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TAXALOGUE

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Dialogue on Tax



Directorate Of Legal & Research
Central Board of Direct Taxes

General Information



Mission

To provide a platform and build a network amongst tax officers, tax practitioners eminent personalities, tax payers etc., for sharing and discussing matters related to tax issues, administrative best practices, such other matters as deemed to be of educational/professional value etc., with a view to promote effective and litigation-free tax administration, voluntary compliance and tax payer service.

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Editorial Policy

1. To invite and publish articles relevant to tax policy, legal issues and tax administration from the fellow officers, tax practitioners, eminent personalities and tax payers .
 2. To disseminate the best practices in tax administration, e-governance initiatives, innovation in administrative matters, newer tax-payer friendly initiatives etc.
 3. To update the knowledge of the officers about latest and important legal/judicial developments in the field of direct taxation.
 4. To provide a knowledge sharing space for the Officers to raise current and critical issues with a view to facilitate live discussions on-line and to share experiences.
 5. To publish any other material relevant for improving the effectiveness and efficiency of Income Tax Department, enhancing professions competency and developing human resources.
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Krishna Mohan Prasad



EDITORIAL

Welcome to the fourth issue of quarterly e-journal 'Taxalogue'; inaugurated exactly an year ago by the Finance Minister, to create a platform for sharing and discussing existing and emerging issues of taxation.

It is a matter of immense satisfaction that the e-journal has become an important knowledge sharing forum of ideas relating to legislative, judicial, administrative, historical aspects of taxation in India.

Like last three issues, despite COVID-19 adversity, the editorial board has selected articles on diverse area of taxation, which the readers shall find useful, interesting and innovative.

The article on "Applicability of Section 2(47)(vi) in Offshore Indirect Transfer of Immovable Property" introduces a fresh perspective to the taxation of offshore indirect transfer of immovable property.

The article on "Taxation of Share Premium" examines the alternative approaches while examining the issue where share premium received is in excess of its fair market value.

"Taxation of Alternate Investment Fund in India" provides appreciation of the progressive evolution of taxation of venture capital and guides both start-up entrepreneurs and assessing officers to act objectively. Article on "Digital Taxation" provides insight into emerging tax issues in India and the world.

To keep officers updated, this edition, introduces a segment of reporting of recent judgments of Supreme Court confirming the views of revenue and a collection of instructions and circulars of CBDT.

Beautiful monsoon clouds are all around, see you in autumn!

Krishna Mohan Prasad

On Behalf of Editorial Board

Member (Audit & Judicial), CBDT

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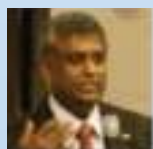
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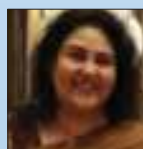
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Assessment of Income from Transactions in Shares and Securities as Business Income



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Executive Summary

Assessment of income from transaction in shares and securities under the Income-tax Act 1961 involves multiple issues. Such transactions give rise to income assessable under different heads of income e.g. business income, capital gain and income from other sources. This article is an attempt to discuss some major issues involved in assessment of such income under the head income from business. Speculative income, non-speculative income, trading, contract, derivatives, setting off losses 43(5), 10, 24(1), 24(2), 28, 73.

INTRODUCTION

Assessment of income from transaction in shares and securities under the Income-tax Act 1961 involves a plethora of issues. Such transactions give rise to income assessable under different heads of income e.g. business income, capital gain and income from other sources. This article is an attempt to discuss some of the major issues involved in the assessment of such income under the head 'Income from Business'.

Business income earned through trading in shares and security can either be speculative income or non-speculative income. Determination of the nature of income as speculative or non-speculative goes to the root of the assessment of such income. Hence, in the first part of the article, speculative income has been discussed. In the second part, the enquiries to be conducted

while assessing the business income from shares and securities have been considered.

PART 1

SPECULATIVE INCOME

Income-tax provision has not defined speculative income but has defined 'speculative transaction'. Therefore, it can be said that income that is derived from the speculative transaction is speculative income.

MEANING OF 'SPECULATIVE TRANSACTION'

Section 43(5) of the Income-tax Act defines 'Speculative transaction' as a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares,

Assessment

is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips. For example, intra-day trading in shares.

EXCEPTIONS

Clauses (a) to (e) of sub-Section 5 of Section 43, following are certain transactions which have been specifically excluded from being treated as 'Speculative Transactions'. These include:

- a. Hedging contract in respect of raw materials or merchandise.
- b. Hedging contract in respect of stocks and shares.
- c. Forward contract.
- d. Trading in derivatives.
- e. Trading in commodity derivatives.

Now we will discuss some of these exceptions relevant for the subject at hand:

TRADING IN DERIVATIVES

An eligible transaction in respect of trading in derivatives referred to in Clause (ac) of Section 2 of the Securities Contracts (Regulation) Act 1956 carried out in a recognized stock exchange is not a speculative transaction.

Prior to the insertion of Clause (d) in proviso to Sub-section 5 of Section 43, the Bombay High Court in its decision in the case of 199 Taxmann 87 (Bom.), *Bharat R. Ruia (HUF)*, has held that exchange traded derivative transactions carried on by assessee before 24.1.2006 were speculative transactions. Further, it is also to be kept in mind that along with the insertion of Clause (d) to Section 43(5), an explanation has also been inserted, which defines the term 'Eligible Transaction used in Clause (d)'. As per

this explanation, only certain type of transactions in trading in derivatives carried on by recognized stock exchanges are eligible for being treated as non-speculative transactions. The notification under this section was made only by Notification No. S.O. 89(e) dated 25.1.2006 with effect from the same date recognizing Bombay Stock Exchange and National Stock Exchange for this purpose. Thus, the transactions in trading of derivatives carried on by following the conditions mentioned in the explanation to Section 43(5) after this date on BSE and NSE or other exchanges from the date of their notification under this section only can be treated as non-speculative transaction.

As on date, the recognized stock exchanges are:

1. National Stock Exchange of India Limited, Mumbai.
2. Bombay Stock Exchange Limited, Mumbai.
3. MCX Stock Exchange Ltd.
4. United Stock Exchange of India Limited.
5. India International Exchange (IFSC) Limited, Gandhinagar, Gujarat.
6. NSE IFSC Limited, Gandhinagar, Gujarat.

TRADING IN COMMODITY DERIVATIVES

An eligible transaction in respect of trading in commodity derivatives carried out in a recognized association, which is chargeable to commodities transaction tax under Chapter VII of the Finance Act 2013 is not a speculative transaction. As on date, the recognized associations are:

1. Universal Commodity Exchange Limited, Mumbai.
2. Multi Commodity Exchange of India Limited, Mumbai.

3. Ace Derivatives and Commodity Exchange Limited, Ahmedabad.
4. Indian Commodity Exchange Limited.
5. BSE Limited Mumbai.
6. National Stock Exchange of India Limited, Mumbai.

The other points discussed in respect of derivative in shares are also applicable here. From AY 2019-20, in respect of trading in agricultural commodity derivatives, the requirement of chargeability of commodity transaction tax has been removed.

HEDGING TRANSACTION

A hedge is an investment that protects one's finances from a risky situation. Hedging is done to minimize or offset the chance that assets will lose value. It also limits loss to a known amount if the asset does lose value. The Circular no. 23D (XXXIX) [F. NO. 412/(4)60/TPL], Dated 12.9.1960 explains the applicability of the provisions of the Section 43(5) to hedging transactions. Its provisions can be summarized as follows:

1. The intention has always been that where bona fide forward sales are entered into with a view to guarding against the risk of raw materials or merchandise in stock falling in value, the losses arising as a result of such forward sales should not be treated as speculation losses. Accordingly, ITOs should not treat such transactions as speculative transactions within the meaning of Explanation 2 to Section 24(1). It is to be noted in this connection that hedging sales can be taken to be genuine only to the extent the total of such transactions does not exceed the total stocks of raw materials or

merchandise in hand. If the forward sales exceed the ready stock, the loss arising from the excess transactions should be treated as loss arising from speculative transactions and not from genuine hedging transactions.

2. Referring to Board's Letter No. 13(102) IT/53, dated 8.9.1954 in which it was stated that as regards hedging in raw materials, the Income-tax Officers should not be too particular about the quantities and timing so long as the transactions constitute genuine hedging. It has been explained that similarly, Income-tax Officers should not treat genuine hedging transactions in connected commodities as speculative transactions though the transactions may not be incidentally the same commodity. Thus, hedging transactions in one type of cotton against another type of cotton, one variety of oil seed against another, one type of grain against another, should not be treated as speculative transactions provided the other conditions of Explanation 2 to Section 24 are satisfied. It has been reiterated again that hedging sales can be taken to be genuine only to the extent the total of such transactions does not exceed the total stocks of raw materials or merchandise in hand. If the forward sales exceed the ready stock, the loss arising from the excess transactions should be treated as loss arising from speculative transactions and not from genuine hedging transactions.
3. It has been held that as a general rule, it is not acceptable that where a transaction contemplating actual delivery is ultimately settled (wholly or partially) by paying differences and without actual

delivery due to any reasons and where there was no intention to speculate, the transaction should be excluded from the purview of speculative transactions. It is already provided, if on the facts of any case it can be demonstrated that the forward transaction has been entered into only for safeguarding against loss through future price fluctuations, such a transaction should not be treated as a speculative transaction but as a case of hedging. However, in case of a bona fide ready delivery contract being settled by delivery to a substantial extent and by payment of differences for the balance is exceptional and, in such a case, the difference paid need not be treated as a loss arising in a speculative transaction.

4. It cannot be accepted that a dealer or investor in stocks or shares can enter into hedging transactions in scrips outside his holdings. The material words in Clause (c) of the proviso to Explanation 2 to Section 24(1) are 'to guard against loss in his holdings of stocks and shares through price fluctuations'. Therefore, hedging transactions having reasonable relations to the value and volume of dealer's or the investor's holdings are exempted from the ambit of speculative transactions; but transactions in scrips outside his holdings are not excepted.
5. For the purpose of set-off under Sections 10 and 24(1), the speculation loss of any year should first be set-off against the speculation profits of that year and the remaining amount of speculation profit, if any, should then be utilized for setting off any loss of that year from other sources. For the purposes of Section 24(2), the Income-tax Officer may allow the assessee:

- a. either to first set-off the speculation losses carried forward from an earlier year against the speculation profits of the current year and then to set-off the current year's losses from other sources against the remaining part, if any, of the current year's speculation profits;
- b. or to first set-off the current year's losses from non-speculation business and other sources against the current year's speculation profits and then to set-off the carried forward speculation losses of the earlier year against the remaining part, if any, of the current year's speculation profits, whichever is advantageous to the assessee.

The Mumbai Tribunal in its decision in the case of *Araska Diamond (P.) Ltd. vs. Assistant Commissioner of Income-tax, 5 (1), Mumbai [2014] 52 taxmann.com 238 (Mumbai-Trib.)*, has explained the applicability of Section 43(5) to hedging transactions. The AOs can refer to this decision to have a better understanding of the issue.

SPECULATIVE BUSINESS TO BE TREATED AS DISTINCT BUSINESS

As per Explanation 2 to Section 28 of the I-T Act 1961 where speculative transactions carried on by an assessee are of such a nature as to constitute a business, the business to be referred to as 'speculation business', shall be deemed to be distinct and separate from any other business.

ALLOCATION OF EXPENSES

Where a part of business being carried on by an assessee is to be treated as speculation business, then all relatable expenses are to be compulsorily allocated to such speculation business too on a rational basis.

