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INCOME TAX

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I INTRODUCTION

DURING THE year 2010, a large number of cases pertaining to income tax were decided by the Supreme Court and various High Courts in the country. Some of the significant decisions of the Supreme Court have been dealt with in the current survey. The subject dealt with in the present survey include the subject of revenue *v.* capital receipt; dividend stripping transactions-interpretation and reconciliation [section 14A read with section 94(7)]; penalty [section 271(1)(c)]; appeal to appellate tribunal [section 253]; loss on account of foreign exchange fluctuation [section 37(1)]; write off of bad debts [section 36(1)(vii)]; deduction of provisions for NPA as per RBI norms in case of NBFC's; MAT companies providing for depreciation as per IT rules in computing book profits [section 115j]; setting off MAT credit before computing advance tax short fall and liability for interest [section 234b and 234c]; deduction [section 80p for interest on investment of surplus funds]; notice [section 143(2) mandatory for block assessment]; copying software onto blank disc, "manufacture" for the purposes of section 80IA; reopening of assessment [section 147]; deduction in respect of profits retained for export business in relation to MAT company [section 80HHC(1B)]; capital gains-computation-right to subscribe shares arises only when offer is made by the company; is stock exchange membership card an intangible asset eligible for depreciation; settlement of cases; is interconnect charges paid by cellular companies constitute fee for technical service liable to TDS [section 194J]; appeal to High Court; capitalization of roll over charges [section 43A]; offences by companies; treatment of advance against depreciation (AAD) in computation of "book profits" [under section 115JB]; income received in kind, at a place where goods delivered-applicability of section 5(2); was territorial nexus necessary for the chargeability of fee for technical services in India even after the insertion of the *Explanation* to section 9 by the Finance Act, 2010; was the assessee not entitled to consider whether the payment was

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chargeable to tax in the hands of the non-resident or not and had to deduct tax under section 195 on all payments, *etc.*

II CAPITAL V. REVENUE RECEIPT

In *CIT* v. *M/s. Saurashtra Cement Limited*[1], the issue pertained to the assessment year 1974-75. The assessee, engaged in the manufacture of cement, *etc*. entered into an agreement with a company for the purchase of additional cement plant from them. As per the terms of contract, the consideration was to be paid by the assessee in four installments. In the event of delay in the delivery of the machinery, the assessee was to be compensated by way of liquidated damages by the supplier, without proof of actual loss. The supplier failed to supply the plant by the scheduled time and, therefore, the assessee received liquidated damages. A question arose whether the amount received by the assessee as damages was a capital or a revenue receipt. The AO rejected the claim of the assessee that the amount was a capital receipt, and treated the same as a revenue receipt. The CIT (A) agreed with the AO. The tribunal, however, came to the conclusion that the amount in question could not be treated as a revenue receipt. According to the tribunal, the payment of liquidated damages by the supplier was intimately linked with the supply of machinery, *i.e.* a fixed asset, and was, therefore, connected with the profit making apparatus of the assessee. It was not a receipt in the course of profit earning process and, therefore, could not be treated as a revenue receipt. The tribunal also observed that the said receipt had no connection with the profit or loss because the very source of income, *viz*. the machinery, was yet to be installed. Accordingly, the tribunal allowed the appeal. At the instance of the revenue, the tribunal referred the questions of law for the opinion of the High Court. The reference was answered against the revenue and in favour of the assessee. Before the Supreme Court, the question for consideration was whether the liquidated damages received by the assessee from the supplier of the plant on account of delay in the supply, was a capital or a revenue receipt.

The Supreme Court dismissing the appeal of the revenue considered the matter in the light of its earlier judgments[2] and held that the compensation paid for delay in the procurement of the capital asset amounted to sterilization of the capital asset as the supplier had failed to supply the plant within the time stipulated in the agreement. The amount received by the assessee towards compensation for sterilization of the profit earning source, and not in the ordinary course of business, was a capital receipt in the hands of the assessee.

1 (2010) 325 ITR 422 (SC) : 2010-TIOL-49-SC-IT.

2 *Commissioner of Income Tax* v. *Rai Bahadur Jairam Valji* (1959) 35 ITR 148 (SC) and *Kettlewell Bullen and Co. Ltd.* v. *Commissioner of Income-Tax,* AIR 1965 SC 65.

III DIVIDEND SRIPPING TRANSACTIONS – APPLICABILITY OF SECTION 14A - RECONCILIATION OF S. 14A WITH S. 94(7)

In *Commissioner of Income Tax* v. *M/s. Walfort Share & Stock Brokers Pvt. Ltd.*,[3] in respect of assessment year 2000-01, the assessee bought units of a mutual fund on 24.3.2000 (the record date) for Rs. 17.23 each and immediately became entitled to receive dividend of Rs. 4 per unit. After the dividend payout, the NAV of the unit fell by Rs. 4 to Rs. 13.23. The assessee redeemed the units on 27.3.2000 at Rs. 13.23 per unit and *claimed a loss of Rs. 4. The dividend of Rs. 4 was claimed as exempt under section 10(33)*. The AO & CIT (A) rejected the claim of loss on the ground that the loss was "artificial" and could not be allowed. On appeal by the assessee, a five member special bench of the tribunal upheld the claim and this was confirmed by the Bombay High Court. On appeal to the Supreme Court, dismissing the appeal, held:

(i) The argument of the department that the loss (the difference between the purchase and sale price of the units) constitutes "expenditure incurred" for earning tax-free income and was liable to be disallowed under section 14A was not acceptable. The difference arose as a result of the dividend payout. The said "pay-out" was not "expenditure" to fall within section 14A. For attracting section 14A, there has to be a proximate cause for disallowance, which was its relationship with the tax exempt income, which was absent in the present case.

(ii) The argument of the department that the transaction was entered into in a pre-meditated manner and that the loss was not genuine was not acceptable because the transaction was a "sale", the sale-price and dividend were received by the assessee. The assessee made use of the provisions of section 10(33), which cannot be called an "abuse of law". Even assuming that the transaction was pre-planned, there was nothing to impeach the genuineness of the transaction. With regard to *McDowell & Co. Ltd.* v. *Commercial Tax Officer*,[4] in the later decision in *Union of India* v. *Azadi Bachao Andolan*,[5] it had been held that a citizen was free to carry on its business within the four corners of the law. *Mere tax planning, without any motive to evade taxes through colourable devices, was not frowned upon even in McDowell & Co.* Accordingly, the losses pertaining to exempted income cannot be disallowed prior to section 94(7).

3 (2010) 326 ITR 1 (SC).
4 (1985) 154 ITR 148 (SC).
5 (2003) 263 ITR 706 (SC).

(iii) Section 94(7) was inserted w.e.f. 1.4.2002 to curb the claim of such loss. However, the effect of section 94(7) was that only losses to extent of dividend have to be ignored by the AO and not the entire loss. Losses over and above the dividend were still allowable even after section 94(7). This shows that Parliament had not treated the dividend stripping transaction as sham or bogus or the entire loss as a fictitious or fiscal loss. If the argument of the Department was to be accepted, it would mean that before 1.4.2002 the entire loss would be disallowed as not genuine but, after 1.4.2002, a part of it would be allowable under section 94(7) which can never be the object of section 94(7).

(iv) As regards the reconciliation of sections 14A and 94(7), the two operate in different fields. Section 14A deals with disallowance of expenditure incurred in earning tax-free income while section 94(7) refers to disallowance of loss on acquisition of an asset. Section 14A applies to cases where an assessee incurs expenditure to earn tax free income but where there was no acquisition of an asset. In cases falling under section 94(7), there is acquisition of an asset and existence of the loss which arises at a point of time subsequent to the purchase of units and receipt of exempt income. It occurs only when the sale takes place. Section 14A comes in when there was claim for deduction of an expenditure whereas section 94(7) comes in when there was claim for allowance for the business loss. One must keep in mind the conceptual difference between loss, expenditure, cost of acquisition, *etc*. while interpreting the scheme of the Act. Also, though sections 14A and 94(7) were inserted by the Finance Act, 2001, section 14A was inserted w.e.f. 1.4.1962 while section 94(7) was inserted w.e.f. 1.4.2002.

(v) The argument of the department that by virtue of para 12 of accounting standards 13, the dividend should be regarded as a "return of investment" and go to reduce the cost of the unit was not acceptable. Accounting standards 13 provides that interest/dividends received on investments are generally regarded as return on investment and not return of investment and it was only in certain circumstances where the purchase price includes the right to receive crystallized and accrued dividends/interest, that have already accrued and become due for payment before the date of purchase of the units, that the same has got to be reduced from the purchase cost of the investment. A mere receipt of dividend subsequent to purchase of units, on the basis of a person holding units at the time of declaration of dividend on the record date, cannot go to offset the cost of acquisition of the units.

IV PENALTY UNDER S. 271(1)(C)

In *Joint Commissioner of Income Tax, Surat* v. *Saheli Leasing & Industries Ltd.*,[6] the issue pertained to the assessment year 1995-96. On return being filed by the assessee, an order under section 143 (3) was passed assessing the total income at a loss. In making the assessment, the AO disallowed an amount of Rs. 24,22,531/- out of depreciation. Penalty proceedings under section 271(1)(c) were initiated. Penalty was sought to be imposed in respect of the disallowance having an effect of reducing the loss. No appeal was filed against the disallowance. Admittedly, the assessee, a leasing company, had claimed depreciation on plant and machinery @ 100 per cent on various items. The statement of depreciation filed along with the computation of income showed the claim. Even after the disallowance of the said depreciation, the taxable income of the assessee was *nil* and hence, there was no tax liability. According to the assessee, in such a case, no penalty under section 271(1)(c) could be levied. The DCIT held that the assessee was liable to pay penalty with reference to *Explanation* 4(a) to section 271(1)(c). The CIT (A) dismissed the assessee's appeal. The tribunal, on the strength of an earlier order passed by special bench of the Ahmedabad tribunal in *Apsara Processors (P) Ltd.*[7] came to the conclusion that no penalty could be levied if the returned income and the assessed income was a loss. The High Court dismissed the revenue's appeal. Before the Supreme Court, the question for consideration was whether penalty can be levied under section 271(1)(c) where assessed income was a loss.

