessing officer, on remand, had concluded that the assessee was entitled to depreciation on the entire bottles and this finding, having not been challenged, had attained finality. The court, therefore, held that the assessee was entitled to depreciation of Rs.18,04,572/-.

59 (2007) 293 ITR 520.
60 (2009) 317 ITR 209.
61 (2009) 317 ITR 199.
62 (2009) 309 ITR 434 (SC).
63 (1967) 63 ITR 232 (SC).