SOME OTHER IMPORTANT CASE LAWS RELATING TO SPECULATIVE TRANSACTION

DAVENPORT & Co. P. LTD. [1975] 100 ITR 715 (SC)

This decision gives the meaning of 'actual delivery' for the purposes of I-T Act 1961. In this case, the Court has held that the words 'actual delivery' in Explanation 2 (Sub-section 5 of Section 43 of the Income-tax Act 1961) mean 'real' as opposed to 'notional delivery'. For income-tax purposes speculative transaction means what the definition of that expression in Explanation 2 says. Whether a transaction is speculative in the general sense or under the Contract Act is not relevant for the purpose of this Explanation. The definition of 'delivery' in Section 2(2) of the Sale of Goods Act which has been held to include both actual and constructive or symbolical delivery has no bearing on the definition of speculative transaction in the Explanation.

COMMISSIONER OF INCOME-TAX VS. JOSEPH JOHN [1968] 67 ITR 74 (SC)

In this, the court has held that the burden of proof was upon the assessee to show that the transactions were merely hedging transactions within the meaning of proviso (a).

COMMISSIONER OF INCOME-TAX VS. SHANTILAL (P.) LTD. [1983] 14 TAXMAN 1 (SC)

The Court held that Section 43(5) speaks of a settlement of the contract, and, consequently, where there is a breach of the contract resulting in a dispute between the parties and culminating in award of damages as compensation by an arbitration award, the transaction cannot be treated as a 'speculative transaction' within the meaning of Section 43(5).

TREATMENT OF LOSS FROM SPECULATIVE BUSINESS

Treatment of speculative business as a distinct and separate business is necessary for the purpose of setting off the loss provisions. As per Section 73, losses from speculation business can be set-off only against profits from speculative business unlike loss from other businesses which can be set-off against the profits of any business. Further, loss from a speculation business carried forward to a subsequent year can be set-off only against the profit and gains of any speculative business in the subsequent year. Along with treating speculative business as separate and distinct business, profits and losses resulting from speculative transactions must also be treated as separate and distinct from other profits and gains of business and profession.

Further, above provisions will apply also to allowance on account of depreciation or capital expenditure on scientific research, if any, incurred in speculative business.

Loss from speculative business cannot be carried forward for more than 4 assessment years succeeding the year in which loss is incurred.

EXPLANATION TO SECTION 73

EXPLANATION TO SECTION 73 STATES

'Where any part of the business of a company [other than a company whose gross total income consists mainly of income which is chargeable under the heads "Interest on securities", "Income from house property", "Capital gains" and "Income from other sources"]', or a company [the principal business of which is the business of trading in shares or banking] or the granting of loans and advances) consists in the purchase and sale of shares of other companies, such company shall, for the purposes of this section, be deemed

to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares.’

Thus, if the provisions of this explanation are applicable, the delivery based share transactions of a corporate assessee would also become speculative transaction.

Applicability of explanation to Section 73 has always been a complex and highly litigated issue. Assesseees have been taking pleas on several occasions to escape the dragnet of provisions of this explanation. Over the period, several decisions of courts and tribunals have been delivered on issues relating to this explanation, however, the issues have not attained finality. Brief analysis of the issues is as follows:

The first issue which goes to the root of the applicability of the provisions of this explanation is, as to whether the provisions are applicable to all sources of losses in share transaction or they are only applicable to the transactions involving sale and purchase of shares of group companies. The Hon’ble Bombay High Court in the case of *Prasad Agents Pvt. Ltd.*, reported in 180 Taxman 178, has held that in view of the clear language of Explanation to Section 73, a company carrying on business of purchase and sale of shares shall be deemed to be carrying on speculation business. It was held that the explanation is applicable even if the sale and purchase of shares of companies outside the group companies of the assessee have been made.

Another issue is whether loss or profit on account of valuation of closing stock in trade in shares would be covered by the provisions of this explanation. The Hon’ble Bombay High Court in the above mentioned decision in the case of *Prasad Agent Pvt. Ltd.* has held that loss on account of valuation of closing stock of shares would also be covered by this explanation.

The other issue is as to whether explanation is applicable only to the losses in share transactions or it covers the profit also. The Hon’ble Bombay High Court in the case of *Lokmat New Paper P. Ltd.*, reported in 189 Taxman 370 has held that once the provision is applicable to an assessee’s company, both losses and profit in share transaction will have to be treated as arising from a speculation business. But subsequently, the Hon’ble Gujarat High court in its decision in the case of *Commissioner of Income-tax-VI vs. Appollo Vikas Steels (P) Ltd.* [2013] 32 taxmann.com 329 (Gujarat), has held that the explanation is attracted only if there is any loss from share trading. Thus, if there is carried forward speculation loss and the assessee has positive income from delivery based share trading and derivative transactions, then no set-off can be allowed as the income from share trading in the current year is not hit by the explanation and hence is to be treated as non-speculative income.

Another important issue is as to whether only the profit is to be considered for the purposes of determining the applicability of this explanation or losses are also to be considered. The High Courts in the decisions given below have held that losses are negative profits and hence they are also to be considered for this explanation.

Another issue is as to whether trading in units of mutual funds are covered by this explanation or not. In *Apollo Tyres Ltd. vs. Commissioner of Income-tax* [2002] 122 Taxmann 562 (SC), the apex court held that buying and selling of units by the assessee-company cannot be treated as a speculative business as per Explanation to Section 73, because units of mutual funds are not shares. The same was followed by the Bombay HC in its decision in the case of *CIT vs. Hertz Chemicals Ltd.* [2016] 69 taxmann.com 338/239 Taxman 431 (Bom.). But SLP filed by the Revenue against this decision

has been admitted in the Supreme Court as reported in *Commissioner of Income-tax-8 vs. Hertz Chemicals Ltd.* [2017] 78 taxmann.com 165 (SC).

Similarly, another issue is as to whether derivative transactions are covered by this explanation or not. In the decision in the case of *Commissioner of Income-tax, Delhi-IV vs. DLF Commercial Developers Ltd.* [2013] 35 taxmann.com 280 (Delhi), it has held that the explanation covers derivative transactions too. But in the decision in the case of *Asian Financial Services Ltd. vs CIT* [2016] 70 taxmann.com 9/240 Taxman 192 (Cal.), the High Court ruled that loss incurred on account of derivatives would be deemed business loss under proviso to Section 43(5) and not speculation loss and, hence, Explanation to Section 73 could not be applied. However, SLP against this decision of the Calcutta High Court has been admitted as reported in, *Commissioner of Income-tax-3, Kolkata vs. Asian Financial Services Ltd.* [2016] 75 taxmann.com 68 (SC).7.2.7 The most important aspect of this issue is to determine as to whether this explanation is applicable to a particular company or not on the basis of analysis of incomes under different heads comprised in the gross total income. For this purpose, it is to be determined whether the assessee is a company whose gross total income consists mainly of income which is chargeable under the head: interest on securities, income from house property, capital gain and income from other sources; or a company whose principal business is business of banking or the granting of loans and advances (and from AY 2015-16 business of trading in shares also). In case of such companies, the provisions of explanation are not applicable, whereas in case of rest of the companies these provisions would be applicable.

The above analysis has to be made on case-to-case basis for every year. There are following

three decisions of Special Bench of ITAT on this issue:

1. The decision in the case of *Concord Commercial Pvt. Ltd.*, reported in 95 ITD 115.
2. The decision in the case of *AMP Spinning Mills Pvt. Ltd.*, reported in 100 ITD 142.
3. The decision in the case of *Venketeshwar Investment and Finance Pvt. Ltd.*, reported in 93 ITD 177. This case relates to analysis of the facts to find out whether the principal business of assessee is of granting loans and advances.

Besides the decision of Hon'ble High Court of Bombay in the case of *Commissioner of Income-tax-3 v. Darshan Securities (P.) Ltd.* [2012] 18 taxmann.com 142 (Bom.), is also very important in which the court has held that in order to determine as to whether exception carved out in form of bracketed portion by Explanation to Section 73 applies, firstly one has to compute gross total income of company under normal provisions of Act and it is only thereafter, it has to be determined as to whether gross total income so computed consists mainly of income which is chargeable under any of heads referred to in Explanation.

Here, the AOs should consider the following situation:

- Business loss: Rs. 1,00,000
- Income from other sources: Rs. 50,000

In such situation, assesses normally contend that a positive figure howsoever small it is, is always greater than a very big negative number and hence, in such circumstances the Explanation to Section 73 will not be applicable. This, one must understand, is a situation not covered by the Mumbai Special Bench decision of *Concord*

Commercial. In such a situation, and in the example taken above, the figures in absolute terms should be seen and the Explanation is invoked as Rs. 1,00,000 is greater than Rs. 50,000.

Besides these, some other important decisions are as follows:

- a. *Commissioner of Income-tax vs. Arvind Investments Ltd.* [1991] 58 Taxmann 216 (Cal), [1991] 58 Taxmann 216 (Cal), held Explanation to Section 73 will apply even where share dealing was company's sole business.
- b. *Commissioner of Income-tax-I, Indore vs. Intermetal Trade Ltd.* [2006] 156 Taxman 21 (MP).: It was held that since objects of memorandum and articles of association of company clearly showed that main business of assessee was trading in metal and shares and not granting advances/loans, no benefit of excepted category could be granted to assessee.
- c. *Commissioner of Income-tax vs. Parkview Properties (P.) Ltd.* [2004] 139 Taxman 38 (Cal.) held that: In speculation business, speculation loss cannot be set off except against a speculative profit permissible of being carried forward for being set-off in subsequent years stretching to a period of eight years and not otherwise, unless test of Explanation is satisfied.
- d. *Aryasthan Corpn. Ltd. vs. Commissioner of Income-tax* [2002] 124 Taxman 516 (Cal) held that: since assessee could not be said to be a company whose gross total income consisted mainly of income which was chargeable under heads 'interest on securities', 'income from house property', 'capital gains' and 'income from other sources' as business loss exceeded income computed under head 'income from other sources', Section 73 was clearly applicable.
- e. *Assistant Commissioner of Income-tax, 4(2)(2), Mumbai vs. Sonal Share & Stock Brokers (P.) Ltd.* [2006] 6 SOT 218 (Mum) held that: Section 73(1) requires loss from shares to be computed in respect of speculation business and in computing said loss, expenses incurred on purchase and sale of such shares have to be taken into account.
- f. *Mafatlal Securities Ltd. vs. Joint Commissioner of Income-tax, Special Range 32, Mumbai* [2009] 119 ITD 444 (Mum) held that: business loss being negative profit cannot be ignored in determining applicability of exception clause of Explanation to Section 73.
- g. *Torrent Finance (P.) Ltd. vs. Joint Commissioner of Income-tax, (Asstt.) Special Range* [2008] 110 ITD 315 (Ahd) held that: since dividend income was earned by assessee for holding shares and not by transfer thereof, it could not be treated to be an income from speculation business and, consequently, speculative business loss of assessee could not be set off against dividend income.
- h. *Yucca Finvest (P.) Ltd. vs. Deputy Commissioner of Income-tax, Circle 3(3), Mumbai* [2006] 101 ITD 403 (Mum.) held that: it is absolute figures of two incomes either under head 'Business' or under head 'Other sources' without sign, i.e., irrespective of whether it is positive income or loss, which should be taken for comparison for deciding as to whether a case falls in first exception of Explanation to Section 73 or not. Therefore, where loss due to trading in

shares had greater figure than figure of income from dividend, Explanation to Section 73 was rightly invoked. Besides, provisions of Explanation would be applicable even if whole of business is that of sale and purchase of shares and to attract provisions of Explanation, it is immaterial whether an assessee deals in shares of a single company, or in shares of several companies.