The Supreme Court, following its earlier decision in *CIT v. Gold Coin Health (P) Ltd.,*[8] held that even if the assessed income was a loss, penalty could still be levied if certain income had been concealed or understated. The court observed that this position was no more *res integra* and stood answered in favour of the revenue and against the assessee in *Gold Coin Health.*[9]

In *Commissioner of Income Tax* v. *Reliance Petroproducts Pvt Ltd.*,[10] the relevant assessment year was 2001-02. In this case, the assessee claimed interest on loan taken for the purchase of some IPL shares as business expense which was disallowed in the assessment. The AO levied penalty under section 271(1)(c) in respect of the said disallowance. The CIT (A), however, deleted the said penalty. In appeal of the revenue, the tribunal confirmed the

6 (2010) 324 ITR 170 (SC).
7 (2005) 92 TTJ Ahd 645.
8 (2008) 304 ITR 308 (SC).
9 *Ibid.*
10 (2010) 322 ITR 158 (SC).

order of the CIT (A) and dismissed the appeal of the revenue. The revenue challenged the said order before the High Court which confirmed the orders passed by the CIT (A) and the tribunal. In further appeal by the revenue, the Supreme Court, referring to previous decisions,[11] dismissed the revenue's appeal.

The court held that making an incorrect claim in law cannot, by any stretch of imagination, tantamount to furnishing inaccurate particulars. It must be shown that the conditions under section 271(1)(c) exist before the penalty was imposed. There can be no dispute that everything would depend upon the return filed because that is the only document where the assessee can furnish the particulars of his income. When such particulars are found to be inaccurate, the liability would arise. As the assessee had furnished all the details of its expenditure as well as income in its return, which details, in themselves, were not found to be inaccurate nor could be viewed as concealment of income on its part. It was up to the authorities to accept the claim in the return or not. Merely because the assessee had claimed the expenditure, which claim was not accepted or was not acceptable to the revenue, that by itself would not attract the penalty under section 271(1)(c).

The above judgment of the Supreme Court should not be interpreted as giving a license to making patently incorrect or illegal claims in the return on the ground that they were merely claims and were not tantamount to concealment or furnishing of incorrect particulars of income. It is pertinent to mention that in *CIT* v. *Escorts Finance Ltd.*,[12] a revised return offering a higher income was made by the assessee on discovery that the wrong claims for deduction were made under section 35D due to a misunderstanding of law and a claim of loss due to a bona fide error on its part. The tribunal spared the penalty on both these items. The High Court found that the explanation for wrong claim under section 35D that it was an inadvertent error arising out of acceptance of chartered accountant's computation of income was not acceptable. The High Court could not accept such omission as bona fide on the assessee's part, when there was no basis for the claim in law and penalty was confirmed. Similarly, in another case,[13] where a claim of payment of commission paid to a director was found to be disallowable, since she was neither a director of the company at the relevant time nor was there any finding of any service by her to the company, penalty, which was deleted by the tribunal, was restored by the High Court considering the fact that the

11 *CIT* v. *Atul Mohan Bindal* (2009) 317 ITR 1 (SC); *Union of India* v. *Dharamendra Textile Processors* (2008) 306 ITR 277 (SC); *Dilip N. Shroff* v. *Joint Commissioner of Income Tax* (2007) 291 ITR 519 (SC) and *Sree Krishna Electricals* v. *State of Tamil Nadu*, 23 VT 249 (SC).

12 328 ITR 44 (Del.); 2009-TIOL-483-HC-DEL-IT.

13 (2010) 328 ITR 53 (Del.).

payment was made to the daughter-in-law of the managing director without any consideration and that, therefore, it was bogus.

Thus, it would be reasonable to conclude that in order not to tantamount to concealment, a claim must be bonafide. Courts may not spare penalty in respect of claims which are malafide, bogus or patently incorrect and unsustainable.

V APPEAL TO THE APPELLATE TRIBUNAL: S. 253

In *Commissioner of Income Tax* v. *Pawan Kumar Laddha*,[14] the assessment pertained to block period 1986-87 to 14th September 1995. Before the tribunal, the revenue raised a preliminary objection as to the maintainability of the appeal on the ground that the assessee had not paid the admitted tax before filing the appeal, invoking section 249(4)(a) in support of its contention. It was argued on behalf of the assessee that section 249(4) dealt with appeals to the commissioner (appeals), and could not be read into section 253(1)(b) which dealt with appeals to the tribunal.

After going through the provisions of sections 249(4)(a) and 253(1)(b) of the Act, which, at the relevant time, dealt with an order passed by the AO under section 158BC(c), the tribunal held that one cannot read section 249(4)(a) into the provisions of section 253(1)(b). While section 253(1) was an enabling provision giving right to the assessee to file an appeal to the tribunal, there was no provision similar to section 249(4)(a) in section 253(1)(b). Hence, it was not a condition mandatory to the filing of appeal to the tribunal to pay undisputed tax amount as a condition precedent. The matter was carried in appeal by the department to the High Court which affirmed the view of the tribunal.

On appeal to the Supreme Court, it was held, dismissing the appeal of the revenue, that in the list of orders, an appeal to the tribunal under section 253(1) was not mentioned. This was a very important indicia to show that each heading in chapter XX dealt with a different subject matter and one cannot read the words in chapter XX(A) into the words used in chapter XX(B). Chapter XX(A) dealt with appeals to the deputy commissioner and commissioner (appeals) whereas chapter XX(B) dealt with appeals to the tribunal. Similarly, reference to the High Court lies under chapter XX(C). It was for this reason that the Supreme Court came to the conclusion that each heading was a stand-alone item and, therefore, one cannot read the provision of section 249(4)(a) into section 253(1)(b) of 1961 Act. If the argument of the department was to be accepted, then, in that event, no appeal or reference could lie even to the High Court without complying with the provisions of section 249(4)(a). This cannot be the scheme of chapter XX of the Act.

14 (2010) 324 ITR 324 (SC).

The court further said that once section 249(4)(a) was treated as a mandatory condition for filing an appeal before the CIT (A) and once that condition stood satisfied at the time of filing an appeal to the CIT (A), there was no necessity for the assessee to once again pay the admitted tax due as a condition precedent to his filing the appeal before the tribunal under section 253(1)(b). Lastly, one must keep in mind the principle that the doctrine of incorporation cannot be invoked by implication. A provision which insists on the assessee satisfying a condition of paying the admitted tax as a condition precedent to his filing of appeal under section 253(1)(b) of the Act is a disenabling provision. Such a disenabling provision must be clearly spelt out by the legislature while enacting the statute. The courts have to be careful in reading into the Act such disenabling provisions as that would tantamount to judicial legislation which the courts must eschew. It is for the Parliament to specifically say that no appeal shall be filed or admitted or maintainable without the assessee(s) paying the admitted tax due. That has been done only in the case of an appeal under section 249(4)(a) of the Act. The court refused to read such a disenabling provision into section 253(1)(b) of 1961 Act.

It may be mentioned that the above case pertained to the period when the first appeal in block assessment cases lay to the tribunal. The law has since been amended with effect from 1.1.1997, and the first appeal in block assessment cases now lies to the CIT (A). Hence, the condition regarding payment of admitted tax before filing the appeal in block assessment cases is now applicable.

VI LOSS ON ACCOUNT OF FOREIGN EXCHANGE FLUCTUATIONS: S. 37(1)

In *Oil & Natural Gas Corporation Ltd* v. *The Commissioner of Income Tax*,[15] the assessee, was engaged in exploration and production of petroleum products for which it had to heavily depend on foreign loans to cover its expenses and for payment to non-resident contractors in foreign currency for various services rendered. It made three types of foreign exchange borrowings: (i) on revenue account; (ii) on capital account, and (iii) for general purposes. Some of the loans became repayable in the relevant accounting year and the date of repayment of some other loans fell after the end of the relevant accounting year. The assessee revalued its foreign exchange loans in foreign exchange on revenue account, on capital account and for general purposes outstanding as on March 31, 1991, and claimed the differences between their respective amounts in Indian currency as on March 31 of 1990 and 1991 as revenue loss under section 37(1) of the Income-tax Act, 1961, in respect of

15 (2010) 322 ITR 180 (SC).

loans used in revenue account. It also treated the similar difference in foreign exchange as an increased liability under section 43A.

The AO allowed the deduction claimed under section 37, taking into consideration the increased foreign exchange liability and repaid in the accounting year for the purpose of depreciation. He did not, however, allow the claim for foreign exchange loss on loans both in relation to capital as well as revenue account which were outstanding on the last day of the accounting year. On appeal, the commissioner (appeals) affirmed the view of the AO in relation to deduction under section 37 in respect of interest on loans outstanding on the last day of the accounting year, but allowed the benefit of increased liability for computation under section 43A in relation to loans outstanding on the last day of the accounting year.

