13
DIRECT TAX LAW (INCOME TAX)

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I INTRODUCTION

THE YEAR under review has seen the reiteration of certain well settled principles in the areas of capital gains on transfer of shares (involving cases of foreign corporate entities). The courts have significantly taken note of transfer of capital assets within the territory of India, regardless of any arrangements through which such transfers take place and have correctly held that income accruing on such transfers would be taxable.

While deliberations are on, to secure a solution to the Vodafone issue, it may be noticed that the Supreme Court very creatively explained the principle of "significant nexus with India" for the purpose of dealing with transactions occurring outside India but directly related to parties in India. The decision of the Supreme Court has struck a much required balance between comprehending tax evasion and understanding tax avoidance.

The case in *Commissioner of Income Tax-I, Chennai* v. *M/s. Tube Investments of India Ltd-I,Chennai*[1] has rendered the apt outcome in favour of an assesse who ventures to take over the management of a sick company and seeks the benefit under section 43 B. By granting the benefit of section 43 B to the assesse towards provision of rehabilitation schemes, the court has come closer to understanding, that the freedom to innovate, while embarking on risky ventures or socially relevant rehabilitation of sick companies deserve to be kept in mind.

In the domain of acquisition of software, courts have considered the relevance of the application of the "enduring benefit test" and the need for a modified approach having regard to technology developments. On the question of the scope of *explanation* 1 to section 32, it appears that the Karnataka High Court's view under review may involve clarification from the Supreme Court.

The issue of registration and cancellation thereof of charitable institutions continues to be a vexed issue and it appears that there is a need for greater latitude in the law relating to the charitable institutions, regardless of the fact that there could always be bad apples. The year under review also saw an important decision

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1 [2012] 341 ITR 199 (Mad)

rendered by the Authority on Advance Ruling in *Citrix Systems Asia Pacific Pvt. Ltd.* v. *Director of Income Tax*.[2] This case involves the determination of the nature of the licensing of a software product and whether the payment for licensing would not be royalty or otherwise within the meaning of section 9(1) (vi) of the Act.

II GENERAL PRINCIPLES

Principle of mutuality

The principle of mutuality relates to the notion that a person cannot make a profit from himself. An amount received from oneself is not regarded as income and is therefore not subject to tax. The concept of mutuality has been extended to defined groups of people who contribute to a common fund, controlled by the group, for a common benefit. Any amount surplus to that needed to pursue the common purpose is said to be simply an increase of the common fund and as such neither considered income nor taxable. What is the nature of interest on the surplus? The interest earned on the surplus funds by the group has been perceived differently by different courts/tribunals. Some courts/tribunals have held that the interest earned would be covered under the principle of mutuality and therefore allowable to deduction while computing income, whereas others have held it to be tainted with commercialism and disallowed deduction. Is there a statutory basis for this view? Is this view an undue extension of the enacted law?

In *CIT* v. *Secunderabad Club Picket (A.P.)*[3] assessee was a recreational club. It made deposits with some banks which were its corporate members and earned interest on such deposits. The high court held that the principle of mutuality ended the moment the club deposited the amount with sole aim of earning interest on the deposits. The court reasoned that by depositing funds with the corporate member banks, a club would help increase the business of the bank. The bank is shown a favour and not provided with a facility by the club.

The Appellate Tribunal, (Cuttak) has taken opposite view in *Asst. Commissioner of Income-tax Circle 1(1), Bhubaneswar* v. *M/s Bhubneswar Club Ltd., A.G. Square, Rajpath, Bhubaneswar*[4] by holding that the principle of mutuality applied as well to the interest earned on the surplus money invested in banks. The appellate tribunal relied on the decision of the High Court of Delhi in *Delhi Gymkhana Club Ltd.,* v. *DCIT*[5] wherein referring to the memorandum and articles of association of the assessee, which empowered the management to invest and deal with the surplus moneys of the club the high court held that the activities of the assessee-club is not tainted with commerciality and cannot be excluded from the principle of mutuality.

The tribunal fell into an error by holding that principle of mutuality applied to the surplus finds of the club deposited with the bank because the transaction was in violation of the conditions of mutuality according to which the moneys should be

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2 [2012] 343 ITR 1.

3 [2012] 340 ITR 121 (AP).

4 MANU/IF/0003/2012, ITA No. 415/CTK/2011&ITA No. 424/CTK/2011, decided on 13.01.2012.

5 2010 131TTJ (Del) 329.

used only for the fulfillment of the purposes of the club and should not be tainted with commerciality. This position has been later clarified by the Supreme Court in *Bangalore Club* v. *Commissioner of Income Tax.*[6] In *Bangalore Club* v. *Commissioner of Income Tax,* the Supreme Court took the same view as that of the Andhra Pradesh High Court in *CIT* v. *Secunderabad Club Picket (A.P.).* The Supreme Court held that the transaction of depositing surplus amount with banks fails to satisfy the four conditions of mutuality.

First, the arrangement lacks a complete identity between the contributors and the participators. The money deposited by the club with the corporate member *i.e.*, banks is used by the banks to advance loans to their clients rupturing the 'privity of mutuality'. *Secondly*, to claim tax exemption, the surplus funds must be used in furtherance of the object of the club which was not done in the present case. The utilization of funds by depositing them in with the bank lacked the degree of proximity between the club and its members and cannot be categorized as an activity of the club in pursuit of its objectives even though it may indirectly benefit the club. The *third* condition is that the funds contributed by the members should be expended on them or returned to them. The money in the present case is given by the bank to its client for commercial purpose before returning it to the club which breaks the link of mutuality and violates the third condition. Thus any snapping of any of the links of mutuality would exclude the benefit of mutuality principle and accruals would qualify for being treated as income.

Binding nature of board's instructions

Can the board issue circulars and even grant benefits seen to be beyond the statutory enactment. Such circulars may be binding on the revenue. But, what if the circular passed is contrary to the law?. Can such a circular be challenged by the revenue? In all circumstances the circular passed by the board must be in consonance with the law and when the doubts exist the revenue can file an appeal or challenge the same and decisions of the courts will prevail in all cases. This rule was followed in *CIT* v. *Nagesh Knitwears P. Ltd.*[7] The circular dated 23.02.98 in this case was issued by the central board for direct taxes to joint secretary, Prime Minister Office, stating that the premium received on export quota can be equated with items mentioned in section 28(iiia) to 28(iiic) *i.e.,* profit on sale of import license, cash assistance and duty drawback. Relying on this circular the assesse claimed benefit under the proviso to section 80HHC (3) of the Income Tax Act. The circular was contrary to the provisions of the Income Tax Act because section 28(iiia) to 28(iiic) only covers profit on sale of import license, cash assistance and duty drawback and premium on sale of export license would be covered under section 28(iv) being the benefit earned by the assesse arising from the business. On appeal by the revenue the high court held that the circular dated 23.02.98 is beyond the provisions of the Act and hence not binding. The premium on sale of export quota thus not falling within the scope of section 28(iiia) to 28(iiic) the benefit of proviso to section 80HHC (3) cannot be given to the assesse.

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6 (2013)255CTR(SC)465.

7 [2012] 345 ITR 135(Delhi).

Revenue or capital expenditure

Acquisition of software

The issue of identification of nature of expenditure is an issue of fact dependent upon real intent and the purposes for which the expenditure is incurred. Even though the test of enduring benefit is still the predominant test to identify the nature of expenditure, there appears a move away from the application of this test. The decision of Delhi High Court in *CIT* v. *Asahi India Safety Glass Ltd.*[8] is an illustration on the point. The assesse in this case was in the business of manufacturing safety glass used in automobiles. The assesse bought 'license to use' and got software installed pursuant to an agreement with an accounting and consulting firm. The assesse claimed a certain amount paid towards software and professional expenses as revenue expenditure. The revenue argued that expenditure incurred was of a capital nature as it would endure to the benefit of the assessee for a long period of time. Rejecting this argument, the high court held:[9]

> It is trite to say that the test of enduring benefit is not a certain and conclusive test which the courts can apply almost by rote. What is required to be seen is the real intent and purpose of expenditure and whether the expenditure results in creation of fixed capital for the assessee.