- i. *AMP Spg. & Wvg. Mills (P.) Ltd. vs. Income-tax Officer* [2006] 100 ITD 142 (AHD) (SB) held that: loss arising from sale of shares acquired by a dealer by making application for allotment of shares in public issue is a speculative loss in view of Explanation to Section 73.
- j. *ALFA Tie-up (P.) Ltd.* [2013] 31 taxmann.com 277 (Cal.) held that: where less than 50 per cent funds of assessee were invested in granting loans and advances, it could not be treated as assessee's principal business; and therefore, share trading loss would be treated as speculative loss.
- k. *S* [2012] 23 taxmann.com 377 (Bom.) held that: Explanation to Section 73 does not operate in respect of a company whose gross total income consists mainly of income which is chargeable under heads of 'interest on securities', 'income from house property', 'capital gains' and 'income from other sources'.
- l. *Savi Commercial (P.) Ltd.* [2015] 60 taxmann.com 295 (Cal) held that: since activity of granting loans and advances was on a larger scale than business of buying and selling shares, granting loans and advances was to be treated as principal business of assessee.
- m. *Snowtex Investment Ltd. vs. Principal Commissioner of Income-tax, Central-2, Kolkata* [2019] 105 taxmann.com 282 (SC), held that: the amendment which was brought by the Parliament to the Explanation to Section 73 by the Finance (No. 2) Act, 2014 was with effect from 1 April, 2015. In its legislative wisdom, the Parliament amended Section 43(5) with effect from 1 April, 2006 in relation to the business of trading in derivatives, the Parliament brought about a specific amendment in the Explanation to Section 73, insofar as trading in shares is concerned, with effect from 1 April, 2015. The latter amendment was intended to take effect from the date stipulated by the Parliament and we see no reason to hold either that it was clarificatory or that the intent of the Parliament was to give it retrospective effect.

PART 2: ENQUIRIES DURING ASSESSMENT

In this part, the enquiries to be made at the time of assessing the business income on account of transactions in share and securities are discussed.

ANALYSIS OF TRADING ACCOUNTS OF TRANSACTIONS IN SHARES

1. First of all, the AO should ask the assessee to furnish trading accounts of delivery-based share transactions, non-delivery based share transactions and derivative transactions separately. Assessee may resist this on the ground that they are carrying on a composite business or carrying on arbitrage activity and hence all such transactions are common to same business. But it should be remembered that, as already discussed in the first part, for

Income-tax purposes all these transactions are separate activities and the treatment to profits or losses earned on them would vary from situation-to-situation. Explanation 2 to Section 28 deems speculation activity as separate business. Provisions of Section 43(5) defining 'speculative transaction' should also be kept in mind. These days due to computerization, the software at the brokers' back-office can give separate reports for each activity; namely, delivery based, non-delivery based, derivatives etc. giving the details of scrip-wise profit/ loss.

2. Now, depending upon the fulfilment of different conditions, the income will be determined as follows:

a. In case of corporate assessee:

i. If the Explanation to Section 73 is applicable, then the losses from delivery-based share transactions and non-delivery based share transactions as well from derivative transactions will be treated as speculative loss and hence will not be set-off against any other income which is non-speculative in nature like brokerage income etc.

Here, it must be kept in mind that if in the pending appeals, it is held by the Supreme Court that derivative transactions doesn't come within the ambit of the Explanation to Section 73, even then derivative transactions done on non-recognized stock exchanges will remain speculative transaction only. But in that case, the losses from delivery-based share transactions and non-delivery based share transactions will not be set-off against any profit from derivative transaction done on recognized stock

exchanges after 24.1.2006 as after this date, derivative transactions carried out on BSE and NSE are not to be treated as speculative transactions.

ii. If Explanation to Section 73 is not applicable, then losses from non-delivery based transactions and losses from derivative transactions carried out on non-recognized stock exchanges will not be set-off against any other income which are non-speculative in nature, including profits from delivery-based share transactions and derivative transactions carried on recognized stock exchanges.

a. In case of non-corporate assessee:

The treatment will be the same as in the case of a corporate assessee in whose case Explanation to Section 73 is not applicable i.e. losses from non-delivery based transactions and losses from derivative transactions carried out on non-recognized stock exchanges will not be set-off against any other income which are non-speculative in nature, including profits from delivery based share transactions and derivative transactions carried on recognized stock exchanges.

ALLOCATION OF EXPENSES

Now the next step will be to allocate the expenses over speculative transactions and non-speculative transactions. Where a part of business being carried on by an assessee is to be treated as speculation business, then all relatable expenses are to be compulsorily allocated to such speculation business too on a rational basis. Such allocation has been approved by the Bombay

and Gujarat high courts in the decisions in the cases of *Sind National Super Mills P. Ltd vs. CIT* (121 ITR 742) (Bom), [2013] 35 taxmann.com 374 (Gujarat), High Court of Gujarat; *Anjalee Exim (P.) Ltd.* [1966] 61 ITR 214 (Allahabad); *Makhanlal Ram Swarup vs. Commissioner of Income-tax*. Hence, the AOs should on some rational basis e.g. turnover, etc. determine the expenses incurred to earn profit in speculation business, reduce it from the profits (or add to the loss) and then determine the profit or loss from speculation business and non-speculation business. By doing this, it may so happen that profit in speculation business may turn into loss and by invoking the provisions of Section 73 this may not be allowed to be set-off against other incomes.

VERIFYING THE NATURE AND GENUINENESS OF DERIVATIVE TRANSACTIONS

Another point of verification is, as to whether the derivative transactions have taken place over notified stock exchanges or not and thus they are eligible transactions or not. This is because as per stand taken by the department in the past, such transactions are considered to be speculative in nature till 25.1.2006 and after that day, these are non-speculative only if carried out on a notified stock exchange. Transactions on other non-recognized exchanges are still speculative.

Besides, as per Section 18A of the SCRA 1956, a derivative contract can be legal and valid only if such contracts are:

- a. Traded on a recognized stock exchange.
- b. Settled on the clearing house of the recognized stock exchange.

in accordance with the rules and bye-laws of such stock exchange.'

Thus, any transaction in derivatives not carried on a stock exchange is illegal. If loss is claimed on such transactions, it cannot be allowed, being an illegal loss. Many assesseees try to claim such bogus losses on the basis of forged contract notes.

Bogus losses created on account of derivative transactions can be detected by investigating as to whether these have been done on recognized stock exchange or not. The AOs should invariably, in case of loss in derivatives, call for the details and contract notes of the broker. From the contract notes, the genuineness should be examined by communicating with the Exchange where the transactions purportedly have been claimed to be executed. In case of a denial from the Exchange, the details as submitted by the Exchange together with the letter of the AO to the Exchange asking for the details, should be immediately informed to the assessee and his explanation must be called for. If the assessee asks, cross-examination should also be provided to him.

SET-OFF OF BROKERAGE INCOME AGAINST SPECULATION LOSS

The AOs assessing the share brokers should keep in mind that the brokerage income of the share-brokers are not to be adjusted against their speculative loss as per ratio of the decisions of the apex court in the case of *Pangal Vittal Nayak and Co. P. Ltd.* 74 ITR 754 (SC) and of ITAT Delhi bench in *Frontline Capital Services Ltd.* 96 TTJ (Del) 201.

SET-OFF OF DIVIDEND INCOME AGAINST SPECULATION LOSS

Similarly, the dividend income cannot be treated as speculation income as this is earned on account of holding of shares and not on account

of their sale and purchase as decided in *Torrent Finance (P.) Ltd. vs. Joint Commissioner of Income-Tax, (Asstt.) Special Range* [2008] 110 ITD 315 (Ahd).

VERIFICATION OF OFF-MARKET TRANSACTIONS

Many-a-times, the assessee claims loss on account of sale and purchase of listed securities carried out privately and outside the stock exchange. Besides making enquiries regarding purchasers and sellers and ascertaining the genuineness of such transactions, the provisions of the Security Contract Regulation Act 1956 also must be kept in mind while assessing such loss. This is because under certain circumstances, such loss would be illegal loss.

Therefore, once it is found that the purchase and sale transactions are off-market transactions conducted through a person who is not a share-broker, then the legality of such transaction is to be verified as per the provisions of the Securities Contract (Regulations) Act 1956 as discussed below:

- a. As per Section 13 of this Act, the Central Government is empowered, to apply the said Section by a notification in the Official Gazette, and, upon such declaration, every contract in securities in the State or area which is entered into after the date of such notification, otherwise than between members of a recognized stock exchange, in such State or area, or through or with such member, is rendered illegal.
- b. The exception to this is the spot delivery contract, i.e. a contract which provides for the actual delivery of securities and the payment of a price there for either on

the same day as the date of the contract, or on the next day.

- c. Similarly, as per Section 18A, contracts in derivative shall be legal and valid only if such contracts are:
 1. Traded on a recognized stock exchange;
 2. Settled on the clearing house of the recognized stock exchange, in accordance with the rules and bye-laws of such stock exchange.
- d. Section 16 of the SCRA provides that:
- e. '16(1) if the Central Government is of the opinion that it is necessary to prevent undesirable speculation in specified securities in any state or area, it may by notification in the official gazette declare that no person in the state or area specified in the notification shall, save with the permission of the Central Government (or SEBI/ RBI), enter into any contract for the sale or purchase of any security specified in the notification except to the extent and in the manner, if any, specified therein.
- f. In accordance with the above, a Notification No. SO 184(E) was published in the Gazette of India on March 01, 2000 stating that no person in the territory to which the said Act extends, shall, save with the permission of the Board (SEBI here as all powers under Sections 13 and 16 of the SCRA have been delegated to SEBI), enter into any contract for sale or purchase of securities other than such spot delivery contract, or contract for

cash, or hand delivery, or special delivery, or contract in derivatives as is permissible under the said Act or the Securities and Exchange Board of India Act 1992 and the Rules and Regulations made under such Acts and Rules, Regulations and Bye-laws of a recognized Stock Exchange.

- g. Thus, outside stock exchanges, only spot delivery contract, or contract for cash, or hand delivery, or special delivery, or contract in derivatives, as is permissible under the said Act, or the Securities and Exchange Board of India Act can be entered. *Hence, all the back-dated share purchases in which the deliveries have not been given within 48 hours of the purchase are illegal and hence do not confer any right on the purchaser.*
- h. In the decision dated 11.7.2016 in the case of Securities and Exchange Board of India.....Appellant VERSUS M/s. Opee Stock-Link Ltd. & AnrRespondents in CIVIL APPEAL NOS. 2285, 2286, 2294 & 2303 OF 2010, related to IPO scam, the Supreme Court of India has also held that: considering the facts and circumstances of the present case, the transfer of shares did not comply with the requirements of the provision of either Section 13 or Section 2(i) of the SCRA. Therefore, the off-market trading indulged into by the Respondents was rightly held to be per se illegal by the Whole Time Member. Similar finding has also been given by the apex court in the decision in the case of *Bhagwati Developers Pvt. Ltd. vs. Peerless General Finance and Investment Company Ltd. & Anr.* (2013) 9 SCC 584.

Thus, if the transactions made outside stock exchange are not 'Spot Delivery' contracts, then the resultant loss would be illegal and cannot be allowed to be set-off against other legal incomes of the assessee.

DIVIDEND STRIPPING

Another aspect is to examine the losses as per the provisions of Section 94(7) to detect any disallowance on account of dividend stripping. For this, the assessee should be asked to give date-wise details of purchase and sale of shares and dividend received along with record dates. In many cases, good disallowances under Section 94(7) have been detected.

VERIFICATION OF OTHER EXPENSES INCLUDING UNDER SECTION 14A

The AO is required to verify all other expenses which are common to all types of business activities like administrative expenses, finance expenses, commission expenses etc. The disallowance under Section 14A is also to be examined by the AO as per relevant laws and rules applicable to the assessment year. The Supreme Court in its decision in the case of *Maxopp Investment Ltd. vs. Commissioner of Income Tax, New Delhi* [2018] 91 taxmann.com 154 (SC) has upheld the applicability of this Section on the exempt dividend income earned from shares held as stock in trade too.