Both the appellant and the department took the matter in appeal to the tribunal. The tribunal held that the loss claimed by the assessee on revenue account was allowable under section 37(1) and rejected the appeal of the department and held that the assessee was entitled to adjust the actual cost of imported assets acquired in foreign currency on account of fluctuation in the rate of exchange in terms of section 43A. On the appeal by department, the High Court reversed the decision of the tribunal on both the issues. On appeal to the Supreme Court, it was held, reversing the decision of the High Court, (i) that the loss claimed by the assessee on account of fluctuation in the rate of foreign exchange as on the date of the balance-sheet was allowable as expenditure under section 37(1); and (ii) that the assessee was entitled to adjust the actual cost of imported assets acquired in foreign currency on account of fluctuation in the rate of exchange at each of the relevant balance-sheet dates, pending actual payment of the liability under section 43A, prior to its amendment by the Finance Act, 2002. The court followed *CIT* v. *Woodward Governor India P. Ltd*.[16] and reversed the decision of Uttarakhand High Court in *CIT* v. *Oil and Natural Gas Corporation Ltd*.[17]

VII FOR DEDUCTION OF BAD DEBT UNDER S. 36(1)(VII), WRITE OFF OF INDIVIDUAL DEBTOR'S A/C IS NOT NECESSARY

In *M/s. Vijaya Bank* v. *Commissioner of Income Tax*,[18] for the assessment year 1994-95, the assessee made a provision for bad debts by debiting the P & L A/c and crediting the provision for bad debts A/c. Thereafter, the provision account was debited and the loans and advances a/c was credited. The AO denied the claim for bad debts under section 36(1)(vii) on the ground that the individual account of the debtor had not been written off. The CIT (A)

16 (2009) 312 ITR 254 (SC).
17 (2008) 301 ITR 415.
18 (2010) 323 ITR 166 (SC).

and tribunal allowed the assessee's claim. This view, however, was not accepted by the High Court which came to the conclusion by placing reliance on *Commissioner of Income Tax* v. *M/s. Wipro Infotech*[19] that, in view of the insertion of the Explanation vide Finance Act, 2001, with effect from 1st April 1989, the decision of the Gujarat High Court in *Vithaldas H. Dhanjibhai Bardanwala*[20] no more held the field and, consequently, mere creation of a provision did not amount to actual write off of bad debts.

The Supreme Court observed that pursuant to the *Explanation* inserted w.i.e.f. 1.4.1989, a mere provision for bad debt was not entitled to deduction under section 36(1)(vii). A division bench of the court in *Southern Technologies Limited* v. *Joint Commissioner of Income Tax*[21] held that if an assessee debits an amount of doubtful debt to the profit and loss account and credits the asset account like sundry debtor's account, it would constitute a write off of an actual debt. However, if an assessee debits 'provision for doubtful debt' to the profit and loss account and makes a corresponding credit to the 'current liabilities and provisions' on the liabilities side of the balance-sheet, it would constitute a provision for doubtful debt. In the latter case, the assessee would not be entitled to deduction after April 1, 1989. However, in the present case, besides debiting the P&L A/c and creating a provision for bad debts, the assessee had also obliterated the said provision by reducing the corresponding amount from the debtors account in the balance- sheet. Therefore, the assessee was entitled to the benefit of deduction under section 36(1)(vii).

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

VIII PROVISIONS FOR NPA AS PER RBI NORMS BY NBFC'S NOT DEDUCTIBLE

In *M/s. Southern Technologies Ltd.* v. *Joint Commissioner of Income Tax*,[22] the assessee, an NBFC, made a 'Provision for NPA' in terms of the RBI directions 1998. It claimed a deduction for the said provision under section 36(1)(vii) on the ground that as it was debited to the P&L account and reduced the profits, it was a 'write off'. In the alternative, it was claimed that there was

19 (2010) 323 ITR 151 (Kar.).
20 (1981) 130 ITR 95 (Guj.).
21 (2010) 320 ITR 577 (SC).
22 (2010) 320 ITR 577 (SC).

a diminution in the value of its assets for which a deduction under section 37 as a trading loss was eligible. It was also claimed that the RBI directions overrode the IT Act. The tribunal allowed the claim but the High Court rejected it. On appeal, the Supreme Court, dismissing the claim, held that:

(i) The RBI directions issued under section 45JA of the RBI Act provide that anticipated losses must be taken into account but expected income need not be taken note of. This is for ensuring that NBFCs state true and correct profits without projecting inflated profits. These are prudential norms or disclosure norms but have nothing to do with the computation or taxability of the provisions for NPA under the IT Act. They did not override the provisions of the IT Act. The RBI directions 1998 and the IT Act operated in different fields.

(ii) The "Provision for NPA" made in terms of the RBI directions did not constitute expense for purposes of section 36(1)(vii). The said provision was for presentation purposes and in that sense it was notional.

(iii) The argument that a provision for NPA under commercial accounting was not "income" hence on the basis of "Real Income Theory" it cannot be added back had no merit. Though profits had to be computed on commercial principles and on real income basis, this was subject to the provisions of the Act. A provision for NPA was only a notional expense. Further, under the *Explanation* to section 36(1)(vii), a provision for doubtful debt was not allowable. For the same reason, deduction can also not be claimed under section 37(1).

(iv) The argument of the NBFCs that the non-grant of benefits under sections 36 (1)(viia) & 43D to NBFCs and confining such benefits to banks, SFCs, HFCs violates articles 14 & 19 of the Constitution of India had no merit. As regards article 14, the business operations of NBFCs and banks were quite different and they satisfied the test of "rational and intelligible differentia" having nexus with the object sought to be achieved. As regards article 19(1), keeping in mind the important role assigned to banks in the economy and the fact that NBFCs are vulnerable to economic and financial uncertainties, the restriction placed on NBFC by not giving them the benefit of deduction satisfies the principle of "reasonable justification". Further, laws relating to economic activities should be viewed with greater latitude than other laws.

IX BAD DEBTS NEED NOT BE PROVED TO BE IRRECOVERABLE UNDER S. 36(1)(VII) - SUFFICIENT IF THEY ARE WRITTEN OFF

In *TRF Limited* v. *Commissioner of Income Tax, Ranchi*,[23] the Supreme Court had to consider whether after the amendment to section 36(1)(vii) w.e.f. 1.4.1989, an assessee had to establish, as a matter of fact, that the debt advanced by the assessee had, in fact, become irrecoverable or whether writing off the debt as irrecoverable in the accounts was sufficient. It was held, deciding in favour of the assessee, that the position in law was well-settled. After 1.4.1989, it was not necessary for the assessee to establish that the debt, in fact, had become irrecoverable. It was enough if the bad debt was written off as irrecoverable in the accounts of the assessee. When a bad debt occurs, the bad debt account is debited and the customer's account is credited, thus, closing the account of the customer. In the case of companies, the provision is deducted from sundry debtors.

However, as the AO had not examined whether the debt had, in fact, been written off in accounts of the assessee, the court remitted the matter to the AO for *de novo* consideration of the above-mentioned aspect only and that too only to the extent of the write off.

X WHETHER MAT COMPANIES CAN PROVIDE DEPRECIATION AS PER INCOME-TAX RULES WHILE COMPUTING S. 115J BOOK PROFITS REFERRED TO LARGER BENCH

In M/s. Dynamic Orthopedics Pvt. Ltd. v. *Commissioner of Income Tax*,[24] the assessee, a private limited company, provided for depreciation in its profit & loss account by adopting the rates specified in the income-tax rules and computed its "book profits" under section 115J on that basis. The AO recomputed the book profits by adopting the depreciation rates as per schedule XIV to the Companies Act, 1956 as those were lower than the income-tax rates. The CIT (A) and tribunal upheld the stand of the assessee on the ground that schedule XIV was not applicable to a private limited company though the High Court took the view that section 205 of the Companies Act stood incorporated into section. 115J and, consequently, depreciation had to be provided at the rates specified in schedule XIV and not in terms of the income-tax rules. On appeal by the assessee, the Supreme Court held, doubting its own judgment in *Malayala Manorama:*[25]

23 (2010) 323 ITR 397 (SC).

24 (2010) 321 ITR 300 (SC).

25 300 ITR 251 (SC). In this case, it was held that that (i) schedule VI does not create any obligation to provide for any depreciation much less for depreciation at schedule XIV rates, (ii) As per the company law board circular, the rates in schedule XIV are the minimum rates and a company can provide for higher rates and (iii) schedule XIV itself contemplates that depreciation can be provided at rates different from the schedule rates.

(i) The law laid down in *Malayala Manorama* needs re-consideration because section 115J by a deeming fiction legislatively only incorporates provisions of parts II and III of schedule VI of the Companies Act and not sections 205, 350 or 355. Once a company, whether private or public, falls within the ambit of it being a MAT company, section 115J applies and is required to prepare its profit & loss account only in terms of parts II and III of achedule VI. By the Companies (Amendment) Act, 1988, the linkage between depreciation as per rule 5 and the Companies Act have been expressly de-linked and the rates are also different.

(ii) If the judgement in *Malayala Manorama* is to be accepted, the very purpose of enacting section 115J would stand defeated, particularly when the said section does not make any distinction between public and private limited companies.

(iii) Accordingly, the matter needed re-consideration by a larger bench of the court.

XI S. 115JAA MAT CREDIT TO BE SET OFF BEFORE COMPUTING ADVANCE-TAX SHORTFALL AND LIABILITY FOR S. 234B/C INTEREST

In *Commissioner of Income Tax* v. *Tulsyan Nec Ltd.*,[26] the issue in these batch of appeals filed by the revenue related to the question whether MAT credit admissible in terms of section 115JAA has to be set off against the tax payable (assessed) before calculating interest under section 234A, B and C of the Income-tax Act. S. 115JAA inserted by Finance Act 1997 w.e.f. 1.4.1997 provides that when tax is paid under section 115JA or 115JB, a tax credit being the difference of the tax paid under section 115JA/115JB and the tax payable under the normal provisions of the Act shall be allowed as set-off in the subsequent years when tax becomes payable under the normal provisions of the Act. The AO, in this case, in computing the tax under the normal provisions of the Act, took the view that though MAT credit was available, the same could not be deducted whilst computing the liability to pay advance tax and interest under section 234B & 234C. The High Court disagreed with the view of the AO. On appeal by the department, the Supreme Court held, dismissing the appeal:

(i) The scheme of section 115JA (1) and 115JAA showed that right to set-off the tax credit follows as a matter of course once the conditions of section 115JAA are fulfilled. The grant of credit was not dependent upon determination by the AO except that the

26 (2011) 2 SCC 1.

ultimate amount of tax credit to be allowed depends upon the determination of total income for the first assessment year. Accordingly, the assessee was entitled to take into account the set off while estimating its liability to pay advance tax. If this interpretation was not given, there will be absurdity;

(ii) The amendment to *Explanation* 1 to section 234B by FA 2006 w.e.f. 1.4.2007 to provide that MAT credit under section 115JAA shall be excluded while calculating advance-tax liability was to remove the immense hardship that would result if this was not done;

(iii) The fact that the form & rules provided for set off of MAT credit balance after computation of interest under section 234B was irrelevant because it was directly contrary to a plain reading of section 115JAA(4).