Acquisition of software was held to be revenue in nature by the Punjab and Haryana High Court as well in *Chief CIT* v. *O.K. Olay India Ltd.*[10] but the court relied on the 'enduring benefit test'. The reason given by the high court was that degree of endurability and permanence cannot be attributed to computer softwares, which is a fast changing area of science. When conceptually the enduring benefit test cannot be applied to the acquisition of assets in the virtual world, can there be any other test?.

Repair and restoration of buildings

The issue of nature of expenditure also came up with respect to repair/restoration of buildings. In *CIT* v. *Talathi and Panthaky Associated P. Ltd.*,[11] where an assessee secured tenancy rights in respect of a floor in a building in its possession by assuming obligations towards repairs and restoration work on the condition that the rent payable by the assesse would not be increased, the expenditure was rightly held to be revenue in nature. The high court reasoned that the expenditure did not result in acquisition of a capital asset but only resulted in a commercial advantage of securing long term tenancy by the assessee. In *CIT* v. *Voith Paper Fabrics India Ltd.*[12] expenditure on laying down of stones and bricks on the pre-existing uneven roads in the premises of the manufacturing unit was held to be revenue is nature because it merely facilitates the carrying of existing business more efficiently and the assessee did not acquire any new building or road.

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8 [2012] 346 ITR 329(Delhi).

9 *Id.*, para 9.

10 [2012] 346 ITR 57 (P&H).

11 [2012] 343 ITR 309 (Bom).

12 [2012] 346 ITR 70 (P&H).

Renovation of buildings

As stated earlier that there are no thumbs rules for distinguishing capital expenditure from revenue expenditure.Various tests can be applied based on the different facts and circumstances of the case. The extents of possible rules have been summarized as given below by the High Court of Karnataka in *CIT* v. *H. P. Global:*[13]

i. The aim and object of the expenditure would be determining the character of expenditure.
ii. When expenditure is made for acquiring or bringing into existence an asset or advantage of enduring benefit of the business, it is properly attributable to capital and is capital expenditure.
iii. If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conducting the business more efficiently or more profitable, leaving the capital untouched, the expenditure would be on revenue account
iv. When the expenditure is incurred while business is going on and not for the extension of the business or for substantial replacement of its equipment, it would be revenue expenditure.

Relying on these principle, the high court held the amount spent on providing wooden partition, painting of leased premises, carrying out repairs to make the premises workable, *etc.,*were held to be revenue expenditure.

But with respect to expenditure incurred towards civil works in the leased premises other factors like nature of construction put up, purpose of the construction and the use to which such construction is put up will have to be considered to classify the expenditure as revenue or capital. Beside this it is also to be seen whether it is a case of repair, replacement, addition or improvement. Again in the context of emergence of new technologies and styles/designs of construction materials etc. it will be a moot question as to what combination of the above factors would be appropriate?.

This is so because as per the *Explanation* 1 to section 32(1), a legal fiction is created that when an assessee carries on his business in leased premises and any capital expenditure is incurred on the construction of any structure or doing of any work in or in relation to and by way of renovation or extension or improvement of the building then the lessee would be treated as owner of the premises for the purpose of section 32 and depreciation would not be allowed. High court applying the same analogy of 'civil works' to 'electrical works' and 'interior decoration' remanded the case back to look into the detailed facts and purpose of electrical works and interior decoration carried on by the assesse to arrive at the conclusion as to nature of expenditure. The decision in the case of *CIT* v. *Madras Auto Service P. Ltd.*,[14] was also brought to the notice of the high court wherein the Supreme Court on similar facts held that when the asset created belonged to someone else

13 [2012] 349 ITR 462 (Karn).
14 [1998] 233 ITR 468 (SC): (1998) 6 SCC 404.

and the expenditure does not bring into existence any capital asset for the company. Even though the company derived an enduring business advantage to the company the expense has to be looked upon as having been made for the purpose of conducting the business of the assesse more profitably. The present case can be distinguished from *CIT* v. *Madras Auto Service P. Ltd.,* because in this case the Supreme Court did not refer to *Explanation* 1 to section 32 of the IT Act.

The question that would arise for consideration is that how far can, the scope of *Explanation* 1 to section 32(1) can be stretched? Was the high court justified in extending the analogy of 'civil works, as per *Explanation* 1 of section 32 to 'electrical works' and 'interior decoration'? The high court should have looked at the purpose of *Explanation 1*. From a bare perusal of the *Explanation 1* it seems that it has been included to disallow deductions to lessee for major modifications made to the structures so as to cause substantial improvement or extension to the building. The explanation does not contemplate minor improvements. If laying down of stone and tiling of the floor can be treated as revenue expenditure as held by the High Court of Punjab and Haryana (*Voith Paper Fabrics India Ltd.)* then why cannot expenses incurred in electrical works in a building be not revenue in nature when the expenditure does not bring into existence any capital asset for the assesse. The issue needs further clarification by the Supreme Court since the Supreme Court in *CIT* v. *Madras Auto Service P. Ltd* did not have an opportunity to consider and interpret the scope of *Explanation* 1 to section 32 of the IT Act.

Payment to relocate slums from area around the airport

The issue that arose for consideration in *Airports Authority of India* v. *CIT*[15] was whether the expenditure incurred by the assessee for removing of encroachers in and around the technical area of the airport would be capital or revenue in nature. The full bench of the Delhi High Court held the expenditure incurred by AAI (Airport Authority of India) to be revenue in nature because the assesse had not made the payments for acquisition of new assets rather it was made to facilitate smooth functioning of its business *i.e.,* in relation to removing disability and carrying out the business in a more profitable manner.

Business expenditure

Expenditure primarily denotes the idea of 'spending' or 'paying out or away': it is something which is gone irretrievably. Section 37(1) of the Income Tax Act provides for deduction for business expenditure, the same is a residuary section. What would come under the ambit of 'expenditure' so that deduction could be claimed depends on the facts and circumstances of each case. In *Commissioner of Income Tax* v. *Khemchand Motilal Jain*, *Tobacco Products Ltd*.,[16] the issue was, whether ransom being paid to the kidnappers after kidnapping one of the director's of the company would be included in 'expenditure' under business expenditure since the same is incidental to business. The court held that the same was business expenditure, since the director was kidnapped while he was on a tour to obtain 'tendu leaves' for the manufacture of the product (biddi) of their business.

15 [2012] 340 ITR 407 (Delhi) [FB].

16 [2012] 340 ITR 99 (MP).

Whether one-time allowance of rebate would be included as deduction towards business expenditure? In *CIT* v. *Housing Board, Haryana*[17] wherein one time allowance rebate was claimed by the assessee to the tune of Rs. 7 crores, the same was authorized at the time of making by board of directors via a resolution, the court held that:[18]

> the said decision to allow the rebate by the board of directors was a commercial decision, relevant to the assessment year, hence allowed to be deducted. The fact that it was a one-time deduction by itself could make no difference, if it is a rebate of trading nature. The need to recognize the freedom involved in taking commercially relevant decisions is within corporate domain, unless extraneous factors are present, is to be emphasized.

Since the law allows expenses only for business, retrenchment compensation would not be deductible. But in cases where the assessee has discontinued its manufacturing activity but still continued with its trading act's, following the rationale by the Supreme Court in *NarainSwadesh weaving Mills* v. *CEPT*,[19] the high court held such expenditure cannot be disallowed as capital expenditure and would be deductible under section 37 of the Act.[20]

In a situation, wherein the assessee takes over the management of the sick company based on the scheme under Sick Industries Companies (Special Provisions) Act, 1985, whether the assessee is entitled to the benefit under section 43B?. In *Commissioner of Income Tax-I, Chennai* v. *M/s. Tube Investments of India Ltd-I, Chennai*[21] it was held thus:[22]

> the contention of the Revenue that the rehabilitation scheme has not specifically directed the allowing of deduction under Section 43B cannot be accepted, as such the benefit should be dealt with in the scheme itself, the assessee would be entitled to the benefits and the scheme should be construed only keeping in mind the rehabilitation measure. Again the freedom to innovate while embarking on risky ventures or socially relevant rehabilitation of sick companies deserves to be kept in mind.

Due to the play of sections 30 and 37of the Act, there needs to be a demarcation of expenditure whether the same is capital or revenue expenditure. The demarcation seems to be very thin, and precise rules for distinguishing capital expenditure from revenue expenditure cannot be formulated. The true test of the character of expenditure is the aim and objective of the expenditure. When expenditure is made for acquiring or bringing into existence an asset or an advantage for the enduring benefit of the business, it is properly attributable to capital expenditure and is of

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17 [2012] 340 ITR 67 (P&H)

18 *Id.*, para 2.