LOSS CLAIMED ON ACCOUNT OF 'MARK TO MARKET' OF OPEN DERIVATIVE CONTRACTS

Another point of verification is as to whether the assessee has claimed any loss on account of 'Mark to market' of open derivative contracts as on 31st March. Assesses should be asked to furnish the details of provision made of notional loss on account of open contracts in derivatives

and Interest Rate Swap (IRS) on the last day of the financial year and debited in the P&L account. Such losses being contingent losses are to be disallowed. As per circular of CBDT Instruction No. 03/2010, Dated 23.3.2010, the MTM losses on forex derivatives are notional loss in nature and hence are not allowable as a deduction in computation of income. The same is applicable to MTM loss in share and security derivatives too.

Further, Clause 4 of Income Computation and Disclosure Standard I relating to accounting policies provides that marked to market loss or an expected loss shall not be recognized unless the recognition of such loss is in accordance with the provisions of any other Income Computation and Disclosure Standard. Further, Clause (xviii) of Section 36 also provides that only marked to market loss or other expected loss as computed in accordance with the income computation and disclosure standards notified under Sub-section (2) of Section 145 are allowable as a deduction in computation of income. No such ICDS is in place as on date which allows such notional losses on share and security derivatives.

Only as per ICDS VI, exchange differences on a forward exchange contract shall be recognized as income or as expense in the previous year in which the exchange rates change provided the contract is not intended for trading or speculation purposes. Even if the assessee claims that the same should be applied to share and security derivatives too, since the derivative transactions in shares and securities are for trading or speculation purposes only; hence, any mark to market loss of such derivatives would not be allowable in computation of income.

The provisions of ICDS and Section 36(xviii) are applicable from AY 2017-18. For assessment years prior to that, there are decisions in favour

of allowing as well as disallowing such notional losses. In the case of *Edelweiss Capital Ltd* in ITA no 5324/Mum/2007, Mumbai ITAT has allowed such losses on the presumptions that derivatives are stock-in-trade. The same has been followed in some other decisions. But this is a wrong presumption as explained below:

- i. As we know, derivatives contracts are of two types: 'Futures' and 'Options'. The assessee is debiting in P&L A/c, provisions for loss on equity index/ stock futures account but the profits are ignored on the basis of prudence principle. This loss is arrived at, on account of adverse price differences, in the future contracts, open i.e. unsettled as on 31st March i.e. the date of preparation of balance sheet.
- ii. The ICAI Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options describes 'futures' is like a forward contract. As futures do not have any cost of their own at the time of execution of the contract, no asset or liability is created on purchase or sale of the futures and the futures contract is not recognized as such at inception in the books of account, unlike when security is purchased in cash market, where an asset is recorded in the books irrespective of the payment made for it. No such accounting takes place for futures.

In case of options, if any premium is paid that remains in the nature of advance, the mark to market adjustments also are in the nature of advances.

- iii. On final settlement of futures contract, parties pay the difference between the final settlement price as on the expiry date and the contract price, which is recognized as income or loss by debiting or crediting the P&L A/c in the year the contract is settled. The margin accounts are appropriately adjusted and closed.
- iv. As the derivative contracts are not accounted for in the books of account at the inception thereof at the time of purchase, they do not, and cannot, form a part of stock-in-trade. Any contract to acquire a derivative at a future date is a forward contract to acquire a commodity. This contract, as such, is not a stock-in-trade and hence it cannot be valued at the time of preparation of balance sheet as stock in trade.
- v. Even for the argument sake, if it is assumed that the futu is re contract for the derivative itself is a stock-in-trade and can be valued at cost or market price whichever is lower, in cases where mark to market results in a loss, the cost of acquisition being NIL, the valuation of such a contract will be a negative figure. By its very nature, the value of stock-in-trade cannot be negative. Hence, this argument is not correct. The mark to market loss at best can be an unascertained liability or a provision for loss which may or may not be incurred at the time of settlement of the contract at a future date.

The above position has been rightly appreciated and applied by the Bengaluru bench of

ITAT in its decision in the case of, *Shankara Infrastructure Materials Ltd.* [2015] 53 taxmann.com 429 (Bangalore-Trib.). The observations of the bench are worth reading for the purpose of understanding this issue.

VALUATION OF CLOSING STOCK

The valuation of stock-in-trade of securities except derivatives has to be checked as per the provisions of the Revised Income Computation and Disclosure Standards (ICDS) Notified Under Section 145(2) notified vide Notification No. SO 3079(E) [NO. 87/2016 (F.NO.133/23/2015-TPL)], Dated 29.9.2016.

The Income Computation and Disclosure Standard VIII relating to security is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of account. Part A of this Income Computation and Disclosure Standard deals with securities held as stock-in-trade except following cases:

- a. The bases for recognition of interest and dividends on securities which are covered by the Income Computation and Disclosure Standard on revenue recognition;
- b. Securities held by a person engaged in the business of insurance;
- c. Securities held by mutual funds, venture capital funds, banks and public financial institutions formed under a Central or a State Act or so declared under the Companies Act 1956 or the Companies Act 2013.

For the purposes of this ICDS, ‘Securities’ shall have the meaning assigned to it in Clause (h) of Section 2 of the Securities Contracts (Regulation)

Assessment

Act 1956 and shall include share of a company in which public are not substantially interested but shall not include derivatives referred to in Sub-clause (ia) of that Clause (h). Thus, it is not applicable to derivatives. As already discussed, it is not allowed to claim deduction on account of mark to market of security derivatives at the year end, hence the valuation of such derivatives is not required to be done.

The relevant parts of the ICDS are as follows:

'Recognition and Initial Measurement of Securities'

1. A security on acquisition shall be recognized at actual cost.
2. The actual cost of a security shall comprise of its purchase price and include acquisition charges such as brokerage, fees, tax, duty or cess.
3. Where a security is acquired in exchange for other securities, the fair value of the security so acquired shall be its actual cost.
4. Where a security is acquired in exchange for another asset, the fair value of the security so acquired shall be its actual cost.
5. Where unpaid interest has accrued before the acquisition of an interest-bearing security and is included in the price paid for the security, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion of the interest is deducted from the actual cost.

SUBSEQUENT MEASUREMENT OF SECURITIES

At the end of any previous year, securities held as stock-in-trade shall be valued at actual cost

initially recognized or net realizable value at the end of that previous year, whichever is lower.

For the purpose of para 9, the comparison of actual cost initially recognized and net realizable value shall be done category-wise and not for each individual security. For this purpose, securities shall be classified into the following categories, namely:

- a. shares.
- b. debt securities.
- c. convertible securities.
- d. any other securities not covered above.

The value of securities held as stock-in-trade of a business as on the beginning of the previous year shall be:

- a. The cost of securities available, if any, on the day of the commencement of the business when the business has commenced during the previous year; and
- b. The value of the securities of the business as on the close of the immediately preceding previous year, in any other case.

Notwithstanding anything contained in paras 9, 10 and 11, at the end of any previous year, securities not listed on a recognized stock exchange; or listed but not quoted on a recognized stock exchange with regularity from time-to-time, shall be valued at actual cost initially recognized.

For the purposes of paras 9, 10 and 11 where the actual cost initially recognized cannot be ascertained by reference to specific identification, the cost of such security shall be determined on the basis of first-in-first-out method or weighted average cost formula.'

The ICDS defines 'Fair value' as the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

Hence, while assessing the income of a trader in share and securities, the closing stock valuation must be checked as per provisions of this ICDS. This will prevent the assessee from evading due taxes by valuing the unquoted shares at lower than cost of acquisition. Such checks will also detect as to whether the assessee has claimed any loss on account of valuations of open contracts in derivatives at market value at the year end.

Another method of claiming lower profit is by way of bogus purchases which are valued at a much lower prices than the alleged cost of acquisition. Most of the time, such practice is resorted to after the end of the financial year. Hence, the assessee can neither show any acceptance of delivery of shares, nor can he make any payments by cheques. Therefore, purchase is shown on credit side and the assessee is also without any evidence of delivery.

Hence, the list of closing stock should be obtained and tallied with the demat statement of the assessee as on 31st March. If any share is not found reflected in the demat statement and loss on account of valuation of the same at market value has been claimed by the assessee, then the assessee should be asked to give details of purchase of these shares like date of purchase, details of persons from whom purchased, whether purchase was on-market or off-market, when was the payment for purchase made.

If the purchase was through stock exchange, the shares must be transferred to the demat account of the assessee within 2 days as per SEBI circular

on transfer of share by broker to its client MRD/DoP/SE/Dep/Cir-30/2004. If it has not been done, the assessee cannot claim any benefit on account of such purchases.

If the assessee claims that the shares were purchased off-market, then the delivery of shares and payment of consideration has to be completed either on the same day as the date of the contract, or on the next day. If it has not been done, then again the purchase is illegal as per the provisions of SCRA 1956, as already discussed. Hence, again the assessee cannot claim the valuation loss of such shares in computation of his income.

In case of unquoted shares, as per ICDS VIII, the closing stock valuation has to be done at cost of acquisition. So, again, no such valuation loss can be claimed for such shares.

CONVERSION OF STOCK-IN-TRADE TO CAPITAL ASSET

Many assessees resort to this practice to take benefit of lower rate of taxes on capital gain. Till AY 2018-19, the Act was silent on this issue. Hence, the most important aspect of this issue was the analysis of the nature of transactions done by the assessee after the alleged conversion. The AO should find out whether after the alleged conversion, the assessee's transactions were in the nature of an investor, or he continued to act as a trader only. This fact should be clearly brought on record. This was to be done in the year of conversion itself. Refer: Clauses 12 and 12A of Form No. 3CD attached to the Tax Audit Report which give such details.

In the judgment in the case of *Wallfort Financial Services Ltd. vs. Additional Commissioner of Income-tax, Range 4(2), Mumbai*, reported in [2010] 41 SOT 200 (Mum.), the ITAT has analyzed this issue in detail. In this case, the

assessee, a share-broker, tried to pass off his trading transactions in shares after 1.10.2004 as investment in order to take advantage of the lower tax rate. The AO and the CIT(A) had passed detailed order bringing out the fact that the assessee continued to behave as a trader even after such conversion. After analyzing all the facts, the ITAT has decided the issue in the favour of the Revenue. Again, it should be noted that in this case, in the assessment order and the appellate order, all the facts had been well marshaled and fully analyzed.

Besides, in *Abhinandan Investment Ltd.* [2015] 63 taxmann.com 263 (Delhi), it has been held that where stock in trade is converted into capital asset, the holding period for the purposes of classifying it as long-term or short-term capital asset shall be reckoned while excluding the period for which it was held as stock-in-trade prior to conversion.

Now from AY 2018-19, a new Clause (via) has been inserted in Section 28 as per which the fair market value of inventory as on the date on which it is converted into, or treated as, a capital asset determined in the prescribed manner is to be taxed as business income of the previous year in which such transaction took place.

TAXATION OF GAINS FROM DEALING IN SHARES—WHETHER CAPITAL GAIN OR BUSINESS INCOME

In view of the differential rate of taxation between income received from trading and capital gains in shares, there is a tendency on the part of the assesses to camouflage the trading receipts as short-term capital gains.

The Instruction No. 1827, dated August 31, 1989 of CBDT sets out guidelines to the Assessing Officers for determining whether a particular assessee is a trader in shares, or the

shares are held as capital assets. This instruction was updated on the basis of subsequent judicial pronouncements by Circular No.4/2007 dtd.15.06.2007 issued by the CBDT. After this, the CBDT has issued another circular vide Circular No. 6 of 2016 dated 29.2.2016. The AO has to consider all these instructions/ circulars while framing assessment orders.