XII DEDUCTION UNDER SECTION 80P NOT ADMISSIBLE IN RESPECT OF INTERST ON INVESTMENT OF SURPLUS FUNDS

In *M/s. The Totgars Cooperative Sale Society Limited* v. *Income Tax Officer, Karnataka*,[27] the assessee was a cooperative society providing credit facilities and marketing agricultural produce of its members. It invested surplus funds not required in its regular business as short-term bank deposits and securities, and earned interest income therefrom. In respect of the said interest income, the assessee claimed deduction under section 80P(2)(a)(i). The AO disallowed the same by treating the interest as 'income from other sources'. The tribunal and the High Court rejected the assessee's appeals.

On appeal to the Supreme Court, dismissing the assessee appeal, it was held that section 80P(1) states that where the gross total income of a cooperative society includes any income from one or more specified activities, then such income shall be deducted from the gross total income. An income which is attributable to any of the activities specified in section 80P(2) would be eligible for deduction. The Parliament has specifically included "business profits" in the definition of the word "income". In the present case, the assessee regularly invested funds not immediately required for business purposes. Interest on such investments, therefore, cannot fall within the meaning of the expression "profits and gains of business". Such interest income can also not be said to be attributable to the activities of the society, namely carrying on the business of providing credit facilities to its members or marketing of the agricultural produce of its members. When the assessee provides credit facilities to its members, it earns interest income. In this case, interest held as ineligible for deduction under section 80P(2)(a)(i) was not in

27 (2010) 322 ITR 283 (SC).

respect of interest received from members, but accrues on funds not required immediately by the assessee for its business purposes and which have been only invested in specified securities as "investment".

Further, the court said that the assessee markets the agricultural produce of its members. It retains the sale proceeds in many cases. It is this "retained amount" which was payable to its members, from whom produce was bought, which was invested in short-term deposits/securities. Such an amount, which was retained by the assessee, was a liability and it was shown in the balance-sheet on the liability side. Therefore, such interest income cannot be said to be attributable either to the activity mentioned in section 80P(2)(a)(i) of the Act or in section 80P(2)(a)(iii) of the Act. Therefore, the assessing officer was right in taxing the interest income under section 56 of the Act.

XIII S. 143(2) NOTICE MANDATORY FOR BLOCK ASSESSMENT - DISCLOSED ITEMS CANNOT BE ASSESSED IN BLOCK ASSESSMENT - CIRCULARS ARE BINDING ON THE REVENUE

Section 158BC(b) provides that in making the block assessment the provisions of section 143 (2) shall so far as may be, apply In *Assistant Commissioner of Income Tax* v. *M/s. Hotel Blue Moon.*[28] The Supreme Court in this case had to consider whether a block assessment order passed without service of notice on the assessee under section 143(2) within the prescribed period of time was valid. It was held, deciding in favour of the assessee:

(i) While notice under section 143(2) was not necessary if the AO accepts the return as filed, the notice within the prescribed time was mandatory if the AO proposes to make an assessment under section 158BC r.w.s 143(3). Omission to issue notice under section 143(2) was not a procedural irregularity and the same was not curable. If the intention of the legislature was to exclude the provisions of section 143(2), the legislature would have indicated that.

(ii) In circular no. 717 dated 14.8.1995, the CBDT had directed that the AO *shall proceed to determine the undisclosed income of the block period and the provisions of s. 142, sub-s (2) and (3) of s. 143 and s. 144 shall apply accordingly*. This circular clarifies the requirement of law in respect of service of notice under section 143(2). The circular was binding on the department though not on the court.

(iii) A search was the *sine qua non* for a block assessment under ch. XIV-B. A block assessment was in addition to regular assessment and not in substitution thereof. The scope and ambit of a block assessment was limited to materials unearthed during search and

28 (2010) 321 ITR 362 (SC).

could only be done on the basis of evidence found as a result of search or requisition.

XIV TWISTING AND TEXTURISING POY IS "MANUFACTURE" - DEPARTMENT MUST EXAMINE PROCESS - OPINION OF EXPERT MUST BE CONSIDERED

In *Commissioner of Income Tax* v. *M/s. Emptee Poly-Yarn Pvt Ltd.*,[29] the assessee was engaged in twisting and texturising POY and the question arose whether this amounted to 'manufacture' for purposes of section 80IA. The assessee provided an opinion from Mumbai University which stated that the activity was 'manufacture' and the same was not controverted by the revenue. The Supreme Court held, deciding in favour of the assessee:

(i) Though the court had repeatedly asked the department to examine the process applicable to the product in question and not to go only by dictionary meanings, the recommendation was not being followed. Even when the assessee gave an opinion on a given process, the department did not submit any counter opinion.

(ii) Applying the test laid down in *Commissioner of Income Tax* v. *Oracle Software India Ltd.*,[30] as POY *simpliciter* was not fit for being used in the manufacture of a fabric and it became usable only after it underwent the operation/process called thermo mechanical process which converts POY into texturised yarn, the said process was "manufacture".

XV COPYING SOFTWARE ONTO BLANK DISCS IS "MANUFACTURE" FOR S. 80-IA

In *Oracle Software India Ltd.*,[31] the assessee imported master media of software from Oracle corporation which was duplicated on blank discs, packed and sold in the market. The question arose whether the activity of copying the discs amounted to manufacture or processing of goods for purposes of section 80IA. It was held, deciding in favour of the assessee:

(i) In interpreting the expression "manufacture or processing of goods", one has to move with the times and bear in mind that technological advancement in computer science makes knowledge as of today obsolete tomorrow. Therefore, where the issue arises for

29 (2010) 320 ITR 665 (SC).
30 (2010) 320 ITR 546 (SC).
31 *Ibid*.

determination, the department should study the actual process undertaken by the assessee to decide whether there was manufacture or processing.

(ii) The term "manufacture" implies a change, but every change was not a manufacture, despite the fact that every change in an article was the result of a treatment of labour and manipulation. However, this test of manufacture needs to be seen in the context of the process adopted by the assessee for duplication of software. If an operation/process renders a commodity or article fit for use for which it is otherwise not fit, the operation/process falls within the meaning of the word "manufacture". Applying this test, as the assessee had undertaken an operation which rendered a blank CD fit for use for which it was otherwise not fit, the duplicating process constituted 'manufacture' under section 80IA(12)(b).

(iii) The argument of the revenue that since the software on the master media and the software on the pre-recorded media were the same, there was no manufacture because the end product was not different from the original product, was over-simplified and did not take into account the ground realities of business in modern times. In *Tata Consultancy Services* v. *State of AP*,[32] it was held that a software programme put in media for transferring or marketing is "goods". When one buys a software programme, one buys not the original but a copy. Accordingly, to say that the contents of the original and the copy were the same was not correct.

XVI AO DEEMED TO HAVE APPLIED HIS MIND IF FACTS ARE ON RECORD - REOPENING U/S 147 ON CHANGE OF OPINION NOT PERMISSIBLE EVEN WITHIN 4 YEARS

In *Commissioner of Income Tax* v. *M/s. Kelvinator of India Limited*.,[33] full bench of the Delhi High Court was considering a case of reopening under section 147 within 4 years from the end of the assessment year. The court held that when a regular order of assessment was passed in terms of section 143(3) of the Act, a presumption can be raised that such an order has been passed on application of mind. It was held that if it be held that an order which has been passed purportedly without application of mind would itself confer jurisdiction upon the assessing officer to reopen the proceeding without anything further, the same would amount to giving premium to an authority exercising quasi-judicial function to take benefit of its own wrong. It was held that section 147 of the Act does not postulate conferment of power upon the assessing officer to initiate reassessment proceedings upon a mere change of opinion.

32 271 ITR 401 (SC).
33 (2010) 320 ITR 561 (SC).

On appeal by the department to the Supreme Court, it was held dismissing the appeal that though the power to reopen under the amended section 147 was much wider, one needs to give a schematic interpretation to the words "reason to believe" failing which section 147 would give arbitrary powers to the AO to re-open assessments on the basis of "mere change of opinion", which cannot be *per se* reason to re-open. One must also keep in mind the conceptual difference between power to review and power to re-assess. The AO has no power to review; he has the power to re-assess. But re-assessment has to be based on fulfillment of certain pre-conditions and if the concept of "change of opinion" is removed, as contended on behalf of the department, then, in the garb of re-opening the assessment, review would take place. One must treat the concept of "change of opinion" as an in-built test to check abuse of power by the AO. Hence, after 1.4.1989, the AO has power to re-open, provided there is "tangible material" to come to the conclusion that there is escapement of income from assessment. Reasons must have a live link with the formation of the belief. This is supported by circular no. 549 dated 31.10.1989 which clarified that the words "reason to believe" did not mean a change of opinion.

XVII DEDUCTION IN RESPECT OF PROFITS AND RETAINED FOR EXPORT BUSINESS: S. 80HHC(1B) IN RELATION TO MAT COMPANY "BOOK PROFITS" U/S 115JB HAVE TO BE REDUCED BY DEDUCTION "*ELIGIBLE*" U/S 80HHC & NOT "*ACTUAL*" DEDUCTION

In *Ajanta Pharma Ltd* v. *Commissioner of Income Tax*,[34] in respect of AY 2001-02, the assessee claimed that though section 80HHC (1B) limited the deduction to 80 per cent of the profits eligible for deduction under section 80HHC, this limitation did not apply for purposes of "book profits" under section 115JB and that 100 per cent of the 80HHC profits were deductible. The tribunal allowed the claim by relying on the special bench judgement in *Syncome Formulations*.[35] On appeal by the revenue, the High Court reversed the decision of the tribunal. On appeal by the assessee, it was held, reversing the decision of the High Court:

(i) The question of law was "whether for determining the "book profits" in terms of s. 115JB, the net profits as shown in the P&L Account have to be reduced by the amount of profits eligible for deduction under Section 80HHC or by the amount of deduction under s. 80HHC?"