19 [1954] 26 ITR 765

20 *CIT* v. *KJS India P. Ltd.* [2012] 340 ITR 380 (Delhi).

21 *Supra* note 1.

22 *Id.*, para 12.

the nature of capital expenditure. if, on the other hand, it is made not for the purpose of bringing into existence any such asset or advantage but for running the business or working it with a view to produce profits it is a revenue expenditure.[23] The same follows that if repairs are done by a tenant in his tenanted premises the same would not be done beyond his likely period of tenancy or to create a new asset. In *Commissioner of Income Tax* v. *H.P.Global Soft Ltd*.[24] Wherein the issue arose was that whether 'repairs' done by the lessee would amount to 'capital expenditure' of not. The assessing officer held that the same came under the ambit of revenue expenditure, while the tribunal held it to be capital expenditure. The high court while dismissing the above orders referred to *Explanation 1* to section 32(1) which states:[25]

> Where the business or profession of the assessee is carried on in a building not owned by him but in respect of which the assessee holds a lease or other right of occupancy and any capital expenditure is incurred by the assessee for the purposes of the business or profession on the construction of any structure or doing of any work in or in relation to, and by way of renovation or extension of, or improvement to, the building, then, the provisions of this clause shall apply as if the said structure or work is a building owned by the assessee.

The court held that the amount so spent on leased premises of carrying out repairs so as to make the premises workable, to replace glasses *etc.,* has to be considered revenue expenditure and hence exempted.

III CAPITAL GAINS

Self-generated asset

How do you deal with the capital gains dimension of sale of a trademark for consideration which is a self-generated asset in a case where the transaction was effected before the amendment to section 55 (2) by the Finance Act, 2001? The High Court of Bombay in *CIT* v. *Fernhill Laboratories and Industrial Establishment*[26] held that cost of acquisition of design was not defined and therefore it cannot be charged under the head of capital gains. The high court followed the decision in *CIT* v. *B.C. SrinivasaShetty*,[27] where it was held that self-generated assets are not taxable under the head of capital gains. This position has been altered by the amendment made to section 55 (2) by the Finance Act, 2001, which specifically allows for computation of any gain achieved through sale of trademarks, which the court held would be applicable from the financial year commencing from 1.04.2002. Since the transaction had occurred before such amendment had been effected, the high court rightly held in favour of the assesse. The inclusion or exclusion of

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23 Assam Bengal Cement Co. Ltd [1955] 27 ITR 34 (SC).

24 *Supra* note 13.

25 *Id.*, para 16.

26 [2012] 348 ITR 1 (Bom).

27 [1981] 128 ITR 294 (SC).

catagories of gains, may not however necessarily be grounded on strict logic. The artificiality of exclusion/inclusion may have to be carefully weighed.

Capital gains regarding property

The question of whether reinvestment in property is subject to tax on capital gains in the event that the property is not in the name of the assesse came up before the high court of Karnataka in *DIT (International Taxation)* v. *Mrs. Jennifer Bhide.*[28] The assesse was a non-resident individual who had purchased residential property after affecting a sale of another residential property; the subsequent property was purchased in her name and in her husband's name. The husband was a co-owner even though he had not contributed in any way to the purchase of the property. The high court, on the facts and in the circumstances of the case, rightly affirmed the view taken by the tribunal and held that in so far as the monies invested is from the sale consideration and it is shown that the husband has not invested any of his monies, the mere fact that his name was registered as a co-owner would not entitle him to any rights, and thereby would not disentitle the assesee from claiming benefit of deduction of the amount.

Vodafone

The Supreme Court in *Vodafone International Holdings B.V.* v. *Union of India (UOI*)[29] has largely reiterated the existing law in this decision. The expansive judgment has harmoniously read the judgments in *Mcdowell* and *Azadi*, and it is submitted that the Supreme Court has rightly interpreted these decisions. The decision of the Supreme Court has struck a much-required balance between comprehending tax evasion and understanding tax avoidance. The question of whether transactions occurring outside India, by parties situated outside India could be taxed by the authorities in India, came up for consideration before the Bombay High Court in *Vodafone International Holdings BV*. The Bombay High Court influenced by the jurisdictions in countries like Australia, Italy, New Zealand held that in so far as there exists "significant nexus with India", the transactions could be taxed by the Indian authorities. It is submitted that the view taken by the Bombay High Court was erroneous. If the view taken by the Bombay High Court was accepted, then any entity having an interest in India, either through investment in shares or in companies, would be amenable to taxation in India regardless of whether they intended their transactions abroad to have any bearing in India or otherwise, in so far as the taxing authority could demonstrate that there was a bearing in India.

While, this would seem to be an attractive proposition, it has the negative consequence of corporations limiting their investments in India and in Indian companies, in order to avoid the taxing authority. The contention of the revenue that the term "any person" would include a foreign company, and that the series of transactions between the parties was affected to transfer ownership of an Indian entity from one corporation to another, with the sole intention to avoid taxation in India also seems plausible. However, the contentions advanced in favour of the revenue, as rightly held by the apex court, fail to take into consideration that no

28 [2012] 349 ITR 80 (Karn).

29 (2012) 341 ITR 1 SC; (2012) 6 SCC 613.

income arose or accrued in India as a result of these transactions, whether directly or indirectly. The decision of the Bombay High Court in *Aditya Birla Nuvo Ltd.* v. *Deputy Director Income Tax (International Tax)*[30] where the Bombay High Court held that the investment made in India through an agent residing in Mauritius, with the intention of selling the shares to an Indian entity would be taxable in India, is consistent with the reasoning of the Supreme Court.

The decision of the Supreme Court was also based on the factual nature of the transactions in question. The onus was on the revenue to prove that the transactions were merely to avoid tax and lacked commercial substance, this was in the event that it possessed the locus to tax these transactions, however, the revenue could not discharge this burden as *Vodafone* was able to demonstrate that the transactions entered into were in pursuance of legitimate commercial interests.

The leeway provided to the taxing authorities to investigate whether transaction entered into between "persons" were with the sole intention to avoid tax has been maintained, while genuine commercial transactions have been provided the benefit of exemption from tax. The court thus avoided the temptation to prescribing rigid principles. The tax evader's ingenuity keenly follows the tightness and spread of the law. Hence the taxing authority has to be vested with the freedom to smell where things go wrong and here the interpreter's task becomes delicate.

Capital gains on transfer of shares (as an agent of non resident)

Where the control of shares is with 1st company and is named under the other company, the court has held that such capital gains would accrue to the company which has a control over it. In the case of *Aditya Birla Nuvo Ltd*. v. *Deputy Director of Income Tax*[31] on 05.12.95, U.S. Co. (then, AT&T Corp / AT&T Wireless Services Inc., U.S.) and the Birla Group2 ("Birla") entered into a joint venture ("ICL" or "JV") for carrying on wireless telecommunication in India. The agreement between the parties provided the shares in ICL shall be held by the 'founders' in their own name or through a 'permitted transferee' *i.e.,* any corporation which is a wholly owned subsidiary of the founder of ICL. Accordingly, Mauritius Co. subscribed to the shares of ICL and such investment was made after seeking an approval from the Reserve Bank of India ("RBI"). However, as stipulated in the JV agreement, all rights in respect of the said equity shares (voting rights, rights of management, right of sale or alienation *etc*.) vested in U.S. Co. It may be noted that subsequently TIL also subscribed to the shares of the JV Co. and on 15.12.00, a shareholder agreement ("SHA") was entered into between U.S. Co., Birla and TIL, whereby there was a change in the shareholding.

In 2005, Birla and TIL were desirous of purchasing the entire 74,35,61,480 equity chares of ICL offered by U.S. Co. for USD 30 million, and it was agreed that each party could get 37,17,80,740 equity shares of ICL on payment of USD 150 million. Therefore, on 28.09.05, Indian Rayon (now Aditya Birla Nuvo Limited, representing the Birla Group) pursuant to a sale and purchase agreement ("SPA") purchased 37,17,80,740 equity shares of ICL from M Co. and U.S. Co. for US$ 150 million. Further, TIL entered into an agreement on the same day for acquiring

30 [2012] 342 ITR 308 (Bom).