The ratios to be considered by the AO as laid down by these instructions/ circulars as well as judicial pronouncements can be summarized as follows:

1. The income shown as capital gain is to be examined on case-to-case basis to find out whether business income is being shown as capital gain or otherwise. No single factor can be termed as conclusive and totality of the facts has to be considered.
2. Intention should be ascertained—the determinants of intention are: (these are only indicative and not conclusive)—frequency and volume of transactions, period of holding, continuity and regularity of the transactions, magnitude of transactions, nature of entry in the books of account, object clause in the Memorandum of Association, organized efforts, loans and borrowings used for investment, profit motive, reasons of sale and the nature of investment of the sale consideration etc.
3. Now, as per the latest CBDT circular, where the assessee itself, irrespective of the period of holding of the listed shares and securities, opts to treat them as stock-in-trade, the income arising from transfer of such shares/ securities would be treated as his business income.
4. Furthermore, in respect of listed shares and securities held for a period of more

than 12 months immediately preceding the date of its transfer, if the assessee desires to treat the income arising from the transfer thereof as Capital Gain, the same shall not be put to dispute by the Assessing Officer. However, this stand, once taken by the assessee in a particular Assessment Year, shall remain applicable in subsequent Assessment Years also and the taxpayers shall not be allowed to adopt a different/ contrary stand in this regard in subsequent years.

5. To have a better understanding of the issue, the AO is recommended to read the following orders of various courts:

- i. *Pari Mangaldas Girdhardas vs. CIT* 1977 CTR (Guj.) 647.
- ii. *Gopal Purohit* 122 TTJ (Mum) 87. Later, the Bombay High Court has approved this decision. In this aforementioned order, after analyzing all the facts, the delivery based transactions were held assessable as capital gain and non-delivery based transactions as business income.
- iii. *Dr. Rajeev Choudhary* [2019] 111 taxmann.com 438 (Madhya Pradesh): The income was held to be business income on account of high frequency of transactions.
- iv. *Ramilaben D. Jain* [2018] 97 taxmann.com 217 (Bombay): held that profit from sale and purchase of shares was business income due to short period of holdings.
- v. *Ratanlal J. Oswal* [2015] 63 taxmann.com 57 (Bombay): Since the assessee borrowed funds for

purchase of shares, transactions was carried out with many brokers and transactions had resulted in crores of rupee of income, the income on such on such transactions was held to be assessable as 'business income'.

- vi. *Manoj Kumar Samdaria* [2014] 45 taxmann.com 394 (Delhi): Where assessee was selling shares very frequently, volume and magnitude was very high and he earned only a meagre amount of dividend, income arising from sales of shares was assessable as business income.
- vii. *PVS Raju* [2012] 18 taxmann.com 3 (AP): where assessee had not purchased shares as an investment, but with intention to trade in such scrips - it was held to be assessable as business income.
- viii. *Rakesh J. Sanghvi* [2010] 7 taxmann.com 40 (Mum): this decision has discussed multiple issues.

Further, if the assessee is utilizing the services of a Portfolio Management Services (PMS), even then the same principles are to be applied to determine whether the income is business income or trading income. For this, reference can be made to decisions in the cases of:

- a. *Radials International* [2012] 18 taxmann.com 20 (Delhi.)
- b. *Tash Investment (P.) Ltd.* [2019] 106 taxmann.com 190 (Ahmedabad-Trib.).
- c. *Nalin Pravin Shah*, [2014] 49 taxmann.com 319 (Mumbai-Trib.).

Assessment of 'On-Money'



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Executive Summary

Assessment of 'On-Money' has been the story of 'Hype vs Reality'. It involves understanding of fundamental issues of taxation such as Receipt vs Income, Heads of Income, Method of Accounting, Business Receipts vs Income from Other Sources, etc. In the absence of a fine understanding of such issues, despite clinching evidence, the AOs have been making assessments, which at times, could not pass the tests of appeal. The essay seeks to flag these issues involved and explains the position of law, as laid down by courts. The paper suggests that despite the power of penalty enshrined in the Act since FY 2015-16, in the interest of equity, there is further need to amend Sections 68/69 of the Act to make the provisions of assessment of 'on-money' rational. The paper has been reviewed by Shri Narendra Kumar, Pr. CIT, Jodhpur and his valuable inputs have also been incorporated in the essay.

ASSESSMENT OF 'ON-MONEY'

During the course of search and survey, evidence of '**on-money**' received in cash, meticulously noted in diaries and documents are commonly found and seized in the cases of action against builders and developers. The evidence is normally considered very clinching with specific details, such as dates of receipt, amount received both in cash and cheque, the property for which the amount has been received, and the persons from whom the payments are received, etc. Generally, such findings of search and survey are followed by disclosures by the

assessee also. Normally, such searches and surveys are celebrated as great successes, both by the Investigation Wing and also assessments are made bringing to tax the on-money receipt as income of the assessee. However, at the appellate stage, the disclosures are retracted and these so-called open and shut cases (from the revenue point of view), face serious challenges. The amendments to the Act since 2015, does provide some teeth to the AOs. Though, these powers are to levy penalty, corresponding to the value of the cash transactions, above a threshold. The penalties would be under stricter scrutiny by the appellate authorities.

Assessment

In the above context, let us examine a simple case of search/ survey on a land developer, where a document, indicating land wise receipt both in cash (on-money) and cheque listed, was found and seized. It is admitted that the cash receipts were 'on-money' receipt for the land parcels booked for sale and that they were not accounted in the regular books of accounts of the assessee. Receipts by cheques are part of the regular books. However, it was claimed that the sale as per the regular accounting practice, only materializes when the possession of subject land parcels are handed over to the respective parties and therefore, it is in the year of handing over possession that the sales are offered to tax. The receipts prior to such hand over are in the nature of 'advance' and not 'income' and therefore, the taxability of such unaccounted receipts in cash cannot arise as per the dates of receipts mentioned in the documents found and seized during the search/ survey, as has been

done by the AO. The argument further goes that in the year of handover of the property, both the cash and cheque components are offered as revenue, as per the project completion method of accounting and offered to tax. In one such typical case, where the search had taken place in July 2011 and documents related to 'on-money' receipts pertained to prior year, the assessee claimed in its Income Tax Return for AY 2015-16, that profit from the project including the on-money receipts have been disclosed in AY 2015-16. On the perusal of the ITR, for AY 2015-16, it was evident that the assessee had offered sale receipts of Rs. 30,73,39,165, including the on-money amounting to Rs. 3,67,94,000, received on account of sale and booking on land. However, after claiming the various expenses, only an amount of Rs. 8,24,947 was offered to tax as profit. The assessee in this case started offering profit for the project from AY 2013-14 and the details of profit shown in successive years has been as under:

Table 1

Sr. No.	Sale Receipt Excluding on Money (in Rs.)	On Money (In Rs.)	Total Sale Receipt (In Rs.)	Profit (In Rs.)
1	16,68,08,905	69,47,000	17,37,55,905	3,20,700
2	8,34,72,567	1,92,00,000	10,26,72,567	4,01,043
3	27,05,45,165	3,67,94,000	30,73,39,165	8,24,947
Total	52,08,26,637	6,29,41,000	58,37,67,637	15,46,690

From the above table, it is evident that despite including the 'on-money' in the sale receipt, the assessee ultimately offered very low profit for all the assessment years. In the above case, while the AO may have assessed to tax, the entire on-money receipt of Rs. 6,29,41,000 what is offered to tax by the assessee is a profit of Rs. 15,46,690 only. Revenue may suspect that the assessee might have inflated its expenses to reduce the taxable income, but this is very difficult to prove.

The above example gives rise to several issues for consideration, some of which are listed as under:

- The 'on-money' on the date of search has neither been declared as 'sales' nor as 'advances' in the books.
- Whether the 'on-money' may be assessed under the head 'income from business and profession' or 'income from other sources'.

- The 'on-money' evidently being business receipts can it be assessed as 'income from other sources'.
- If 'on-money' is business receipts then will the method of accounting determine its accrual as income as per past practices.
- 'Documents' containing 'on-money' details not being books of accounts, can it be assessed under Section 68 of the Act.
- As receipts are not entered in the regular books of accounts and are unaccounted and undisclosed, can it partake the character of 'income' to be assessed as 'income from other sources'.
- Which is the year in which, the 'on-money' receipts can be brought to tax.
- What are the requirements as per the accounting standards vis-a-vis the 'project completion method' and 'percentage completion method'.
- Can the cash component and cheque component of the sale receipts be taxed in different assessment years, when cash component is 'on-money' and not recorded in books and cheque money is recorded and offered to tax on project completion method.
- The levy of penalty on the cash component and its sustainability in appeal.

'RECEIPTS' VS. 'INCOME'

The first principle in Income-tax is that all receipts are not income. Generally speaking, the word 'Income' covers receipts in the shape of money or money's worth which arise with certain regularity or expected regularity from a definite source. The Income-tax Act has given an inclusive definition of income as per Section

2(24) of the Act. The Supreme Court in *CIT vs. Karthikeyan* (GR) (1993) 201 ITR 866 (SC) has held that the purpose of the inclusive definition is not to limit the meaning but to widen its net, and the several clauses therein are not exhaustive of the meaning of income; even if a receipt did not fall within the ambit of any of the clauses, it might still be income if it partakes of the nature of income. In order to constitute 'income', the receipt must be one which comes in (a) as a return, and (b) from a definite source. It must also be of the nature which is of the character of income according to the ordinary meaning of that word in the English language and must not be one of the nature of a windfall. *Mehboob Productions (P) vs. CIT* [1977] 106 ITR 758 (Bom). However, the income-tax authorities cannot assess all receipts, they can assess only those receipts that amount to income. Therefore, before they assess a receipt, they must find that to be income. They cannot find so unless they have some material to justify their finding. (*Lalchand Gopaldas vs. CIT* 48 ITR 324 (All)).

HEADS OF INCOME

Section 14 of the I-T Act classifies income under the heads of Salaries, Income from House Property, Profit and Gains of Business or Profession, Capital Gains and Income from Other Sources; for the purposes of charge of Income Tax and Computation of Total Income. The quantum of income which is assessed to Income-tax is peculiar to that head, but it is not unusual that commercial considerations may properly describe the source differently (*Brooke Bond and Co. Ltd. vs. CIT* [1986] 162 ITR 373 (SC)). Income falling specifically under any of the heads of income other than the residuary head of income specified in Section 14 of the I-T Act 1961 cannot under any circumstance be charged under the residuary head i.e. Income from

Other Sources. Heads of income are mutually exclusive and an item of income coming under an exclusive head cannot in any circumstance be charged under another head (*Bihar State Co. Bank Ltd. vs. CIT* [1960] 39 ITR 114 (SC)). Neither assessee nor revenue has the option to choose the head for a particular item of income (*United Commercial Bank Ltd. vs. CIT* [1957] 32 ITR 688 (SC)).

METHOD OF ACCOUNTING

The I-T Act (Section 145) provides that income chargeable under the head Profits and Gains of Business or Profession or Income from Other Sources shall be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Income is brought to tax either on accrual basis or on receipt basis, as per the method of accounting regularly employed by the assessee. In the case of a developer/ builder, the income has been offered to tax either on project completion method or on percentage completion method. In case where the accounting method followed was project completion method, it was claimed that the full consideration along with the 'on-money' receipt cannot be brought to tax in the hands of the assessee till the project is completed or substantially completed. The argument taken is that while the receipt of 'on-money' is an objective fact, 'income' is a legal concept, which has to be arrived at after considering various aspects such as expenditure and the year of taxability. In the case where the assessee is following the project completion method for computing its income and the same is established in the returns of income filed prior to search, it is argued that even after search and detection of 'on-money', the taxation of income can only be as per the method of accounting regularly followed by the assessee.

On the basis of the principle of consistency, it is argued that the revenue should compute income as per the method of accounting regularly followed by the assessee. In the case of *CIT vs. Bill Hari Investment Ltd.* 299 ITR 1, the Hon'ble Supreme Court has held as follows:

'15. Recognition/ identification of income under the 1961 Act, is attainable by several methods of accounting. It may be noted that the same result could be attained by any one of the accounting methods. Completed contract method is one such method. Similarly, percentage of completion method is another such method.'

Under *project completion method*, the revenue is not recognized until the contract is complete. Under the said method, cost is accumulated during the course of the contract. The profit and loss is established in the last accounting period and transferred to P&L account. The said method determines results only when contract is completed.