34 (2010) 327 ITR 305 (SC).
35 106 ITD 193 (Mum.) (SB).

(ii) Section 115JB was a self-contained code and taxes deemed income. Section 115JB begins with a *non obstante* clause and requires *vide* clause (iv) for the "eligible" profits derived from exports to be excluded from the "book profits". Section 80HHC operated in a different sphere. Section 80HHC(1B) was concerned with the "extent of deduction";

(iii) If an assessee earns Rs.100 crores, while for AY 2001-02, the extent of deduction was 80 per cent thereof, for purposes of computation of book profits, 100 per cent of the profits are "eligible profits" and cannot be reduced to 80 per cent by relying on s. 80HHC(1B). The idea is to exclude "export profits" from computation of book profits under section 115JB which imposes MAT on deemed income;

(iv) The argument of the department that because clause (iv) of *Explanation* to section 115JB provides that the deduction is "subject to the conditions specified in section 80HHC", both "eligibility" as well as "deductibility" of the profit has to be considered together has no merit. If the dichotomy between "eligibility" of profit and "deductibility" of profit is not kept in mind then section 115JB will cease to be a self-contained code. One cannot rely upon the last sentence in clause (iv) of *Explanation* to section 115JB to obliterate the difference between "eligibility" and "deductibility" of profits.

XVIII CAPITAL GAINS - COMPUTATION - RIGHT TO SUBSCRIBE FOR SHARES ARISES ONLY WHEN OFFER IS MADE BY THE COMPANY

In *Navin Jindal* v. *Asstt Commissioner of Income Tax,*[36] the assessee held shares in Jindal Iron and Steel Co. Pursuant to a rights issue of partly convertible debentures announced by Jindal, the assessee received an offer to subscribe to 1875 PCDs on rights basis. The assessee renounced his right to subscribe to PCDs and received a consideration of Rs. 56,250/- for the renunciation. Against the said sale consideration, the assessee claimed on the basis of *Dhun Dadabhoy Kapadia*[37] that he had suffered a diminution in the value of the original 1500 equity shares being the difference between the cum-right price per share and the ex-rights price per share aggregating to Rs. 3,00,000. The difference of Rs. 2,43,750 was claimed as a short-term capital loss. The lower authorities held that as the shares were held long-term, the said loss was also long-term. On appeal by the assessee, it was held, allowing the appeal:

36 (2010) 320 ITR 708 (SC).
37 63 ITR 651 (SC).

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

(ii) For the purposes of section 48 an important principle that must be borne in mind is that chargeability and computation go hand in hand. Computation was an integral part of chargeability under the Act. Accordingly, the right to subscribe for additional offer of shares/ debentures came into existence only when the company decides to come out with the rights offer and it is only when that event takes place, that diminution in the value of the original shares held by the assessee takes place. One has to give weightage to the diminution in the value of the original shares which takes place when the company decides to come out with the rights offer as held in *Dhun Dadabhoy Kapadia*.

XIX WHETHER STOCK EXCHANGE MEMBERSHIP CARD IS INTANGIBLE ASSET ELIGIBLE FOR DEPRECIATION

In *M/s. Techno Shares & Stocks Ltd* v. *The Commissioner of Income Tax*,[38] the assessee, a company, filed its return of income for the impugned year disclosing loss. The same was processed under section 143(1) of the Act. Subsequently, the case was reopened under section 147 of the Act on the ground that depreciation on the value of BSE card had been wrongly allowed to the assessee. CIT (A) affirmed the view of the AO. ITAT allowed the appeal of the assessee holding that depreciation was allowable. The High Court reversed the decision of the ITAT and held that no depreciation was allowable since the BSE card was a personal asset and, therefore, out of the purview of the definition of "capital assets" and, further, it could also not be equated with business or commercial right. Appeal was filed in the Supreme Court on the questions: (a) Whether the right of nomination in the non-defaulting continuing member of the Bombay stock exchange falls within the expression

38 (2010) 327 ITR 323 (SC).

"business or commercial right of similar nature" in section 32(1)(ii); and (b) Whether the membership right could be said to be owned by the assessee and used for the business purpose in terms of section 32(1)(ii).

The Supreme Court, allowing the appeal of the assessee, held that the right of membership of the stock exchange was a "business or commercial right" which gave a non-defaulting continuing member a right to access the exchange and to participate therein and in that sense it was a license or akin to license in terms of section 32(1)(ii) of the 1961 Act. Such a right vests in the exchange only on default/demise in terms of the rules and bye-laws of the exchange, as they stood at the relevant time. The court, however, added that their judgment should not be understood to mean that every business or commercial right would constitute a "license" or a "franchise" in terms of section 32(1)(ii) of the 1961 Act.

XX REVISION OF UNDISCLOSED INCOME IN SETTLEMENT APPLICATION NOT PERMISSIBLE

In *Ajmera Housing Corporation* v. *Commissioner of Income Tax,*[39] the assessee filed a settlement application under section 245C(1) in which it disclosed additional income of Rs. 1.94 crores. This was revised to disclose further undisclosed income of Rs. 11.41 crores. After the section 245D(1) order, a further disclosure of Rs. 2.76 crores was made. Despite the department's objection that the assessee had not made a "full & true disclosure", the settlement commission passed a final order under section 245D(4) determining the total income at Rs. 42.58 crores and imposing a token penalty of Rs. 50 lakhs. The department filed a writ petition to challenge the settlement commission's order. The High Court held that as the settlement commission had not applied its mind to the maintainability of the application under section 245D (1) for want of full and true disclosure of income, the matter had to be remanded to the settlement commission for fresh consideration. That order of the High Court was challenged by the assessee in the Supreme Court. The Supreme Court remanded the matter to the High Court on the ground that a report given by the commissioner estimating the undisclosed income at Rs. 42.50 crores which approximately coincided with the figure arrived at by the settlement commission had not been considered by the High Court.

In the second round, the High Court held that in view of the multiple disclosures made by the assessee, the assessee could not be said to have made a full and true disclosure of income. However, it did not set aside the application on that ground but remanded the matter to the settlement commission for re-determination of the undisclosed income. The result of the second remand order of the High Court was that the settlement commission was not required to go into the question of maintainability of the application but only the question of determination of income. The department did not

39 (2010) 326 ITR 642 (SC).

challenge the High Court's order though the assessee did. The Supreme Court, dismissing the appeal, held that:

(i) The disclosure of "full and true" particulars of undisclosed income and "the manner" in which such income had been derived were pre-requisites for a valid application under section 245C(1) and unless the settlement commission records its satisfaction on this aspect, it will not have jurisdiction to pass any order on the settlement application;

(ii) The scheme of settlement does not contemplate revision of the income so disclosed in the application. If an assessee was permitted to revise his disclosure, in essence, he would be making a fresh application in relation to the same case by withdrawing the earlier application. Section 245C(3) prohibits the withdrawal of an application. An assessee cannot be permitted to resile from his stand at any stage during the proceedings. By revising the application, the applicant would be achieving something indirectly what he cannot otherwise achieve directly and in the process rendering section 245(3) otiose and meaningless. As there is no stipulation for revision of an application filed under section 245C(1), the natural corollary is that determination of income by the settlement commission has necessarily to be with reference to the income disclosed in the application;

(iii) The High Court, having come to the conclusion that the assessee had not made a full and true disclosure of undisclosed income, was wrong in treating the application as maintainable. The High Court's order was clearly erroneous as it had not appreciated the object and scope of the scheme of settlement. "However, for reasons best known to the Commissioner, he has chosen not to challenge this part of the impugned order";

(iv) The argument of the assessee that the scope of judicial review being limited, the High Court should not have interfered with the order of the settlement commission was not acceptable. "We have no hesitation in observing that the manner in which assessee's disclosures of additional income at different stages of proceedings were entertained by the settlement commission, rubbishing the objection of the commissioner that the assessee had not made a full and true disclosure of their income in the application under section 245C(1), leaves much to be desired".

XXI WHETHER INTERCONNECT CHRAGES PAID BY CELLULAR COMPANIES CONSTITUTE FEE FOR TECHNICAL SERVICE LIABLE TO TDS U/S 194J

Commissioner of Income Tax v. *M/s. Bharti Cellular Ltd*[40] involved a bunch of appeals. The assessee companies, engaged in providing cellular telephone facilities to their subscribers, had been granted licences by the department of telecommunication for operating in specified circles. The licences stipulated that the department of telecommunication/MTNL/BSNL would continue to operate in the service areas in respect of which licences were issued. Where calls were to be made by subscribers of one network to another network, such calls were to be routed through MTNL/BSNL through interconnection points known as ports. For providing interconnection, the assessees entered into agreements with MTNL/BSNL, which were regulated by the telecom regulatory authority of India and under the agreement the assessees had to pay interconnection, access charges and port charges to the interconnection providers. The department was of the view that interconnect/ port access charges were liable for tax deduction at source in view of the provisions of section 194J of the Act and that these charges were in the nature of fee for technical services.

The tribunal and the High Court disagreed with the revenue. The High Court said that the services rendered *qua* interconnection/port access did not involve any human interface and, therefore, the services could not be regarded as "technical services" as contemplated under section 194J of the Act. The interconnect/port access facility was only a facility to use the gateway and the network of MTNL/other companies. MTNL or other companies did not provide any assistance or aid or help to the assessees in managing, operating, setting up their infrastructure and networks. No doubt, the facility of inter-connection and port access provided by MTNL/other companies was "technical" in the sense that it involved sophisticated technology. The expression "technical service" was not to be construed in the abstract and general sense but in the narrower sense as circumscribed by the expressions "managerial service" and "consultancy service" as appearing in *Explanation* 2 to section 9(1)(vii) of the Act. The expression "technical service" would have reference to only technical service rendered by a human. It would not include any service provided by machines or robots. The inter-connect charges/port access charges could not be regarded as fees for technical services.