31 [2012] 342 ITR 308 (Bom).

the entire issued and paid up share capital of M. Co. from U.S. Co.

As a result, the issue in question is whether the said ICL shares were owned by M Co. or by U.S. Co. According to the Revenue, the said shares were owned by U.S. Co. and the capital gains arising or accruing there from is taxable in India either in the hands of U.S. Co. or in the hands of Indian Rayon as an agent of U.S. Co. under section 163(1) of the Income Tax Act, 1961 ("Act"). Additionally, TIL was sought to be treated as an assessee in default, since it failed to deduct tax as required under the provisions of the Act before making a payment to U.S. Co. for the purchase of shares of M Co. on the grounds that it represented a sale of shares of ICL by the U.S. Co.

The main issue was that whether any income chargeable to tax in India accrued or arose to U.S. Co. on account of US$ 150 million paid by Aditya Birla Nuvo Limited to AT&T Mauritius ("M. Co.", a wholly owned subsidiary of U.S. Co.) for the sale of about 16% stake in ICL and the subsequent consideration paid by Tata Industries Ltd. to U.S. Co., for acquiring the M Co. which held the remaining 17% interest in ICL.

What was contended was that the beneficial ownership accrued only the M.Co. therefore applying India – Mauritius Tax Treaty ("Treaty") the capital gains accruing to M. Co. shall be taxable only in Mauritius and therefore there is no question of treating Indian Rayon as a representative assessee while the revenue authorities argued that the allotment of ICL shares in the name of M. Co. was only in the capacity of a permitted transferee of U.S. Co., and that M. Co. was not conferred any ownership rights relating to the shares. The court held thus:[30]

> In our opinion, the fact that the shares of the JV stood in the name of AT&T Mauritius did not make AT&T Mauritius the legal owner of the shares because in the present case, allotment of shares of the JV was to the JV partner, receipt of the shares of ICL by AT&T Mauritius was on behalf of the JV partner and the sale of the said shares was from one JV partner another JV partner under the JV Agreement / Shareholder Agreement.

In light of the above, the court held that the income accruing or arising in India to U.S. Co. on transfer of a capital asset situate in India, (sale of shares of ICL to Indian Rayon) would be income deemed to accrue or arise in India to U.S. Co. and can be assessed in the hands of the U.S. Co. or in the hands of Indian Rayon as an agent of the non-resident under section 163 of the Act.

IV PROPERTY LAW

Conveyance of title- when

Transfer of property through sale agreement, GPA (General power of Attorney) sale or Will transfer (SA/GPA/Will transfer) have become commonplace. In order to evade income tax, wealth tax, stamp duty and registration fees these methods of transfer of property are used very often. Such transfers do not confer any right, title or interest in an immovable property on the purchaser and are outside the purview

32 *Id.*, para 50.

of section 54 of the Transfer of Property Act. According to Transfer of Property Act, transfer of immovable property can only be made by a registered instrument. The requirement of registration is mandatory to provide safety and security to the transactions and to give public exposure to the document in order to prevent forgeries and frauds in relation to transactions and execution of documents. Section 53 of Transfer of Property Act recognizes possession in pursuance of an agreement which only confers limited right to safeguard the right of the person in possession against the owner. Similarly Power of Attorney is only a device to obtain specific performance or to defend possession but does not amount to transfer. This proposition has been confirmed by the Supreme Court in *Suraj Lamps & Industries P. Ltd* v. *State of Haryana & Another*[33] where the court expressly held that SA/ GPA/Will transfer do not convey any title nor creates any interest in an immovable property and that it can be legally and lawfully transferred/ conveyed only by a registered deed of conveyance.

Minimum alternate tax

Deduction under section 80HHC in a case where section 115JA is applicable

Wherein normal computation assesse brings forward previous year's losses and adjusts it against current year's profit leaving no net profit, he will not be entitled to further deduction under section 80HHC. This proposition is clearly explained by the Supreme Court in *CIT* v. *Bhari Information Tech. Sys, P. Ltd.*[34] The court held that as per the law, adjusted book profit is amenable for further deductions on specified grounds under section 80HHE.Computation for deduction under 80HHC is to be worked out not on the basis of regular income tax (*i.e.,* profit and loss of the business) but it has to be worked out on the basis of adjusted book profits in a case where sections 115J and 115JA are applicable.

Carrying forward losses or unabsorbed depreciation

The issue in *CIT* v. *Madras Fertilizers*[35] was whether the assesse would be allowed to carry forward losses or unabsorbed depreciation from previous year for computation of next year's profit. It was held by the Madras High Court that when the unabsorbed depreciation had already been adjusted towards the general reserves of the previous year and dividend had been declared, there remained no loss or unabsorbed depreciation to be carried forward. Hence, no adjustment was possible in computation of profit for the next year in terms of section 205(1) (b) of the Companies Act.

Reduction of amount withdrawn from revaluation reserve

The issue in *CIT* v. *SRF Ltd.*[36] was whether the assesse can be permitted to reduce the amount withdrawn from revaluation reserve if in the first instance it was created not by crediting any amount to the profit and loss account but to the revaluation reserve account. It was held by the High Court of Delhi that the intention of the legislature in inserting clause (i) appended to the *Explanation* to section

33 [2012] 340 ITR 1(SC).
34 [2012] 340 ITR 593 (SC).
35 [2012] 341 ITR 609 (Mad).
36 [2012] 342 ITR 106 (Delhi).

115J is to counter a situation where a credit is made to a profit and loss account in the first instance at the time of creation of the reserve thereby increasing the book profits. When on revaluation the amount is withdrawn from the reserve it stands squared off by reducing the amount from the book profit. When no such credit is made to the profit and loss account the assesse cannot be allowed reduction in the amount. The opinion of the court is further supported by the "Memorandum Explaining the Provisions in the Finance Bill, 1989" clearly indicated that the reduction of amount withdrawn from the reserves created or provisions made was only available if such an amount in the first instance have been credited to the profit and loss account. Same view has been taken by Madras High Court in *CIT* v. *W.S. Industries (India) Ltd.,*[37] wherein relying on the decision of the SC in *Indo Rama Synthetics (I.)Ltd.* v. *CIT*[38] and High Court of Delhi in *CIT* v. *SRF Ltd*. the high court held that if at the time of the creation of reserve, the same is not referable to the profit and loss account; but to the balance-sheet, in the computation of book profit, the assesse cannot be allowed to reduce the withdrawal from the revaluation reserve account.

Prior period expenses

Whether for the purpose computation under section 115JA, the prior year's expenses be deducted when the same was not debited in the profit and loss account?. This issue came up for consideration before the High Court of Madras in *Tamil Nadu Cements Corporation Ltd.* v. *Joint CIT.*[39]The high court relied on the decision in *CIT* v. *Khaitan Chemicals and Fertilizers Limited* wherein the High Court of Delhi stated that prior period items are income or expensed which arise in the current period as a result of errors or omissions in the preparation of the financial statement of one or more prior periods and are to be included in the determination of net profit and loss. It was therefore held that prior period items form part of the net profit or loss and thus assesse would be entitled to adjustment (deduction) of prior period expenses in computing the net profits

Applicability of advance tax

The issue whether profit on sale of fixed assets formed part of book profit under section 115JA of the IT Act arose in *GKW Ltd.* v. *CIT.*[40] Following the decision of Supreme Court in *Joint CIT* v. *Rolta India Ltd.*,[41] the high court held that the profit on sale of fixed assets was held to form part of book profit under section 115JA of the IT Act. The high court also relied on the provisions of the Companies Act 1956 and observed thus:[42]

> where in case of an assesse being a company, total income in the previous year commencing on or after 01.04.97 but before 01.04.00, is less than 30 % of its book profit, the total income of such assesse chargeable to tax for

37 [2012] 342 ITR 231 (Mad).
38 [2011] 330 ITR 363 (SC).
39 [2012] 349 ITR 58 (Mad).
40 [2012] 347 ITR 429 (Cal).
41 [2011] 330 ITR 470 (SC).
42 Companies Act, 1956.