On the other hand, *percentage of completion method* tries to attain periodic recognition of income in order to reflect current performance. The amount of revenue recognized under this method is determined by reference to the stage of the completion of the contract. The stage of completion can be looked at under this method by taking into consideration the proportion that cost incurred to date bears to the estimated total cost of contract.

In the decision of the Bombay High Court in *CIT vs. Taparia Tools Ltd.* 260 ITR 102 (Bom), it has been held that in every case of substitution of one method by another method, the burden is on the Department to prove that the method invoked is not correct and it distorts the profits of a particular year.

Various Tribunals and Courts have held that undisclosed income detected as a consequence of search and seizure operation has to be taxed on the basis of method of accounting followed by the assessee.

In exercise of the powers conferred by Sub-section (2) of Section 145 of the Income-tax Act 1961, the CBDT has notified the Income Computation and Disclosure Standards (ICDS). This notification has come into force with effect from 1st day of April 2015 and accordingly applies to the assessment year 2016-17 and subsequent assessment years. All contract or transaction existing on the 1st day of April 2015 or entered into on or after the 1st day of April 2015 shall be dealt with, in accordance with the provisions of this standard. In the case of conflict between the provisions of the Income-tax Act, and the Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent. As per the ICDS, the contract revenue and contract costs associated with the construction contract shall be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. The recognition of revenue and expenses by reference to the stage of completion of a contract is referred to as the 'percentage of completion method'. As indicated, under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. As such, with the ICDS notified by the CBDT, the percentage completion method has become the de facto method for recognition of costs and revenue for the builders/ developers and applies to all contracts and transactions existing as on 1st April 2015. This should simplify the job of the Assessing Officers.

'ON-MONEY' NOT RECORDED IN BOOKS

The common argument taken of the assessing officers in assessing the 'on-money' has been that as per the provisions of the I-T Act, unaccounted and undisclosed income is deemed to be income of the assessee of the FY in which it is received. It is generally argued that had the diaries/ documents indicating unaccounted 'on-money' receipts, not being unearthed as a result of search, the 'on-money' would not have been offered to tax. It is therefore, argued that the question of any method of accounting for determining taxable income does not arise as the entire 'on-money' being undisclosed is taxable in the year of search/ survey. The disclosure made during the course of search (though generally retracted later) is also relied upon as a ground for bringing to tax the entire 'on-money' receipt in the year of detection.

BUSINESS RECEIPT OR INCOME FROM OTHER SOURCES

The details of 'on-money' receipt found during the course of search and seizure in the form of Diaries or Documents are at times self-explanatory and speaking documents. This is so because they may be found from the business premises of the assessee, at times even in the handwriting of the key persons of the business and list in detail the property against which the 'on-money' has been received with dates, amount, cash and cheque components and names of the persons from whom received and such other details. Sometimes even the expenses incurred in cash are found along with the details of 'on-money' receipts. In such cases, the only logical inference to draw would be that the 'on-money' receipts even though unaccounted in the regular books of accounts are actually receipts from the business of the assessee. However,

only where details of receipts of unaccounted money in cash or cheque are found, and there is no satisfactory explanation to the source of the money, such receipts may be assessed under the head 'Income from Other Sources'.

Once the 'on-money' receipt is confirmed and quantified, the AO will face the challenge of determining the 'taxable income' and the year in which such taxable income may be brought to tax. Depending on the facts of the case, the AO may take recourse to one of the following methods:

REJECTION OF BOOKS AND DETERMINATION OF INCOME ON A BEST JUDGMENT BASIS

Once deficiencies in the regular books of accounts are found, books may be rejected either on grounds of their incorrectness, incompleteness or non-verifiability and the AO gets the power to estimate the assessee's income in a fair and reasonable manner. Once the fact of receiving 'on money' is admitted, the Assessing Officer is legally entitled to reject the book results and estimate the 'on money' in respect of all the shops. In this connection, the AO may rely on the Supreme Court judgments in the case of *H.M. Esufali H.M. Abdulali*, in the case of *Raguwar Mandal Harihar Mandal* 8 STC 770 and in the case of *Dhakeswari Cotton Mills Ltd. vs. CIT* (1954) 26 ITR 775 (SC). The only exception to this proposition is that estimate must be rational and not arbitrary, though some guess-work is bound to be there. The AO may also refer the property for valuation to the Valuation Officer as per Section 142A and a similar reference can also be made by the authorized officer of a search under Section 132(9D). If the projects have been completed and the sales substantially made, the AO may take recourse to determining the total

cost and total sales and bring to revenue for taxation, the total area of sales effected in various years on a pro rata basis. A good method would be to spread the total cost of the project over the saleable area of the land/ shops/ flats/ stalls etc., so as to determine the cost per sq. ft. of the saleable area and then ascertain the cost of the total area sold during each year by multiplying the rate per sq. ft. saleable area to the area sold by the assessee in each year. Once this exercise is done, then the same may be deducted from the total receipts of each year as the case may be including the 'on money' charged by the assessee. The difference so arrived at would be assessable profits/ losses of each year.

In the case of *Golani Brothers* (2000) 75 ITD 1; the ITAT Pune has upheld the action of the AO in assuming that assessee must have also received the 'on money' in respect of the balance 67 shops sold during these years, when the material found and seized in search contained only a list of 201 shops in respect of which 'on money' was received by the assessee. In this connection, the reliance was placed on the decision of the Hon'ble President, of the Tribunal as Third Member in the case of *Overseas Chinese Cuisine vs. Asstt. CIT* (1996) 55 TTJ (Bom) 304 (TM) : (1996) 56 ITD 67 (Bom)(TM) wherein it has been held that once a fact has been proved to be in existence, the presumption can be raised in respect of other transactions. This treatment by the ITAT Pune was also reaffirmed by the Bombay High Court in the case reported as (2017) 160 DTR (Bom) 24. In another judgement of the Bombay High Court in the case of *Harish Textiles Engineers Ltd.* (2015) 128 DTR (Bom) 145, the estimation of 'on-money' on machines was also upheld for the period prior to the period for which evidence was found.

BOOKS ACCEPTED AND TAXABLE INCOME DETERMINED AS PER THE METHOD OF ACCOUNTING FOLLOWED

Where the seized or impounded documents contain details of unaccounted 'on-money' as also details of expenditure in cash which have not been recorded in regular books, the taxable income may be determined by allowing the cash expenses from the cash receipts as per the documents. However, before taking this path, the AO has to examine the fact that the receipts and expenses relate to the business of the assessee and both the receipts and expenses relate to the same project. The relevance of the provisions of Section 40A(3) in such cases may also be examined. As the 'on-money' is by definition collected in cash, if there is evidence of 'on-money' spent in cash, the AO should examine this aspect and apply provisions of Section 40A(3). In rare cases, where the 'on-money' has been deposited in bank, AO may apply Section 68/69 provisions and even then disallow the expenditure made in cash by relying on provisions of Section 40A(3) of the Act. In *CIT vs. Mohan Lal Agrawal* [2017] 393 ITR 402 (Calcutta), the Hon'ble Court held that as the application of the provision of Section 40A(3) to the unverified expenditure of undisclosed sales would have led to 20 per cent disallowances thereof, since the seized documents of undisclosed income showed that the transactions had taken place mostly in cash; this oversight by the Assessing Officer in not applying Section 40A(3) had been prejudicial to the interest of the revenue. The court held that it was also not a case where two views were possible and the Assessing Officer had taken one of them. As regards the applicability of Section 40A(3), it was held that whenever any expenditure was claimed, there were never two views. Therefore, revision order was to be upheld. In the case of *Sai Metal Works* [2011]

241 CTR 377 (Punjab & Haryana), the Punjab & Haryana High Court held that Section 40A(3) applies to the proceedings of assessment under Chapter XIV-B. Where the seized/ impounded documents indicate only unaccounted receipts but no details of unrecorded expense, it may be prudent for the AO to assess the entire receipts as income as per the method of accounting followed. Alternatively, he may consider a percentage of the receipts as income considering the facts of the case.

ASSESS THE UNRECORDED RECEIPTS AS TAXABLE INCOME?

The difficult path is to assess the entire unaccounted receipts as taxable income. For this course of action, it has to be proved that the receipts being not recorded and undisclosed, partakes the character of income. One line of investigation may be to examine all the persons whose details may be found in the documents as the source of the 'on-money'. The assessee may be asked by the AO to produce those persons or at least confirmations from them of having paid such amounts in cash. Where no such confirmations of the cash payments are filed, the AO may have better ground to assess the 'on-money' as taxable income. This method may be justified on grounds of equity. It would be against the principle of equity if an assessee who has not recorded part sales in his books and therefore evidently had no intention to offer the said receipts to tax, even after detection, is allowed to reconstruct its books and again given the leeway to offer the receipts to tax on a future date. This option for the AO, from the revenue point of view, needs to be strengthened and a suitable provision under Section 68 of the Act may be incorporated to tax such unaccounted receipts as 'taxable income' in the year of receipt. This will strengthen the anti-avoidance

provisions of the Income-tax Act and can be justified on grounds of equity. Currently, in all such cases, even though the CIT(A) and ITAT may not support the cause of revenue, in view of the existing adverse judgements of most Tribunals and Courts; Principal CsIT may still pursue such cases in appeal (subject to the threshold limits) at the level of the High Courts and Supreme Court, as it certainly gives rise to a question of law. The legal issue for the courts is to determine whether the undisclosed income detected during the course of search and survey be treated differently from the income earned from business in the ordinary course.

TAKING RECOURSE TO SECTION 68/69 OF THE ACT

Whenever on the basis of the seized or impounded documents/ diaries and the notings therein it is not possible to ascertain that the receipts in cash are business receipts, the same may be assessed as income from other sources. As books of accounts have not been defined in the Income-tax Act, there are court judgements which support the view that the entries found in the diaries and documents and not recorded in regular books may be considered as unexplained cash credits and assessed under Section 68 of the Act. Similar view may be taken in respect to unexplained expenditures, assets and investments under Section 69, etc.

YEAR OF TAXATION

As indicated above, the method of accounting normally determines the year of taxation of the profits earned by the developer/ builder under the regular proceedings. However, where unexplained cash is found, the same can be assessed in the year of search/ survey. The taxability of 'on-money' found should be guided by the year of receipt and the method of

accounting regularly followed. Depending on the validity of the books and the method adopted by the AO in quantifying the profits, the year of taxation may be determined. However, there is a need for specific provision in the Act to tax the 'on-money' in the year of receipt as 'deemed income'.

PENALTY PROVISIONS ON CASH TRANSACTIONS

In recent years, the following provisions have been inserted to prohibit cash transactions, with a particular eye on the builders/ developers:

- a. The Finance Act 2015 included 'specified sum' within the ambit of Section 269SS of the Act w.e.f 01.06.2015. 'Specified sum' as per this Section means any sum of money receivable, whether as advance or otherwise, in relation to transfer of an immovable property, whether or not the transfer takes place. Contravention of Section 269SS shall attract penalty under Section 271D of the Act for an amount equal to the contravention.
- b. Finance Act, 2017 inserted Section 269ST w.e.f. 01.04.2017, prohibiting receipt above Rs. 2 lakh in cash, except in conditions allowed under Section 269SS of the Act. Contravention of Section 269ST is now punishable under Section 271DA by levy of penalty of an amount equal to the contravention.