The matter was placed before the Supreme Court in a bunch of matters on the question whether provisions of TDS are applicable to interconnection charges paid by cellular companies, and whether such port services by the PSU telecom companies to the assessee qualify as 'technical services'.

The Supreme Court, disposing of the bunch of cases, held that there was no expert evidence from the side of the department to show how human

40 (2010) 193 Taxmann 97.

intervention takes place, particularly, during the process when calls take place. During the traffic of such calls whether there was any manual intervention, was one of the points which required expert evidence. Similarly, on what basis was the "capacity" of each service provider fixed when interconnect agreements are arrived at? On what basis such "capacity" was allotted and what happens if a situation arises where a service provider's "allotted capacity" got exhausted and it wants, on an urgent basis, "additional capacity"? Whether at that stage, any human intervention was involved was required to be examined, which again needed technical data. These types of matters cannot be decided without any technical assistance available on record. The interconnect agreement in these cases was based on obligations and counter obligations, called a "revenue sharing contract". According to the assessee, section 194J of the Act was not attracted in the case of a "revenue sharing contract". In such contracts, there was only sharing of revenue and, therefore, payments by revenue sharing cannot constitute "fees" under section 194J of the Act. This submission had not been examined by the tribunal.

The court further observed that the assessee(s) was not at fault in these cases for the simple reason that the question of human intervention was never raised by the department before the CIT. It was not raised even before the tribunal; it was not raised even in these civil appeals. However, keeping in mind the larger interest and the ramification of the issues, which was likely to recur, particularly, in matters of contracts between Indian companies and multinational corporations, the cases were required to be remitted to the assessing officer (TDS). The court directed the TDS in each of these cases to examine a technical expert from the side of the department and to decide the matter within a period of four months. Such expert(s) will be examined (including cross-examined) within a period of four weeks from the date of receipt of the order of the court. Liberty was also given to the assessee to examine its expert and to adduce any other evidence.

The court directed the CBDT to issue directions to all its officers that in such cases the department need not proceed only by the contracts placed before the officers. With the emergence of India as one of the BRIC countries and with the technological advancement matters such as present one will keep on recurring and hence time has come when department should examine technical experts so that the matters could be disposed of expeditiously and further it would enable the appellate forums including the court to decide legal issues based on the factual foundation. The court, therefore, held the interest and penalty were not justified at the present stage.

XXII APPEAL TO HIGH COURT: S. 260A

In *Vijay Kumar Talwar* v. *Commissioner of Income Tax*,[41] having noted that the outstanding realisations of the Calcutta branch in the preceding years

41 (2011) 330 ITR 1 (SC).

varied from Rs 25,000/- to Rs 30,000/-, the assessing officer held that the assessee's submission that cash receipts of Rs 3,49,991/- related to earlier years was untenable. Therefore, the AO added a sum of Rs 3,49,991/- as assessee's income under the head "unexplained cash receipts". The CIT (A) confirmed the addition made by the AO. The tribunal, while partly allowing the appeal, remitted the matter back to the AO for *de novo* adjudication. The High Court dismissed the appeal of the assessee as no question of law, let alone a substantial question of law was involved.

On further appeal, the Supreme Court, dismissing the appeal with cost, held that on a conspectus of the factual scenario, the conclusion of the tribunal to the effect that the assessee had failed to prove the source of the cash credits cannot be said to be perverse, giving rise to a substantial question of law. The tribunal, being a final fact finding authority, in the absence of demonstrated perversity in its finding, interference therewith by the court was not warranted. What is "substantial question of law"? Though not defined in the Act, it has acquired a definite connotation through various judicial pronouncements.[42] A finding of fact may give rise to a substantial question of law, *inter alia*, in the event the findings are based on no evidence and/or while arriving at the said finding, relevant admissible evidence had not been taken into consideration or inadmissible evidence had been taken into consideration or legal principles had not been applied in appreciating the evidence, or when the evidence had been misread.

XXIII SS. 234A TO 234C ARE APPLICABLE TO SETTLEMENT COMMISSION PROCEEDINGS – INTEREST PAYABLE ONLY UP TO S. 245D(1) ORDER – INTEREST CANNOT BE LEVIED U/S 154

In *Brij Lal* v. *Commissioner of Income Tax*,[43] in the light of the divergent judgements of the Supreme Court in *Anjum Ghaswala*,[44] *Hindustan Bulk Carrier*[45] and *Damani Brothers*,[46] a reference was made to the full bench of the Supreme Court to answer the questions: (i) whether sections 234A, 234B & 234C were applicable to settlement commission proceedings, (ii) whether such interest is payable up to the date of the section 245D(1) order or up to the date of the section 245D(4) order and (iii) whether the settlement commission can re-open its concluded proceedings by having recourse to section 154 so as to levy interest under section 234B, if it was not done in the original proceedings. It was held by the full bench:

42 See constitution bench decision in *Sir Chunilal V. Mehta and Sons Ltd* v. *Century Spinning and Manufacturing Co. Ltd* (2001) 3 SCC 179 and decision of three-judge bench in *Santosh Hazari* v. *Purushottam Tiwari* (2001) 3 SCC 179.

43 (2010) 328 ITR 477 (SC).

44 252 ITR 1 (SC).

45 259 ITR 449 (SC).

46 259 ITR 475 (SC).

(i) Though Chapter XIX- A is a self-contained Code, the procedure to be followed by the settlement commission under sections 245C and 245D was nothing but assessment or computation of total income which takes place at the section 245D(1) stage. In that computation, provisions dealing with a regular assessment, self-assessment and levy and computation of interest for default in payment of advance tax, *etc*. were engrafted. Accordingly, sections 234A to 234C were applicable;

(ii) Interest under sections 234A to 234C was payable only up to the date of the section 245D(1) order and not up to the date of the section 245D(4) order. In a case where 90 per cent of the assessed tax was paid but on the basis of the commission's order under section 245D(4), the advance tax paid turns out to be less than 90 per cent of the assessed tax as defined in the Explanation to section 234B(1), no interest was payable for the shortfall. The legislature had not contemplated levy of interest between the section 245D(1) stage and the section 245D(4) stage. Interest under section 234B was chargeable only till the order of the settlement commission under section 245D(1), *i.e*. admission of the case;

(iii) In view of section 245I which provides that the order of the settlement commission shall be final and conclusive and also in view of the controversy as to liability for interest, the settlement commission cannot re-open concluded proceedings by having recourse to section 154 to levy interest under section 234B if it was not done in the original proceedings.

The court in giving the above judgment followed *Modi Industries Ltd* v. *CIT*[47] and relied on *Abraham (CA)* v. *ITO*.[48]

XXIV OFFENCES BY COMPANIES

In *M/s. Govind Impex P Ltd* v. *Appropriate Authority Income Tax Department*,[49] by a registered lease deed dated May 31, 1991, the petitioners leased out a property for a period of nine years. Clause 12 of the lease deed stipulated that the lease could be renewed for further period of nine years at the option of the tenant if the latter gave at least three months prior notice expressing its intention for renewal and executed a fresh lease deed. On December 4, 1995, the respondent appropriate authority, income-tax department, issued a show cause notice to the petitioners asking them to show cause as to why the petitioners be not prosecuted under chapter XX-C for

47 (1995) 216 ITR 759 (SC).
48 (1961) 41 ITR 425 (SC).
49 Criminal Appeal No. 41 of 2006; 2010-TIOL-107-SC-IT.

their failure to submit form no. 37-I within 15 days of the draft agreement. According to the appropriate authority, the lease deed was for a period of more than 12 years and, therefore, the non-submission of form no. 37-I within 15 days of the agreement was punishable under section 276AB for violation of section 269UC.

A criminal complaint was filed rejecting the petitioners' objection to the notice. On a writ petition against the complaint, the Delhi High Court held, dismissing the writ petition, that so far as the petitioners were concerned, the lease was intended to be executed for more than 12 years as the renewal/ extension of lease was purely at the discretion and option of the lessee. If the lessee opted to renew/extend the lease for the second term, the petitioners could have no objection thereto. So, in view of the *Explanation* to section 269UA(f)(i) of the Act, such a lease had to be deemed to be a lease for a term of not less than twelve years. The provisions of chapter XX-C were, therefore, applicable to the lease.

The Supreme Court dismissing the appeal of the assessee held that a lease for twelve years renewable for a further period of nine years was deemed to be a lease for more than twelve years. The court said that on a plain reading of the explanation it was evident that a lease which provides for the extension of the term thereof by a further term, it shall be deemed to be a lease for a term of not less than twelve years if the aggregate of the period for which the lease was granted and period of extension counted together makes it more than twelve years.

The petitioner's counsel in this case argued that renewal of lease and extension of lease were not one and the same, and a lease which provides for renewal as in the present case, cannot be fictionally taken into account in calculating the period of lease in terms of the aforesaid explanation. In support, the counsel relied on several decisions of the Supreme Court.[50] The court, however, did not go into the issue whether the *Explanation* under reference would cover cases of renewal, because it found that the relevant lease agreement in this case, read in its entirety, in fact provided for extension of the term of the lease even though the word renewal had also been used in certain clauses thereof.

XXV ROLL-OVER CHARGES FOR FOREIGN CURRENCY CONTRACTS HAVE TO BE CAPITALIZED U/S. 43A

In *Asst. Commissioner of Income Tax* v. *Elecon Engineering Co. Ltd*,[51] the assessee procured a foreign currency loan for expansion of its existing

50 *Provash Chandra Dalui* v. *Biswanath Banerjee* (1989) Suppl. (1) SCC 487; *State of UP* v. *Lalji Tandon* (2004) 1 SCC 1; *Hardesh Ores (P) Ltd*. v. *Hede and Co*. (2007) 5 SCC 614.