> the relevant previous year shall be deemed to be an amount equal to 30% of such book profit. The assesse shall prepare its profit and loss account for the relevant period in accordance with the provisions of parts II and III of the Companies Act, 1956. Under clause 2 of part II of schedule VI to the Companies Act, where a company receives an amount on account of surrender of leasehold rights, it is bound to disclose in profit and loss account the said amounts as non-recurring transaction or a transaction of exceptional nature, irrespective of its nature whether revenue or capital. Under clause 2(b) of part II of schedule VI to the Companies Act, the profit and loss account shall disclose every material feature including credits or receipts and debits or expenses in respect of non-recurring transaction or transactions of an exceptional nature which includes profit on sale of fixed assets.

Another issue that was settled in *CIT* v. *Rolta India Ltd.*[43] was whether provisions of section 234B and 234C for levy of interest would be applicable in case of MAT companies when no advance tax had been deducted. Therein it was held that in view of specific provisions under section 115JA and 115JB of the IT Act, 1961, to the effect that all other provisions of the Act shall apply to the MAT company and amendments have been made in the relevant finance Acts for payment of advance tax under sections 115JA and 115JB of the Act and section 234B applies to all companies there is no exclusion of section 115J/115JA in the levy of interest under section 234B.

The same ratio was followed by the High Court of Karnataka in *CIT* v. *Kaveri Telecoms Ltd.*[44] the high court held that when the assessment was made under section 115J and 115JA and no advance tax had been deducted, the provisions of sections 234B and 234C would be applicable

Provision for bad debt

The issue whether the provision for meeting 'liabilities' other than ascertained liabilities as mentioned in clause (c) of explanation to Sub-Section 1A of section 115JA would include 'bad and doubtful debts' arose in *ICI India Ltd.* v. *CIT (Appeals)*.[45] The assesse which is an incorporated company carrying on the business of manufacturing and trading in paint filed returns for a period of 18 months from 01.10.87 to 31.03.89 corresponding to assessment year 1989-1990. The assessing officer after issuing notice under section 154 recomputed the profit under section115J of the Act by adding back the provision for bad and doubtful debts and advances. The assessee contended that the clause (c) of explanation to sub-section 1(A) of section 115J of the Act required adding back of the amount provided to meet the liabilities other than ascertained liabilities to calculate the book profits and the provision for bad and doubtful debts and advances which is for diminution in the value of the assets is not a provision to meet the liabilities which is not an ascertained liability, such contention was not accepted by the assessing officer.

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43 [2011] 330 ITR 470 (SC)

44 [2012] 347 ITR 365(Karn).

45 [2012] 347 ITR 442 (Cal).

The court distinguished between debt receivable and debt payable by assesse. While holding that the debt receivable by the assesse cannot be said to be a provision for a liability, the high court relied on the decision of Supreme Court in *CIT* v. *HCL Comnet Systems and Services Ltd*.[46] wherein it was held that the provision for bad and doubtful debt, is made to cover up the probable diminution in the value of the asset, *i.e.,* debt which is an amount receivable by the assessee. Therefore, such a provision cannot be said to be a provision for a liability, because even if a debt is not recoverable no liability could be fastened upon the assessee.

V CHARITABLE INSTITUTIONS

Registration and cancellation

The term charitable institutions has not been defined, however, section 12 of the Act, provides for registration of charitable institutions, while section 11 provides for exemption of income from property held for charitable or religious purposes.[47] There seemed to be confusion regarding the activity of publication of magazines, and whether they could be said to be for "educational purpose", this issue arose before the High Court of Andhra Pradesh in *CIT* v. *VijayaVani Educational Trust*.[48] The Andhra Pradesh High Court followed its own judgment in *Aurora Educational Society* v. *Chief CIT*[49] and the judgment of the Supreme Court,[50] and held that the trust satisfies the test of 'pre-dominant object' previously laid down, and the running of the magazine was ancillary to the main object, and hence the trust was eligible for exemption under section 11.

Even otherwise, the activity of publication of books has been held to be charitable in nature, even though the books were of professional interest to be used as a reference material by general public including professionals'.[51] The books in this case were published by a society known as "The Chartered Accountants Study Circle".The society was further involved in conducting courses and seminars and these activities along with publishing and selling books of professional interest could only be construed as a part of on going education of chartered accounts (Sic), as held by the tribunal.[52] The department's claim that the activities of publishing and selling to the general public as well as to the professionals amounted to trade or commerce as per the amended section 2 (15) of the Income Tax Act, 1961 was negatived by a division bench of the High Court of Madras. The high court, rightly, held that the books were also made available for sale to the general public aiming to help the society to get better, well-equipped and skilled set of chartered accountants for maintaining audit quality. There is no reason as to why the same rationale cannot be applied to other organisations, even if they are, merely, publishing

46 [2008] 305 ITR 409 (SC)

47 Income Tax Act, 1961.

48 [2012] 349 ITR 280 (AP).

49 [2011] 339 ITR 333 (AP).

50 Yogiraj Charity Case [1976] 103 ITR 777.

51 *Director of Income Tax (Exemptions)* v. *Chartered Accountants Study Circle* [2012] 347 ITR 321.

52 *Id.*, para 1.

and selling books, as long as the organisations can show a link between the subject matter of publication and larger utility to society. However, this seems to suggest that there is no blanket exemption provided to the activity of 'publishing' or 'selling' books and magazines. This particular rationale may have the effect of either providing a blanket exemption to the activity of 'publishing' and 'selling' of books or magazines or it may see increased litigation with the omniscient question of 'where to draw the line'.

The question of whether registration granted under section 12 to a trust, which was purely functioning as an organization publishing and selling *Sarvodaya Literature* and *Gandhian Ideologies*, could be revoked if it was found that the activities carried on by the registered organization were not amenable to the exemption under section 11, came up before the High Court of Madras.[53] The high court held thus:

> the registration was granted after considering the objects of the trust, and further, it was not the case of the commissioner that the activities of the trust were not genuine or that the activities of the trust were not in accordance with the objects of the trust.

The Madras High Court further held that the income derived from the activities of the trust and its eligibility for exemption was a matter for the assessing officer to determine under section 11 and this did not depend upon the registration under section 12 of the Act. The High Court of Madras rightly refused interference with the order of the tribunal, which had held that the two (2) conditions under section 12 were not satisfied for the cancellation to be held valid. The power of cancelling the registration, given to the commissioner, is relatively recent, and was introduced by the Finance Act, 2010, by amending section 12AA(3).

Whether amendment of section 12AA (3) is retrospective in nature

This question arose before the Bombay High Court.[54] In the present case, a previous action of the commissioner cancelling the registration after issuance of a show cause notice, was held to be invalid by the tribunal, on the sole ground that under section 12AA(3), the commissioner had no power to cancel the registration once granted. After the said amendment, a fresh show cause notice was issued. The Bombay High Court refused to interfere with the show cause notice and without commenting on the merits of the matter held that the amendment does not take away any vested right nor does it create new obligations in respect of past actions. The Bombay High Court also noted that the words "obtained registration at any time under section 12 A" were used intentionally by the legislature and hence the power may be exercised by the commissioner in respect of a trust registered prior to 01.06.10 as well.

Coaching – whether a business?

This question arose before the High Court of Delhi. The ICAI, a statutory body established under the Chartered Accountants Act, 1949, for regulating the profession

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53 *CIT* v. *SarvodayaIlakkiyaPannai* [2012] 343 ITR 300 (Mad).

54 *Sinhagad Technical Education Society* v. *Commissioner of Income Tax*, [2012] 343 ITR 23(Bom).

of chartered accountants in India, is engaged in the activity of conducting coaching classes. The CBDT (central board of direct taxes) had approved the said institute under section 10 (23C) (iv) of the 1961 Act[55] in the assessment years 2003-2004 to 2005-2006.

The order of the assessing officer, under section 263 of the 1961 Act, was based on two grounds, namely coaching activity undertaken was "business" and not a charitable activity. In these circumstances the institute was required to maintain separate books of accounts. Secondly, the institute had incurred expenditure of Rs. 164.33 lakhs on overseas activities including travelling, membership of foreign professional bodies, *etc*., without permission from the CBDT as required under section 11 (1) (c) of the 1961 Act. Thus income of the institute was not entitled to exemption as a charitable institution. The tribunal rightly disagreed with the orders of the assessment officer and held that the assessment officer had not considered the concept/term "business". The tribunal examined the object and role assigned to the institute and there was no need to interfere with the orders of the tribunal. The high court rightly refused interference and held that the tribunal had followed the relevant high court and Supreme Court judgments in interpretation of the concept of "business".