The contravention of Section 269SS and levy of penalty under Section 271D of the Act is subject to the condition that any loan or deposit or specified sum, where the person from whom the loan, or deposit, or specified sum, is taken, or accepted, and the person by whom the loan, or deposit, or specified sum is taken, or accepted, are both having agricultural income and neither

of them has any income chargeable to tax under this Act. Further, contravention of Section 269ST is subject to condition as per Section 269SS and the levy of penalty under Section 271D and 271DA is subject to good and sufficient reasons for the contravention. The Hon'ble Supreme Court in the case of *CIT vs Adinath Hi-Tech Builders (P) Ltd* (2019) 261 Taxmann 168 (SC) dismissed the Special Leave Petition against the judgment of Bombay High Court. The Bombay High Court in this case had held that there was violation of Section 269SS where assessee received advances against journal entries hence attracted penalty under Section 271D. In another recent judgement of the Bombay High Court in the case of *Nitin Wadikar* (2019) 414 ITR 647 (Bom), the Bombay High Court upheld the judgement of the ITAT and held that the assessee has not given reasonable explanation for failure to fulfill the requirement of Section 269SS and, therefore, penalty under Section 271D is leviable. However, Pune ITAT in the case of *PR. Associates* (2019) 70 ITR_Trib (Trib) 469 (Pune), has recently held that in order to meet its financial obligations, assessee borrowed money from unorganized financial sector in cash and filed a loss return; therefore, there was reasonable cause for not conforming to requirement of Section 269SS, penalty was held to be invalid. In the case of *Shivaji Ramchandra Pawar (HUF)* (2018) 163 DTR (Bom) 308, the Hon'ble court held that the law provides that the breach of Section 269SS invites penalty under Section 271D. The aforesaid breach has no relation to addition and/ or deletion of income. The mere fact that a party accepts loans in cash (which are otherwise explainable) would not absolve a party from

penalty under Section 271D in the absence of reasonable cause. The fact that the assessee's appeal in quantum proceedings before CIT(A) deleted addition under Section 68 would have no bearing in respect of penalty imposed under Section 271D, for breach of Section 269SS. Even if the assessee has explained the identity, the source and genuineness of receipt in cash for the purpose of Section 68, would not by itself permit/ allow a party to obtain loans in cash in breach of Section 269SS. *CIT vs. Jai Laxmi Rice Mills* (2016) 286 CTR (SC) 159 : (2016) 134 DTR (SC) 223: (2015) 379 ITR 521 (SC) distinguished.

CONCLUSION

To conclude, all receipts are not income. But wherever on facts, it can be proved that the unrecorded receipts (on-money, etc.) partake the character of income,, the AO may assess it as taxable Income. All such cases may be pursued in the High Courts and Supreme Court, as they give rise to a question of law. Where evidence indicates business connection for the receipt, the taxable income can be assessed as per the method of accounting regularly followed. As per the ICDS notified by CBDT, percentage completion method has to be followed w.e.f. 01.04.2015. In fit cases, AO may invoke Section 145(2) to reject books and estimate income on a reasonable basis. Since 01.06.2015, the cash receipts are punishable with penalty of an equal amount. As levy of penalty is subject to conditions, in order to rationalize the assessment of 'on-money' receipts to tax, an amendment may be considered in Section 68 of the Act to deem 'on-money' receipts as income of the year of receipt, particularly in cases of search/ survey.

Assessment Years to be Considered under Section 153C: Revenue's Perspective



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Executive Summary

Section 153C as part of provisions of search assessment lays down the law relating to the assessment of persons other than the searched person. The author in this article discusses the situation arising from interpretation of provisions relating to the years to be considered u/s 153C assessment in the light of judicial pronouncements and the amendment brought in by the Finance Act 2017.

INTRODUCTION

By the Finance Act 2003, departing from the concept of Block assessment, scheme of search assessments was amended by bringing in provisions of Sections 153A to 153D with effect from 01.06.2003. Section 153A lays down the provisions for the assessment of 'searched person' whereas Section 153C deals with the assessments of 'other person'. The assessments under this new scheme are to be done for six assessment years prior to the assessment year relevant to search year in relation to the total income of the assessee. Assessment of the other person has to be carried out by the AO of such other person, if AO of the searched and other person is not the same; which is the case in majority of the cases, consequent to handing over of the relevant material by the AO of the searched person to the AO of the other person. Since the Act does not provide any time limit

for handing over of the material belonging/pertaining to/ information relating to such other person by the AO of the searched person, hence the Act envisaged the limitations with regard to abatement of the assessment proceedings and completion of assessments under Section 153C with reference to the date of handing over of material.

JUDICIAL PRONOUNCEMENTS

As the new provisions of search assessments came into operation, a dispute arose with regard to the assessment years to be considered while issuing notice and completing assessments under Section 153C in respect of 'other person'. The Hon'ble Delhi High Court in the case of *CIT -7 vs. M/s RRJ Securities Ltd.* [2016] 380 ITR 612 (Delhi), held that the date of handing over of material, will be construed as the reference date for initiation of action under Section 153C,

as against date of initiation of search construed the reference date for initiation of action under Section 153A. According to the decision, for example in case of search conducted on 05.06.2009, if the material relating to the other person is handed over to the concerned AO on 11.07.2011, the assessment years to be considered for assessment under Section 153C will be taken with reference to the date of handing over of the material rather than the date of search as done for assessment under Section 153A.

The relevant part of the judgment of the Hon'ble High Court reads as under:

14. The proviso to Section 153C(1) of the Act expressly indicates that reference to the date of initiation of search for the purposes of second proviso to Section 153A shall be construed as a reference to the date on which valuable assets or documents are received by the AO of an Assessee (other than a searched person). Thus, by virtue of the second proviso to Section 153A of the Act, the assessments/ reassessments that were pending on the date of receiving such assets, books of accounts or documents would abate.

15. The controversy in this regard is no longer res integra. A Coordinate Bench of this Court in SSP Aviation Ltd. vs. Deputy Commissioner of Income Tax (2012) 346 ITR 177 has held that:

'in case of the searched person, the date with reference to which proceedings for assessment or reassessment of any assessment year within a period of six assessment years shall abate, is the date of initiation of search under Section 132 or requisition under Section 132A. However, in case of other person, such date will be the date of receiving the books of account or documents or assets seized or requisition by the Assessing Officer having jurisdiction over such other

person. In the case of other person, the question of pendency and abatement of proceedings of assessment or reassessment to the six assessment years would have to be examined with reference to such date'....

22. The aforesaid principles would be equally applicable to proceedings initiated under Section 153C of the Act as Section 153C(1) of the Act expressly provides that once the AO has received 'money, bullion, jewellery or other valuable articles or thing or books of account or documents seized' from the AO of the searched person, he would proceed to assess or reassess the income of the person to whom such assets/books belong in accordance with Section 153A of the Act.

23. In the present case, the Assessee had claimed that the assessments for the concerned assessment years were not pending on the date of recording of satisfaction by the AO and, therefore, would not abate by virtue of the second proviso to Section 153A of the Act. Further, the period of six years would also have to be reckoned with respect to the date of recording of satisfaction note - that is, 8th September, 2010 - and not the date of search.

24. As discussed hereinbefore, in terms of proviso to Section 153C of the Act, a reference to the date of the search under the second proviso to Section 153A of the Act has to be construed as the date of handing over of assets/documents belonging to the Assessee (being the person other than the one searched) to the AO having jurisdiction to assess the said Assessee. Further proceedings, by virtue of Section 153C(1) of the Act, would have to be in accordance with Section 153A of the Act and the reference to the date of search would have to be construed as the reference to the date of recording of satisfaction. It would follow that the six assessment years for

which assessments/reassessments could be made under Section 153C of the Act would also have to be construed with reference to the date of handing over of assets/documents to the AO of the Assessee. In this case, it would be the date of the recording of satisfaction under Section 153C of the Act, i.e., 8th September, 2010. In this view, the assessments made in respect of assessment year 2003-04 and 2004-05 would be beyond the period of six assessment years as reckoned with reference to the date of recording of satisfaction by the AO of the searched person. It is contended by the Revenue that the relevant six assessment years would be the assessment years prior to the assessment year relevant to the previous year in which the search was conducted. If this interpretation as canvassed by the Revenue is accepted, it would mean that whereas in case of a person searched, assessments in relation to six previous years preceding the year in which the search takes place can be reopened but in case of any other person, who is not searched but his assets are seized from the searched person, the period for which the assessments could be reopened would be much beyond the period of six years. This is so because the date of handing over of assets/documents of a person, other than the searched person, to the AO would be subsequent to the date of the search. This, in our view, would be contrary to the scheme of Section 153C(1) of the Act, which construes the date of receipt of assets and documents by the AO of the Assessee (other than one searched) as the date of the search on the Assessee. The rationale

appears to be that whereas in the case of a searched person the AO of the searched person assumes possession of seized assets/ documents on search of the Assessee; the seized assets/ documents belonging to a person other than a searched person come into possession of the AO of that person only after the AO of the searched person is satisfied that the assets/ documents do not belong to the searched person. Thus, the date on which the AO of the person other than the one searched assumes the possession of the seized assets would be the relevant date for applying the provisions of Section 153A of the Act. We, therefore, accept the contention that in any view of the matter, assessment for AY 2003-04 and AY 2004-05 were outside the scope of Section 153C of the Act and the AO had no jurisdiction to make an assessment of the assessee's income for that year.

The aforesaid decision of the Hon'ble High Court has *inter alia* been followed in the case of *Pr. CIT vs. Sarwar Agency (P.) Ltd.* reported in 397 ITR 400, *ARN Infrastructure India Ltd. vs. Assistant Commissioner of Income-tax, Central Circule-28, New Delhi* [2017] 394 ITR 569 (Del.) besides multitude of other decisions of the Tribunals and CIT(A)s.

For easy understanding, if the dates given above are taken as example, then as per the decision of the Hon'ble High Court (supra) the assessment years to be considered for action 153C will be as under:

Table 1

Date of Search	05.06.2009	Date of Handing over of Material to the AO of the other Person	11.07.2011
Six prior assessment year for 153A	2009-10 2008-09 2007-08 2006-07 2005-06 2004-05	Six prior Assessment years for 153C	2011-12 2010-11 2009-10 2008-09 2007-08 2006-07

From the illustration above, it may thus be seen that the assessment years to be considered for taking action under Section 153C will be different from the years for action under Section 153A for the searched person. The assessment years under Section 153C would, thus, be contingent upon the date of handing over of the material to the AO of the other person. Since the Act does not provide the time limit for handing over of material, such interpretation would lead to absurd consequence resulting in action under Section 153C for the assessment years much later than search year for which there will not be any material found in the search and at the same time escaping assessments of the relevant year (searched year).

Since the genesis of action under Sections 153A and 153C lies in the same search action, the assessment years should remain the same notwithstanding the date of handing over of material to the AO of the other person or date of initiation of proceedings under Section 153C.

The aforesaid construction in judicial pronouncements apparently arose on account of interpretation of first proviso to Section 153C which reads as under:

Provided that in case of such other person, the reference to the date of initiation of the search under Section 132 or making of requisition under Section 132A in the second proviso to Sub-section (1) of Section 153A shall be construed as reference to the date of receiving the books of account or documents or assets seized or requisitioned by the Assessing Officer having jurisdiction over such other person.

However, it is evident from the plain reading that this proviso makes the qualification with regard to second proviso to Section 153A (1) only and should not be construed otherwise.

Second proviso to Section 153A (1) deals with the abatement of assessment proceedings pending on the date of search and in the case of Section 153C, the date of handing over of the material. The proviso reads as under:

Provided further that assessment or reassessment, if any, relating to any assessment year falling within the period of six assessment years and for the relevant assessment year or years referred to in this Sub-section pending on the date of initiation of the search under Section 132 or making of requisition under Section 132A, as the case may be, shall abate :

The case of the Revenue is that the first proviso to Section 153 C refers only to the second proviso to Section 153 A(1) of the Act, which only indicates that any assessment relating to any AY falling within the period of six AYs which is pending as of the initiation of search shall abate. Therefore, the second proviso to Section 153 C is also concerned only with the aspect of abatement of pending assessments. Accordingly, this makes no difference to the computation of the block of six years preceding the AY relevant to the previous year/ in which the search was conducted. In other words, the block period for both the searched person and the 'other person' would remain the same notwithstanding that there may be some delay in transmitting the documents recovered during the search which belong or pertain to the other person' to the AO of such other person.