51 (2010) 322 ITR 20 (SC).

business. To ensure availability of foreign currency, the assessee booked forward contracts with a bank. The contract was for the entire amount and delivery of foreign currency was obtained from the bank for the installment due from time to time. The balance value of the contract was rolled over for a further period up to the date of the next installment. The assessee paid "roll over premium charges" for the same. The AO disallowed the said charges on the ground that as it were incurred for purchase of plant & machinery, it was capital expenditure. The CIT (A), relying on *India Cements Ltd* v. *CIT*,[52] reversed the AO on the ground that the charges were expenditure for raising a loan and was consequently revenue in nature. The tribunal reversed the CIT (A) order on the ground that under section 43A, the expenditure had to be capitalized. The High Court reversed the order of the tribunal on the ground that the charges were in the nature of interest or commitment charges and allowable under section 36(1)(iii). On appeal, the Supreme Court held, reversing the High Court:

(a) Exchange differences were required to be capitalized if the liabilities were incurred for acquiring fixed assets like plant and machinery. It is the purpose for which the loan was raised that was of prime significance. Whether the purpose of the loan was to finance the fixed asset or working capital was the question which one needed answer;

(b) The cost for carrying forward the contracted foreign currency not immediately required for repayment was called the roll over charge(s). The argument that section 43A applied only to cases where there was a fluctuation in the rate of exchange and that since roll over charges were paid to avoid increase or reduction in liability on account of such fluctuation, section 43A did not apply had no merit because section 43A applied to the entire liability remaining outstanding at the year end and was not restricted merely to the installments actually paid during the year. Therefore, the year-end liability of the assessee had to be looked into. Further, it cannot be said that roll over charge had nothing to do with the fluctuation in the rate of exchange. Roll-over charges represented the difference arising on account of change in foreign exchange rates. Roll over charges paid/received in respect of liabilities relating to the acquisition of fixed assets should be debited/credited to the asset in respect of which liability was incurred. However, roll-over charges not relating to fixed assets should be charged to the profit & loss account.

52 (1966) 60 ITR 52 (SC).

The court said that the cases cited on behalf of the assessee, namely *India Cements Ltd.*[53] and *CIT* v. *Gujarat Alkalies & Chemicals Ltd*,[54] were not relevant as they were concerned with commitment charges, warranty charges, *etc*. and did not deal with roll-over charges at all.

In *National Hydroelectric Power Corporation Ltd*. v. *Commissioner of Income-tax*,[55] the assessee, a public sector company, supplying electricity, was required to sell electricity to state electricity boards, discoms, *etc*., at tariff rates, which consisted of: (a) the basic expenses incurred by the applicant, (b) depreciation and advance against depreciation, (c) return on equity, and (d) incentive for higher production. The advance against depreciation was meant to facilitate repayment of loans taken for the equipment/projects. As an accounting policy, the applicant had reduced from the total sales of each year, the amount representing the advance against depreciation component of the tariff and shown it as an income received in advance on the liability side of the balance-sheet to be transferred to sales in the profit and loss account in the subsequent years in which the depreciation charged in the books was more than the depreciation rate fixed for tariff purposes.

The applicant stated a case to the authority for a ruling on the question whether the amount of advance against depreciation had to be included for the computation of the "book profits" under section 115JB of the Income-tax Act, 1961, in the year of receipt or in the future year to which the depreciation might relate. For earlier years, the applicant had offered the advance against depreciation as part of its income, but for the assessment year 2001-02 and subsequent years, the applicant had shown only the net amount excluding the advance against depreciation, and had made a note in its return of income that the question relating to the inclusion of the advance against depreciation was before the authority for an advance ruling and as such the amount was not included for computing the "book profits" for the purpose of minimum alternate tax. The authority ruled: The applicant supplied electricity at the tariff rate notified by the CERC and recovered the sale price from the beneficiaries. At no point of time in the future was the sale price or any part thereof refundable or adjustable against the future bills of the beneficiaries. Inasmuch as section 209 of the Companies Act, 1956, specifically required that the accounts should be maintained on accrual basis, the entire sale price of the energy in accordance with the notified tariff (which included the advance against depreciation) would be income of the applicant in the year of receipt and it was also shown as such (gross sales) in the profit and loss account. However, for the purpose of computation of book profits the applicant had deducted the advance against depreciation component from the total sale price and the balance amount alone had been taken to the profit and loss account.

53 *Ibid*.
54 (2008) 299 ITR 85 (SC).
55 (2010) 320 ITR 374 (SC).

The amount of advance against depreciation so set apart from the sales in the profit and loss account was nothing short of creation of "reserve". As reserve, it fell within clause (b) of the *Explanation* to section 115JB and the advance against depreciation had to be added to the total income and included for the computation of "book profits" under section 115JB.

On appeal, the Supreme Court held that the advance against depreciation (AAD) was neither a reserve nor was it an appropriation of profits. Right from the inception, the AAD was to get adjusted in the future, and hence it could not be designated as a reserve. The AAD was nothing but an adjustment by reducing the normal depreciation includible in future years in such a manner that at the end of the useful life of the plant it would be reduced to nil. The assessee could not use the AAD for any purpose (which was possible in the case of a reserve) except to adjust it against future depreciation so as to reduce the tariff in the future years. The AAD was an income received in advance. It was a timing difference. Therefore, clause (b) of *Explanation* 1 to section 115JB(2) of the Act was not applicable to the AAD of the assessee.

The court further said that to make an addition under clause (b) of *Explanation* 1 to section 115JB(2) of the Income-tax Act, 1961, providing for taxing the book profits of certain companies, two conditions must be jointly satisfied: (a) there must be a debit of the amount to the profit and loss account, and (b) the amount so debited must be carried to the reserve. Further, the reserve contemplated by clause (b) of *Explanation* 1 to section 115JB (2) is required to be carried through the profit and loss account. As a result, the ruling of the authority for advance rulings (income-tax)[56] was reversed.

XXVI INCOME RECEIVABLE IN KIND, RECEIVED AT PLACE WHERE GOODS DELIVERED – S. 5(2) OF THE INCOME-TAX ACT, 1961

In *Kanchanganga Sea Foods Ltd* v. *CIT*,[57] the assessee, a fishing company, obtained two fishing vessels on charter from a foreign company based in Hong-Kong. The charter fee of $ 600,000 was payable from the earning from the sale of fish and for that purpose 85 per cent of the gross earnings from the sale of fish was to be paid to the foreign company. The trawlers were delivered to the assessee at Chennai port. Actual fishing operations were done outside the territorial waters of India but within the EEZ. The voyage commenced and concluded at Chennai port. The catch made at high seas were brought to Chennai where its value was assessed for local taxes. The assessee thereafter arranged customs clearance for the export of the fish and the trawlers carried the fish to the destination chosen by non-resident

56 (2005) 273 ITR 171.
57 (2010) 325 ITR 540 (SC).

company. The trawlers reported back to Chennai port after delivering the fish to the destination and commenced another voyage. The AO took the view that the assessee ought to have deducted tax at source under section 195 whilst making payment to the foreign company. He treated the assessee as in-default under section 201. The CIT (A), ITAT & High Court decided against the assessee. On appeal to the Supreme Court, it was held, dismissing the appeal:

(i) The argument that the income of the non-resident had not been received in India is not acceptable. The agreement provided that the charter fee of $ 600,000 was "payable by way of 85 per cent of gross earning from the fish-sales". The chartered vessels with the entire catch were brought to the Indian port, the catch was certified for human consumption, valued, and after customs and port clearance and the non-resident received 85 per cent of the catch. So long the catch was not apportioned, the entire catch was the property of the assessee and not of non-resident company as the latter did not have any control over the catch. It was after the non-resident company was given share of its 85 per cent of the catch it did come within its control. It was trite to say that, to constitute income, the recipient must have control over it. As the apportionment was in India, the non-resident effectively received the charter-fee in India. This being the first receipt in the eye of law and being in India was chargeable to tax under section 5(2).

(ii) The said catch was, in sum and substance, the receipt of value of money. Had it not been so, the value of the catch ought to have been the price for which the non-resident sold at the destination chosen by it.

(iii) Accordingly, the assessee was liable to deduct tax under section 195 and was rightly held to be in default under section 201.

The Supreme Court distinguished its earlier decision in *Toshoku*[58] on the ground that in that case, mere entries had been made in India and that was held not to be a receipt in India. The court also distinguished its earlier decision in *Ishikawajima*[59] on the ground that in that case the entire transaction was completed on high seas.

58 *CIT* v. *Toshoku Ltd.*, 125 ITR 525 (SC).
59 288 ITR 408 (SC).

XXVII IS TERRITORIAL NEXUS NECESSARY FOR THE CHARGEABILITY OF FEE FOR TECHNICAL SERVICES IN INDIA EVEN AFTER THE INSERTION OF THE *EXPLANATION* TO S. 9 BY THE FINANCE ACT, 2010

Supreme Court in *Ishikawajima*,[60] had held that, in order to be taxable in India whether for fees for technical services, royalty or business, there must be sufficient territorial nexus between the income of the non-resident and the territory of India and that services must be both rendered as well as used in India. Services rendered from outside India were thus taken out of the tax net. To overcome the outcome of this decision, an *Explanation* was added below sub-section (2) to section 9 to clarify that where income is deemed to accrue or arise in India under clauses (v), (vi) and (vii) of section 9, such income shall be included in the total income of the non-resident regardless of whether the non-resident has a residence or a place of business connection in India. Nevertheless, the Karnataka High Court in *Jindal Thermal Power Company Limited* v. *DCIT*,[61] held that on a plain reading of the *Explanation*, the criteria of rendering services in India as laid down by the Supreme Court in *Ishikawajima* were not dispensed with. Accordingly, by the Finance Act, 2010, the said *explanation* was replaced with retrospective effect by a new *Explanation* to the effect that income shall be deemed to accrue to a non-resident under the head interest, royalty or fees for technical services, regardless of whether or not the non-resident has a residence or place of business or business connection in India or the non-resident has rendered services in India. In other words, the earlier *Explanation* said that where income is deemed to accrue, the requirement of residence, place of business, *etc*. was immaterial whereas the new *Explanation* states that income will be deemed to accrue whether or not the non-resident has residence, place of business, *etc.*

The Department had filed SLP before the Supreme Court against the decision of the Karnatake High Court. In view of the retrospective amendment vide Finance Act 2010, the Supreme Court allowed the department to move a review petition before the High Court.[62]

60 (2007)-TII-01-INTL.