Income of a trade association

The provision of section 11 of the Income Tax Act, 1961 has been a contentious provision. Litigants advance arguments to bring their Income within the provisions of section 11 in order to claim exemption, section 11 provides for exemption of income of any charitable institutions, in so far as the income is applied in India, and is applied to such purpose in India as prescribed under section 11. The extent of the meaning of the words "to the extent to which such income is applied to such purposes in India" came up before the High Court of Delhi.[56] The questions were a) whether payment under the Voluntary Disclosure of Income Scheme (VDIS), could be income used for the purposes of the trust in India, and whether money spent in Germany could fall under "is applied to such purpose in India". The High Court of Delhi while rightly holding the first question in favour of the assessee has wrongly held the second question in favour of the revenue. The reasoning of the high court seems tenuous compared to the reasoning of the tribunal.

The tribunal had rightly held both the questions in favour of the assessee. While dealing with the first question, the tribunal based its finding on the fact that the VDIS (voluntary disclosure of income scheme) was paid to protect the existence of the trust which was absolutely necessary for its continuance. The tribunal further held that not treating the payment of taxes as application of income for the purposes of the trust would result in reducing the corpus of the trust which would be to the detriment of the trust. The tribunal has rightly followed the judgments in *CIT* v. *JanakiAmmalAyyaNadar Trust*[57], *MunnaLal and Sons* v. *CIT*[58] and *CIT* v. *Ganga*

55 *Supra* note 51.

56 *Deputy Director of Income Tax* v. *NASSCOM* [2012] 345 ITR 362 (Del).

57 [1985] 153 ITR 159 (Mad).

58 [1991] 187 ITR 378.

Charity Trust Fund.[59]The tribunal while dealing with the second question took the view that the words "is applied to such purposes in India" appearing in section 11 (1) (a) of the Act only mean that the purposes of the trust should be in India and that the application of the income of the trust need not be in India. It was observed by the tribunal that the words "to such purpose" between "is applied" and "in India" shows that the application of income need not be in India, but the application should result and should be for the purposes of charitable and religious purposes in India.

The high court has misapplied the judgment of the Supreme Court in *H.E.H. Nizam's Religious Endowment Trust* v. *CIT.*[60] It is submitted that the facts of the above case does not apply to this case squarely. The argument raised on behalf of the assessee, that exemption be allowed, in so far as the income is utilized for charitable or religious purposes in India, regardless of whether the amount was spent abroad was not before the Supreme Court in the above case. In *H.E.H. Nizam's Religious Endowment Trust's* case, the application of the income was abroad and there seemed to be no connection with such application of income abroad to purposes in India. It could not be said that income applied for the benefit of mosques abroad would be for religious purposes in India. The example of the cases of funding of candidates or students, from India, who pursue foreign education given by the counsel for the assessee raises fresh questions, which should have been explained by the high court. The court while accepting the contentions as forceful has summarily discarded them without giving them due consideration. The conclusion of the tribunal seems to carry more weight than the conclusions drawn by the high court. This decision may require review.

Who is an assesse?

The question of whether a separate assessment may be carried out against a hospital, which was run by a society, was answered in the negative by the High Court of Kerala.[61] The high court took the view that merely because no separate approval was granted under section 10 (23C) (*via*) for the functioning of the hospital did not mean that it had to be assessed separately or the benefit under section 11 could not be extended to it. The hospital by itself was not a legal entity and assessment could only be conducted on a legal entity. The high court, however, observed that if the activities of the society are found to be violative of the scheme of exemption granted under section 12 A, it is always open to the department to bring to tax such of the income that could be assessed under the Act after issuing notice to the assessee.

Accrued income whether can be utilized in subsequent year. This question came up before the High Court of Delhi in *Director of Income Tax* (Exemption) v. *Bagri Foundation.*[62] The court held that in so far as the accumulation did not exceed the prescribed limit of fifteen per cent, the income could be utilized in a subsequent year, it further held that section 11 (1),[63] was absolute and section 11 (2) cannot have the effect of whittling down 11 (1) (a). A similar view has been followed in

59 [1986] 621 ITR 612 (Guj).
60 [1966] 59 ITR 582 (SC).
61 [2012] 344 ITR 257 (Ker).
62 [2012] 344 ITR 193 (Del).
63 Income Tax Act, 1961.

Tiruppani Trust's case.[64] The court, further held that inter se donation between trusts is covered by section 11. The high court followed the decision in *CIT* v. *Shree Ram Memorial Foundation*[65] in this regard. A similar view was taken by the Madhya Pradesh High Court in *CIT* v. *GujratiSamaj* (Regd.).[66]

VI INCENTIVE DEDUCTION

80HHC

As a measure to provide incentive to an assessee to carry on export business so that in turn, the country earns foreign exchange, under the provisions of section 80HHC of the Income-tax Act, 1961, 100 percent deduction is allowed to exporters in respect of profits derived from export of goods or merchandise for some years and subsequently it is scaled down percentage wise. Section 80 HHC provides that to an assessee who is engaged in the business of 'export out of india' of any goods or merchandise, to which this section applies, deduction to the extent of profits referred to in sub-section 1(b) derived by the assessee from the export of such goods or merchandise is allowed. In *Anil Kumar* v. *Income Tax officer and others*[67] it was explained by the court that the goods so exported do not have to be goods only from India. Wording such as "what is to be exported out of India should be from India" is conspicuously missing in the provision. The stress is only on the earning of the foreign exchange.

The total deductions under chapter IV A of the Act are restricted to the total profits and gains in respect of such eligible business. All the sections which fall under heading "c"- deductions in respect of certain incomes- are independent of each other. An industrial unit can claim deductions under two heads independently if he comes under the ambit of those sections. In *Commissioner of Income Tax and Another* v. *Millipore India P. Ltd.*[68] Wherein the issue was that whether deductions under 80I and 80 HHC independent of each other, the court held that the assessee is entitled to sections 80HHC and 80-I are independent of each other. A new industrial unit can claim deduction under both sections on the gross total income independently. Sub-section (9) of section 80-IA makes it clear that such profits and gains which is allowed deductions under section 80-IA cannot be again allowed deduction under any other provisions of the chapter under the heading "C.-Deductions in respect of certain incomes". The stress on the profits and gains of such eligible business in the case of section 80HHC is the profits and gains from export business. Under the provisions of chapter VI-A of the Act, various deductions from the profits and gains are allowed to the assessee who has to fulfill certain requirements specified under the relevant section. The total deductions under chapter VI-A of the Act are restricted to the gross total profits in respect of the assessee as a whole.

The primary condition to claim deduction under section 80HHC of the Income Tax Act, 1961, would be that the assessee should have derived profits from export

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64 [1998] 230 ITR 636 SC.
65 [2004] 269 ITR 35.
66 [2012] 349 ITR 559 (MP).
67 [2012] 343 ITR 30 (Karn).
68 (2012) 341 ITR 219 (Kar).

of goods or merchandise. In *Anil Dang* v. *ITO*[69] the issue that arose was whether 'processing charges' were includible in the total turnover in the formula of section 80HHC (3) and not with reference to gross or net *i.e.,* whether the tribunal was right in not issuing any directions to the assessing officer to bifurcate professional charges between procuring order and rendering other services so as to exclude only that part as attributable to procuring order in computing the profits of the business. The court following the decision of *K.Ravindranath Nair*[70] wherein it was held "in our view…., the said processing charges which was part of gross total income was an independent income like rent, commission, brokerage, *etc.,* and therefore, 90 percent of the said sum had to be reduced from the gross total income to arrive at the business profits and since the said processing charge was an important component of business profits it also had to be included in the total turnover in the said formula to arrive at business profits in terms of clause (baa) to the said explanation", held that the tribunal's finding was correct and the court should not intervene.

80-IA

'Infrastructural facility' defined in section 80-IA means a road, highway, bridge, airport, port or rail system or any other public facility of similar nature as may be notified by the CBDT. The finance (no.2), 1998, included the words 'inland water ways and inland ports' in the definition of 'infrastructural facility.' In *Container Corporation of India Ltd.* v. *Assistant Commissioner of Income Tax*[71] wherein the question before the court was that whether the income from the inland container depots qualify for the deduction under section 80-IA(4)(i) of the Act read with the explanation (d). The assessee was engaged in the business of handling and transportation of container goods. The activity of the assessee was carried out mainly on its inland container depots. He claimed special deduction under section 80-IA(4) for the assessment year on all 45 inland container depots, claiming them to be under the ambit of 'inland ports'. There is no definition of the words 'inland ports' in any of the dictionaries. But the words 'inland container depot' were introduced in Customs Act 1962 which defines customs port. The court concluded that the assessee's claim keeping in view the object of including 'inland ports' in the definition, then CDBT's communication and the definition in Custom's Act, requires to be upheld.