61 (2009)-TII-16-HC-KAR-INTL.

62 *Dy Commissioner of Income Tax (Tds), Bangalore* v. *Jindal Thermalpower Co Ltd.,* 2010-TII-04-SC-INTL; also see *Apara Enterprises Sol Pvt Ltd.* v. *Commissioner of Income Tax, International Taxation, Bangalore* (2010)-TII-02-SC-INTL.

XXVIII WHETHER PAYMENTS MADE TO THE FOREIGN SUPPLIER CONSTITUTE ROYALTY – NEED TO ANALYZE THE PROCESS, THE CONTRACT AND THE PRICE STRUCTURE BEFORE ARRIVING AT A DECISION

Many Indian companies act as distributors of software products of foreign companies. If the ownership right is retained by the foreign companies and the Indian companies are allowed to duplicate the software against payment of royalty, questions may arise about the nature of the payment made: whether the same is revenue in nature fully allowable under section 37 of the IT Act or whether the same is capital in nature and should be amortised in terms of section 35AB. In *Commissioner of Income Tax* v. *Mastek Limited*,[63] the AO had allowed deduction under section 35AB. However, the tribunal held that since the payment was made for duplication of software, the same was allowable under section 37. The High Court, having refused to state question of law, special leave petition was filed before the Supreme Court. On behalf of the department, it was pointed out that in that case the royalty for use of the software owned by the American company was being shared in a 60 : 40 ratio and that such a high ratio suggests that the payment was not for duplication *simpliciter*. The Supreme Court, after going into the meaning of ‘duplication’, ‘Back-end system’, ‘Database System’, *etc*., held that all the aspects were not considered by the High Court and directed the High Court to frame a question of law. It was also observed that the department had to analyze the process undertaken by the assessees, analyze the contracts and the price structure to ascertain the nature of payment and one cannot decide such cases merely on the basis of labels affixed to a given process.

XXIX HIGH COURT’S JUDGEMENT ON TRANSFER PRICING OF TRADEMARKS & BRANDS LICENSING NULLIFIED

In *Maruti Suzuki* v. *ACIT*,[64] the Delhi High Court whilst remanding the matter to the TPO for fresh consideration, *inter alia*, held that if a domestic associate enterprise is mandatorily required to use the foreign trademark on its products, the foreign entity should make payment to the domestic entity on account of the benefit the foreign entity derives in the form of marketing intangibles from such mandatory use of the trademark. Certain other far-reaching principles on transfer pricing of trademarks and brands were set out. On appeal by the assessee, the Supreme Court, disposing off the appeal, observed:[64a]

63 (2010) 2 SCALE 493.
64 328 ITR 210 (Del.).
64a *Maruti Suzuki* v. *ACIT* (2011) 335, ITR 121 at 121-22 (SC).

> In this case, the High Court has remitted the matter to the Transfer Pricing Officer... with liberty to issue fresh show-cause notice. The High Court has further directed the Transfer Pricing Officer to decide the matter in accordance with law. Further, on going through the impugned judgement of the High Court dated July 1, 2010, we find that the High Court has not merely set aside the original show-cause notice but it has made certain observations on the merits of the case and has given directions to the Transfer Pricing Officer, which virtually concludes the matter. In the circumstances, on that limited issue, we hereby direct the Transfer Pricing Officer, who, in the meantime, has already issued a show-cause notice on September 16, 2010, to proceed with the matter in accordance with law uninfluenced by the observations/directions given by the High Court in the impugned judgement dated July 1, 2010.

It may be mentioned here that the judgment of the Punjab & Haryana High Court in *Coca Cola India Inc.* v. *ACIT*[65] was nullified in a similar manner.

XXX TRANSFER PRICING PROVISIONS SHOULD BE EXTENDED TO DOMESTIC TRANSACTIONS TO "REDUCE LITIGATION"

In *CIT* v. *Glaxo Smithkline (Asia)*,[66] the assessee did not have any employee other than a company secretary and all administrative services relating to marketing, finance, HR, *etc*. were provided by Glaxo Smith Kline Consumer Healthcare Ltd ("GSKCH") pursuant to an agreement under which the assessee agreed to reimburse the costs incurred by GSKCH for providing the various services plus 5 per cent. The costs towards services provided to the assessee were allocated on the basis suggested by a firm of CAs. The AO disallowed a part of the charges reimbursed on the ground that they were excessive and not for business purposes which was upheld by the CIT (A). However, the tribunal deleted the disallowance on the ground that there was no provision to disallow expenditure on the ground that it was excessive or unreasonable unless the case of the assessee fell within the scope of section 40A(2). It was held that as it was not the case of the department that section 40A(2) was attracted, the disallowance could not be made. The department challenged the deletion. The Supreme Court, dismissing the appeal, held that:[67]

65 309 ITR 194.
66 (2010) 195 Taxman 25 (SC).
67 *Id.* at 37.

A. The authorities below have recorded a concurrent finding that the said two companies are not related companies under s. 40A(2). As far as this SLP is concerned, no interference is called for as the entire exercise is a revenue neutral exercise. Hence, the SLP stands dismissed. For other years, the authorities must examine whether there is any loss of revenue. If the Authorities find that the exercise is a revenue neutral exercise, then the matter may be decided accordingly;

B. The larger issue is whether transfer pricing regulations should be limited to cross-border transactions or whether the transfer pricing regulations be extended to domestic transactions. In domestic transactions, the under-invoicing of sales and over-invoicing of expenses ordinarily will be revenue neutral in nature, except in two circumstances having tax arbitrage such as where one of the related entities is (i) loss making or (ii) liable to pay tax at a lower rate and the profits are shifted to such entity;

C. Complications arise in cases where the fair market value is required to be assigned to transactions between related parties u/s 40A(2). The CBDT should examine whether transfer pricing regulations can be applied to domestic transactions between related parties u/s 40A(2) by making amendments to the Act. The AO can be empowered to make adjustments to the income declared by the assessee having regard to the fair market value of the transactions between the related parties and can apply any of the generally accepted methods of determination of arm's length price, including the methods provided under transfer pricing regulations. The law can also be amended to make it compulsory for the taxpayer to maintain Books of Accounts and other documents on the lines prescribed in rule 10D and obtain an audit report from his CA that proper documents are maintained;

D. Though the court normally does not make recommendations or suggestions, in order to reduce litigation occurring in complicated matters, the question of extending transfer pricing regulations to domestic transactions require expeditious consideration by the Ministry of Finance and the CBDT may also consider issuing appropriate instructions in that regard.

XXXI TDS OBLIGATION U/S 195(1) ARISES ONLY IF THE PAYMENT IS CHARGEABLE TO TAX IN THE HANDS OF NON-RESIDENT RECIPIENT

In *Ge India Technology Centre Private Ltd* v. *Commissioner of Income Tax*,[68] the assessee, an Indian company, made remittance to a foreign company for purchase of software. The assessee took the view that the payment was not chargeable to tax in India and did not deduct tax at source under section 195. The AO & CIT (A) took the view that the payment constituted "royalty" and was chargeable to tax and that the assessee was liable u/s 201 for failure to deduct tax at source though this was reversed by the tribunal. On appeal by the department, the High Court reversed the Tribunal by taking the view in *CIT* v. *Samsung Electronics*[69] that the assessee was not entitled to consider whether the payment was chargeable to tax in the hands of the non-resident or not and had to deduct tax under section 195 on all payments. On appeal by the assessee, the Supreme Court, reversing the High Court, held:[70]

(a) Section 195(1) uses the expression "sum chargeable under the provisions of the Act". This means that a person paying interest or any other sum to a non-resident is not liable to deduct tax if such sum is not chargeable to tax. Also s. 195(1) uses the word 'payer' and not the word "assessee". The payer is not an assessee. The payer becomes an assessee-in-default only when he fails to fulfill the statutory obligation under section 195(1). If the payment does not contain the element of income the payer cannot be made liable. He cannot be declared to be an assessee-in-default;

(b) Section 195(2) applies where the payer is in no doubt that tax is payable in respect of some part of the remittance but is not sure as to what is the taxable portion. In that situation, he is required to make an application to the ITO (TDS) for determining the amount. Section 195(2) and (3) are safeguards and of practical importance;

(c) The department's apprehension that if tax is not deducted on all payments, there will be a seepage of revenue is ill founded because there are adequate safeguards in the Act to prevent the payer from wrongly not deducting tax at source such as section 40(a)(i) which disallows deduction for the expenditure;

68 (2010) 10 SCC 29.

69 (2010) 320 ITR 209 (Kar.)

70 *Id.* at 211.

(d) The Karnataka High Court in *CIT* v. *Samsung Electronics*[71] misunderstood the observations in *Transmission Corporation of AP*.[72] The only issue raised in that case was whether TDS was applicable only to pure income payments and not to composite payments which had an element of income embedded in them. The controversy was different and the court held that if some part of the payment was taxable, an application under section 195(2) had to be made. The High Court's interpretation completely loses sight of the plain words of section 195(1) which in clear terms lays down that tax at source is deductible only from "sums chargeable" under the Act, *i.e.* chargeable under sections 4, 5 and 9;

(e) As the High Court had not decided the question whether the payments for supply of software was "royalty" or not, the matters are remitted to the High Court for a decision on that point.

The court in giving the above judgment followed *CIT* v. *Cooper Engineering*,[73] *C.I.T.* v. *Eli Lilly & Co. (India) (P.) Ltd*[74] and *Vijay Ship Breaking Corporation* v. *CIT*.[75] The court distinguished the case of *Transmission Corporation of A.P. Ltd*. v. *C.I.T.*[76]

71 *Supra* note 69.
72 (1999) 239 ITR 587 (SC).
73 (1968) 68 ITR 457 (Bom.).
74 (2009) 312 ITR 225 (SC).
75 (2009) 314 ITR 309.
76 *Supra* note 72.