80HHD

Section 80 HHD provides for deduction for a hotel or a tour operator approved by the prescribed authority or of a travel agent at the specified percentage of the profit derived from services provided to foreign tourists, subject to creation of reserves to this extent for utilization for the purpose of its business. Such persons are entitled to receive consideration for their services in foreign exchange. In the case *of CIT* v. *ITC Hotels Ltd*.[72] the assessee ITC has a multi chain of hotels wherein some hotel units are owned, some are leased and some are managed by ITC. The

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69 [2012] 344 ITR 143(Kar).

70 [2007] 295 ITR 228 (SC).

71 [2012] 346 ITR 140 (Del).

72 [2012] 344 ITR 680 (Karn).

issue that arose was whether in computation of deductions under section 80 HHD of the Income Tax Act, the profits of individual branches of hotels should be taken into account and not the entire profits (including losses) of the assessee. Karnataka High Court in the case of *Maini Precision Products Private Limited* v. *The Joint Commissioner of Income Tax* (ITA nos. 52 of 2009, 182-185 of 2009 disposed of on 18.08.2009), held:[73]

> indicated the manner of understanding the concept of export turnover *vis-a-vis* total turnover and the comparison in the present case is the receipts attributable to the foreign exchange receipts and the total receipts of the assessee with all hotel industries put together and the decision may have some indirect bearing as in that case we have taken the view for the purpose of computation of the total turnover of the assessee should necessarily include even the turnover relating to machining activity for which the assessee was collecting separate charges and was not necessarily the manufacture of a product which was being exported by the assessee

In the present case, on an analogy though a unit is not recognized for the purpose of computing the benefit under section 80HHD of the Act, it can nevertheless form part of the entire business activity in the hotel industry and therefore it should necessarily be part of the total receipts from all such units which figure in the denominator portion of the formula. The Court further stated thus:[74]

> We are of the clear view that overall profits of the assessee, computation of which is provided in sub chapter [D] of Chapter - IV of the Act is only one of computing the total income of the assessee under this head as a whole and as one unit and not on any unit wise method etc.

VII NON-RESIDENT TAX

The Finance Act 1976 effected three basic changes as regards assessment of nonresidents.

i. It inserted clause (v), (vi) and (vii) in s 9(1), deeming interest, royalty and technical fees to accrue or arise in India, making the non-resident recipient chargeable to tax in cases where there was no tax liability under the pre-existing law.
ii. It inserted ss 44C and 44D denying deductions, entirely or in part, in respect of expenses wholly and exclusively incurred for the purposes of non-resident's business or for earning technical fees or royalty.
iii. It inserted s. 115A prescribing new rates of tax for dividends, royalty and technical fees in the case of foreign companies.[75]

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73 *Id.*, para 8.

74 *Id.*, para 82.

75 The Law and Practice of Income Tax, Kanga, Palkhivala and vyas, I, 9th edn., Lexis Nexis Butterworths.

Royalty

Definition of royalty

In *Citrix Systems Asia Pacific Pty. Ltd*[76] wherein the applicant was a company incorporated in Australia, providing software services. The company had entered into an agreement with an Indian distributor on a non-exclusive basis for sale of its software and hardware in India. For the software product, while sale and collection was made through the distributor, no physical delivery was made to the distributor. The main issue that had to be ruled out was whether the payment received by the applicant from the distributor is the price of sale of the software product or would be included in royalty under the Income Tax Act or under DTAA between India and Australia. Authority defined royalty as:

> The definition of royalty in the Income Tax Act is consideration for the transfer of all or any rights (including the granting of licence) in respect of patent, innovation, model, design, secret formula or process or trade mark or similar property. Consideration for the grant of use of any of the above would be also included in royalty.
>
> Article 12 of the India – Australia DTAC defines royalty to mean payment made as consideration for the use of or the right to use any copyright, patent, design or model, plan, secret formula or process, trade mark or other like property or right.

Where the payment occurs only on the use on the product of research and not otherwise *i.e.,* the same is described as the contribution towards the cost of the research and development, the same would satisfy the definition of royalty under Explanation 2 to section 9(i) (iv) of the Act.[77]

When would it amount to royalty?

In the abovementioned case on the issue that whether the payment received by applicant from distributor is (a) price for sale, or (b) royalty the court held thus:[78]

> The licensing of a software for use by the end-use customer, is not a mere sale of copyrighted article but does involve the grant of a right to use the copyright in the software. Further it stated the scope of the definition of royalty in Income Tax which speaks only of transfer of all or any rights, including the granting of a license in respect of the copyright. It does not speak of the grant of an 'exclusive right'

In order to qualify as royalty payment, within the meaning of Section 9(1)(vi) and particularly clause (v) of Explanation-II thereto, it is necessary to establish that there is transfer of all or any rights (including the granting of any license) in respect of copy right of a literary, artistic or scientific work. Section 2(o) of the Copyright Act makes it clear that a computer programme is to be regarded as a 'literary work'. Wherein the payment towards the usage of such a computer programme does not

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76 [2012] 343 ITR 1 (AAR), also see Acclerys K.K. [2012] 343 ITR 304 (AAR).

77 "A" Systems, in re [2012] 345 ITR 479(AAR) the Netherlands.

78 *Ibid.*

include obtaining of all or any copyright rights in such 'literary work', would not be termed as royalty and hence not taxable.[79]

Territorial nexus in case of royalty

As far as foreigner's and foreign income are concerned, the well established principle is that given a sufficient territorial connection or nexus between the person sought to be charged and the country seeking to tax him, income tax may properly extend to that person in respect of his foreign income. If the Indian Parliament could cast the net wide enough to collect tax in such cases where the foreigner's income has no nexus with India, only because the income is derived from a transaction with an Indian, it can equally levy a tax on a hotel in a foreign country where an Indian goes to stay or dine, or buys grocery *etc*. The connection must be a real one and the liability sought to be imposed must be pertinent to that connection.[80]

In *Dir. Of Income Tax* v. *Ericsson A.B*[81] where the assessee, a Swedish company, main business was the supply of hardware and software which was used in the business of rendering telecommunications services and for this purpose it undertook projects on turnkey basis. It entered into agreements with various cellular operators and entered into three main contracts with them, and were signed in India. The supply of the equipment was a continuous process. In accordance with the contract, the equipment was not to be accepted till it was finally tested through a test known as acceptance test. The assessing officer held that assessee had provided software to the cellular operators under a license and the income which arose therefrom was to be taxed as royalty. The issue that arose was whether the asessee has business connection in India by virtue of the acceptance test and the place of signing. The court held:[82]

> that the terms of the contract made it clear that acceptance test was not a material event for passing of the title and risk in the equipment supplied. The places of negotiation, the place of signing of agreement or formal acceptance thereof or overall responsibility of the assessee, are irrelevant circumstances.

Section 9(1)(i) of the Act as it stood before the amendment to it by the Finance Act, 2010 provides that income accruing or arising, whether directly or indirectly, through or from any business connection in India is deemed to accrue or arise in India. The department has not stated that the assessee has any business connection in India, inasmuch as the cellular operators are independent contracting parties and action cannot be held to be assessee's business connection. In such circumstance, the case would be covered by explanation-1 to section 9(1) (i) of the Act. clause (a) of explanation-1 lays down that in the case of business if all the operations are not carried out India, the income of business that is deemed to accrue or arise in India would be only such part of the income as is reasonably attributable to operations carried out in India.

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79 *Dir. of Income Tax* v. *Ericsson A.B* [2012] 343 ITR 470 at para 59.

80 *Supra* note 75 at 385.

81 [2012] 343 ITR 470.

82 *Id.*, para 41.

Technical services

Whether expenditure incurred even when it did not involve any element of profit bore the same character as fees for technical services and chargeable to tax under section 9(1)(viii) of the Act. In XYZ Ltd. Re.[83] it was held that the expenditure incurred even when it did not involve any element of profit bore the same character as fees for technical services and chargeable to tax under section 9(1)(vii) of the Act. That in the present case the applicant, a tax resident of Hong Kong, belonged to X group of companies. The group entities were engaged in the business of inspection, verification, testing and certification services. The issue that arose was that whether the payments received or receivable in connection with costs incurred or proposed to be incurred for and on behalf of X India on procurement of goods or services, *etc.*, whether recovery of reasonable administrative cost incurred for and on behalf of X India was chargeable to tax. It was held, that the expenses incurred, whether in the form of reimbursement or sharing administrative or sharing administrative cost, were in connection with the provision of inspection, verification, testing and certification services. The same being technical services, the applicant was liable under section 9 (1) (viii) of the Act.

Jurisdiction of advance ruling

The term 'advance ruling' [clause (a) of 245 N] has been defined to mean the determination by an authority constituted by the central government and known as authority for advance rulings, of a question of law or fact in relation to a transaction which has undertaken or is proposed to be undertaken, by a non-resident.

When it cannot be invoked

Section 245R deals with the procedure to be followed after the receipt of an application. On the receipt of the application, the authority may, by order, either allow or reject the application after examining the application and the records. The first proviso to sub-section (2) of 245R divests the authority of jurisdiction in cases where its jurisdiction could be invoked by a qualified applicant, such situations where the question of law or fact raised is already pending in the case of the applicant before any income tax authority, the tribunal or any court

Scope of "before any income tax authority"

Mere pendency of a proceeding under section 195 or 197 of the Income Tax Act, 1961, or even a final order thereon does not stand in the way of an application for advance ruling being entertained. *In SEPCO III Electric Power Construction Corporation, In Re*[84] wherein the issue arose after the applicant filed an application under section 197 of the Act, and then filed a revision against the authority under section 264 of the Act, the same was pending. Simultaneously a notice was issued under section 148 and 143 (2) for the assessment years 2008-09 and 2009-10. At that stage an application was filed for an advance ruling on the question whether the amount received or receivable by the applicant were liable to be taxed in India, the AAR dismissing the application held:

83 [2012]348 ITR 20 (AAR)

84 [2012] 340 ITR 225 (AAR)

> When a Return of income is filed under Section 139 of the Act either voluntarily or on being called upon to do so by a notice under Section 142(1) of the Act, all the claims raised by the person who furnishes the return relating to the assessment are before the Assessing Officer for consideration and decision. Section 143(2)(ii) enables the Assessing Officer to require the person to attend his office to establish his claims. Under Section 143(3) (ii) the Assessing Officer has to pass an order making an assessment of the total income or loss of the person and determining the tax payable or the refund if any due to him as the case may be on the basis of the assessment.

The court stated that assessment before an Assessing officer would be hit by bar of Section 245R. Whether on filing of a return, the assessee invites adjudication on all questions out of that return. The AAR in the case of *Wave Field Insies ASA*[85] following the SEPCOIII decision held:[86]

> When a return is filed, so many aspects arise out of that return. The question of computation of total income, of computation of the exemptions and exclusions, acceptance or non-acceptance of an item of expenditure and ultimately the determination of chargeable income and the determination of the tax due, are all questions that arise. Therefore filing of a return ushers in all these questions. By filing a return, an assessee invites an adjudication on all the questions arising out of that return. Subsection (2) of section 245R only speaks of the question arising before the Authority. So if an answer to that question would be involved in the return filed or would arise out of the return filed, it would be a case where the bar is attracted.

Further in *Nuclear Power Corporation of India Ltd*.[87] The authority went into the scope of dropping of the words "in the applicant's case"- and stated that:

> What is barred by the proviso to Section 245R (2) of the Act in the context of clause (1) thereof is the allowing of an application under section 245R(2) of the Act where "the question raised in the application is already pending before any income-tax authority, or Appellate Tribunal or any Court." It is not necessary that when the question is sought to be raised by the applicant, the proceeding already pending must be against him. The significance of the dropping of the words, "in the applicant's case" cannot be wholly ignored. That apart, the question raised, arises out of a transaction and the question can arise at the instance of either party to the transaction, the payer or the payee in the context of the obligation imposed respectively on them by the Act.The question relates to an issue or a transaction which is

85 [2012] 343 ITR 136 AAR.

86 *Id.*, para 6, also refer to *Red Hat India P. Ltd., In Re* [2012] 349 ITR 398 (AAR).

87 [2012] 343 ITR 220 (AAR).

designed *prima facie* for the avoidance of income tax, or the question raised relates to the determination of the fair market value of any property.

VIII APPLICABILITY OF ADVANCE RULING

The ruling of the authority for advance ruling, do not bind any court, tribunal, income tax authority or assessee, except as prescribed by section 245 sub-section 245S makes the advance ruling pronounced by the authority as binding on the applicant, in respect of the transaction and the commissioner and the Income Tax authorities subordinate to him in respect of the applicant and the transaction. It would not affect the jurisdiction of either the Supreme Court under article 136 of the Constitution or the high courts under article 226 and 227 of the Constitution to entertain a challenge to the advance ruling pronounced by the authority. Articles 136,226 and 227 are constitutional provisions vesting jurisdiction on the Supreme Court and high courts and a provision of an act of legislature making the decision of the authority final or binding could not come in the way of the Supreme Court or the high courts exercising jurisdiction vested under the Constitution.[88]

IX TRANSFER OF SHARES

Buy back shares whether covered by DTAA between India and Mauritius

In the case of A, *In Re.*,[89] the applicant is a company incorporated in India, 48.87 percent, of whose shares were held by a group holding company in the U.S.A, 25.06 per cent by a group holding in Mauritius, 27.37 per cent by a group holding company in Singapore and 1.76 per cent by the general public. On June 15.06.10, the board of directors of the applicant passed a resolution proposing a scheme of buy back of its shares from its existing shareholders in accordance with section 77A of the Companies Act 1956. Mauritius company which acquired the shares sought advance ruling on whether the capital gains that may arise, were chargeable to tax in India in the context of the Double Taxation Avoidance Agreement between India and Mauritius and whether it would have the obligation to withhold the tax in terms of section 195 of the Income-tax Act, 1961.

On the facts of the case the authority held that the applicant had not paid dividend to any of the shareholders after 01.04.03, on which date section 115-O of the Act was introduced. Neither the holding company in the U.S.A. nor that in Singapore accepted the offer of buy- back for obvious reasons that it would have been taxable in India as capital gains. There was no proper application on the part of the applicant why no dividends were declared subsequent 2003, when the company was regularly making profits and when dividends were being distributed before the introduction of section 115-O of the Act.

88 *Columbia Sportswear Company* v. *Director of Income Tax* [2012] 346 ITR 161 (sc), also see *Verizon Data Services India P. Ltd*. v. *Authority for Advance Rulings* [2012] 346 ITR 489.

89 [2012] 343 ITR 455 (AAR).

The proposal of buyback was thus a scheme devised for avoidance of tax, a colorable devise for avoiding tax on distributed profits as contemplated in section 115-O of the Act. The arrangement could only be treated as a distribution of profits by a company to its shareholders satisfying the definition of dividend which includes any distribution by a company of accumulated profits to its shareholders. The proposed payment would be taxable in India in terms of article 10(2) of the DTAA between India and Mauritius hence the applicant was required to withhold tax on the proposed remittance of the proceeds to the Mauritius company.

In RST, *In Re*.[90], wherein the transfer of shares of the Indian company by the applicant to its wholly owned subsidiary whether would be exempt from tax. The basic facts of the present case are that the applicant, a company in Germany held 43, 83,994 shares in the capital of a public limited company in India. Balance 6 shares were held by group companies as nominee of German company to maintain minimum number of shareholder to 7 as required by the Companies Act, 1956. The Indian company had proposed to buy back shares from the applicant.

AAR held that the exemption under section 47(iv) is available only where the parent company itself holds, or its nominees separately hold 100% shares of the shares of the subsidiary. Also the AAR observed that a nominee shareholder has the same rights in the company as any other shareholder and hence the shareholding by the nominees is not to be equated with the shareholding by the applicant. The AAR held that section 46A has to prevail over section 45. The intent behind the section was to clarify that income earned on buy back of shares would be deemed to be capital gains and not dividend income. On that basis AAR ruled the capital gains to be taxable in India.

90 [2012] 348 ITR 368 AAR.