AMENDMENT BROUGHT IN 2017

The interpretation rendered in the judgment of *RRJ Securities (supra)* has been overcome by introducing amendment in Section 153C by the Act by the Finance Act 2017 with effect from 01.04.2017 by inserting the following: 'for six

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assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted or requisition is made and'

This amendment in effect states that the block period for the searched person as well as the 'other person' would be the same six Assessment Years immediately preceding the year of search.

CONCLUSION

The amendment brought in by the Finance Act 2017 has sought to bring clarity on the dispute relating to the assessment years to be considered for taking action under Section 153C. However, this amendment is not declared as clarificatory

and has been made effective from 01.04.2017; hence, the courts and appellate forums are construing it as prospective and rightly so. In these circumstances, question arises as how to defend the point of the revenue in cases relating to period prior to the amendment? An SLP has been admitted by the Hon'ble Supreme Court against the decision of the Hon'ble High Court in the case of *CIT-7 vs RRJ Securities Limited* 79 taxmann.com124(SC) which is pending for adjudication. It may, therefore, be suggested that to safeguard the interest of revenue-appellate forums may be requested to keep such cases in abeyance till the decision on the said SLP is rendered by the Hon'ble Supreme Court.

Assessment and Investigation of Contractors



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Executive Summary

This sector specific article aims to share knowledge regarding issues faced during assessment and investigation in case of contractors. Various points of discussion include inflation of expenses, manipulation of stock, revenue recognition methods, common types of additions, how to make additions have a better standing at appellate stages, important case laws, common issues in case of Construction Joint Ventures etc.

A contractor is a person who carries out work (including supply of labour for carrying out any work) in pursuance to a contract between the contractor and another person (contractee). Under Section 2(h), the Indian Contract Act 1872 defines a contract as an agreement which is enforceable by law. Further, a contract may be an oral or written. A careful assessment and investigation of contractors becomes very important due to the nature of this business. A contractor can employ various methodologies to generate unaccounted money, use the unaccounted money in business and evade taxes. In light of various avenues available for manipulation of accounts, where cash plays a major role in many such businesses, there is a huge scope of work in this regard to plug the various loopholes employed by contractors to evade taxes. Moreover, many-a-times the contractor assessee shows very low net profit (e.g. less than 2%) and at the same time claim high refund; this attains grave importance from the point

of revenue in case the claims are not genuine. Hence, during the assessment of contractors, various aspects need to be kept in mind which would help in effective scrutiny of books of accounts and prevent loss of revenue. Further, investigation becomes thoroughly important in such cases so as to bring factual material on record which would be able to stand the test of judicial scrutiny at various appellate stages. In this article, various aspects to be considered while doing assessment and investigation in case of contractors will be discussed.

ASSESSMENT IN CASE OF CONTRACTORS

One of the first and foremost thing to realize while doing assessment of contractors is to identify the areas in which the scope of manipulation is highest in terms of book of accounts of the assessee. In case of contractors, one major point to note is that most manipulation and dressing

up of books of accounts is done on the debit side of Profit and Loss (P&L) account i.e. the *Expenses* side. As we know there are primarily two ways of reducing the taxable income in case of businesses by the assessee: one is by decreasing the income (i.e. Credit side of P&L account) and the other is by increasing the expenses (i.e. Debit side of P&L account). In case of contractors, most manipulation is done by inflating the expenses. The reason for this is that it is easier to do so compared to reduce income because TDS under Section 194C of the Income-tax Act 1961 (the Act) is deducted on the income or the contractual receipt received by the contractor from the contractee. Hence, while doing assessment, special emphasis should be made in verifying the expenses compared to the receipts.

Another high risk area in case of contractors is the maintenance of *stock*. Many times the contractor assessee does not perform stock-taking regularly. The assessee does not keep correct watch over stock over the year; this is also because of complexity and nature of stock. Many times materials like plywood, shuttering ply, marble, paint, tiles, steel, cement, chinaware, brick, sand etc. form part of the stock and sometimes due to complexity in maintaining stock of some of these items or due to multiple site projects the assessee ends up foregoing the exercise and instead do it at one go at the end of the year, or on adhoc/ estimate basis thereby leading to huge manipulation in the balance sheet.

In this background, while doing the assessment, it becomes very important to verify the maintenance of stock by the assessee. The AO (Assessing Officer) should check for the registers maintained to satisfy himself/ herself that the stock has been maintained properly. Now comes another major point of contention in case of

contractors, i.e. *Valuation* of stock. The method of valuation used by the assessee is explained in the audit report also. However, care should be taken during assessment to ask for valuation method item-wise and check if the same are in line with market trends. It must, hence, be checked that there are no major discrepancies in the valuation of closing stock. Otherwise, an inflated closing stock value would result in higher cost of goods sold and lower gross profit; thus, leading to less taxable income in a particular year.

While at the discussion of closing stock it is important to discuss revenue recognition in case of contractors, it is imperative that the revenue is recognized in proper manner so that income is offered to taxation in right amount by the assessee. Many civil contractors recognize revenue on the basis of bills submitted to the contractee called 'Running bills' which are then approved/ certified by the contractee. After certification, the revenue related to these bills is recognized by the contractor in his books. Another major revenue recognition method in case of civil construction contractors is *Percentage of Completion method (POCM)*. The revenue recognition of this method is governed by the Accounting Standard 7 (AS 7) issued by the Institute of Chartered Accountants of India (ICAI) which corresponds to the (Income Computation and Disclosure Standards) ICDS III which is notified by the Government of India. As per this method, the revenue is recognized as per the following formula:

$$\text{Percentage of Completion (POC)} = \frac{\text{Cost incurred upto reporting date}}{\text{Total Estimated Cost of the project}} \times 100$$
$$\text{Current year revenue} = \text{Total revenue} * \text{POC} - \text{cost incurred upto reporting date}$$

Once the value of current year revenue to be recognized in a particular year is recognized, the

taxes are paid on that corresponding revenue and the expenses are claimed in proportion to the revenue recognized in the current year as per the AS7. The point to be noted here is that sometimes the assessee does not correctly recognize revenue as per POCM. Care has to be taken that the revenue is recognized and is in line with the latest contract/ agreement.

Another point which is faced very commonly in case of contractors when it comes to revenue offered for taxation is contractual receipts of the assessee as per its P&L/ ITR and as per Form 26 AS. Great care should be taken that there should not be any difference in the receipts as per Form 26AS and as per P&L of the assessee. The assessee should not be under-reporting its revenue in the books/P&L i.e. the ITR should conform to Form 26AS. In case there is any difference, it should be reconciled by asking the assessee the reason for difference. Many times this difference arises on account of TDS under Section 194C being deducted on Gross Amount while assessee realizes the Net Amount; further, it might be a case where the TDS is deducted on Mobilization advance which is not offered for taxation by the assessee in the year in which it is received. In such cases, care has to be taken that TDS credit can be given to the assessee in such a case only when the assessee offers the corresponding income for taxation.

Now, we shall discuss most frequent types of disallowances which are made in case of contractors. Many times AOs end up doing *ad hoc disallowance* on estimate basis. For example, unverifiable purchases or unverifiable fuel charges or unverifiable labour charges etc. and a proportion of these expenses claimed is disallowed. This practice should not be followed as it leads to arbitrariness and it does not hold ground in any of the appellate forums especially in the ITAT. In this background, order

of jurisdictional ITAT in case of *ACIT vs M/s. Modi Rubber Limited* (ITAT Delhi) is important where it was held that disallowance made on ad hoc basis without pointing out any defects in assessee books or vouchers maintained for impugned expenses, and, the same was not, therefore, sustainable. Hence, making ad hoc disallowance should not be encouraged and it should only be made after pointing out the defects in books or faulty bills/ vouchers etc. Also, in case the scope of discrepancies in the books of accounts is high and is not limited to bills/ vouchers of one particular expense then *books of accounts should be rejected* under Section 145(3) of the Income-tax Act 1961. This also stands the test of scrutiny in appeals. Moreover, one more important point to be kept in mind while making such disallowance; e.g. while considering Vehicle and Maintenance expense, a corresponding disallowance on depreciation claimed under Section 38(2) of the Income-tax Act 1961 (the Act) should also be made.

Reliance can be placed on various case laws which should be mentioned in the assessment order itself. A few of such case laws are as follows:

- a. The judgment of Hon'ble Supreme Court held in the case of *CIT vs. British Paints India Ltd.* [1991] 188 ITR 44/54 Taxmann 499 (SC) held that as from the books of the assessee, due to reasons detailed by the Assessing Officer in his order, correct income of the assessee was not deductible, the application of Section 145 was upheld.
- b. In the case of *Kesharichand Jaisukhlal* (248 ITR 47) wherein the Hon'ble High Court had upheld the estimation of income consequent to rejection of books of account on the basis of various infirmities and inconsistencies in the accounts found by the AO.

- c. Similarly, the Delhi High Court in the case of *Chetan Dass Lachhman Dass* (255 ITR 197) upheld the rejection of books of account and estimation of income wherein no evidence in respect of expenses could be produced by the said assessee.
- d. In the case of *Mani & Co.*, a contractor, was unable to produce the books of original entry and proper bills and vouchers, the Hon'ble Kerala High Court in its judgment cited in (256 ITR 373) held that the AO was justified in rejecting the work account of the assessee and estimating the profit.
- e. In a recent judgment pronounced by the Hon'ble ITAT, Delhi 'A' Special Bench in the case of *Deputy Commissioner of Income-tax vs Allied Construction* (2007) 106 TTJ (Del) (SB) 595 it has been held that:
- 'When purchases of material, labour payments and other expenses debited to Profit & Loss Account were unvouched and without underlying bills/ vouchers, the Assessing Officer was correct in rejecting the books of accounts of the assessee'; also in the same judgment bench has upheld decision of the AO to estimate net income of assessee at @ 8% of work receipts.
- f. The finding is fortified with the authority of the Hon'ble Supreme Court as rendered in the case of *Kachwala Gems vs. Joint Commissioner of Income Tax* [2007] 288 ITR 10 (SC) wherein the books of accounts of the assessee was rejected on the consideration of non-maintenance of stock register, low gross

profit rate compared to previous years, low gross profit rate compared with similar assessee's in similar business and where purchases were also not verifiable.

- g. The Hon'ble Allahabad High Court has similarly held in the case of *Bimalkumar Anant Kumar* (288 ITR 278 Allahabad) that non-maintenance of stock register is the strong ground for rejecting the books of accounts of the assessee when it is coupled with various other irregularities.
- h. The decisions in the cases, namely, *Bombay Cycle Stores Co. Ltd. vs Commissioner of Income-tax* as well as *Ghanshyamdas Permanand vs. Commissioner of Income Tax* (Nagpur High Court) supports the case of revenue in rejecting the books of accounts and estimating the correct income.

The rejection of books is one of the strongest tools which has stood the test of appeals on several occasions. The AO should carefully point out the discrepancies and inconsistencies in the books of accounts after elaborate investigation bringing material facts on record. The methodology of rejection of books of accounts plays a major role in making the assessment order strong. Subsequently, the income may also be estimated at reasonable rate of the total revenue keeping in mind also Section 44AD of the Act.

Another common type of disallowance in case of contractors is addition under Section 36(1) (va) of the Act. Many times, contractors have employees and deduct employees contribution for funds mentioned under Section 2(24)(x) of the Act i.e. EPF/ESI or any other similar fund mentioned in the provision. However, if the employees contribution is not deposited in the relevant fund before the due date, the same is

treated as income under Section 36(1)(va) read with Section 2(24)(x) of the Act. The above issue has been dealt with in CBDT Circular No. 22 of 2015 dated 17.12.2015 wherein the stand of the Department regarding allowability of employer's contribution to funds for the welfare of employees in term of Section 43B(b) of the Act has been clarified. The said Circular vide para 5 further clarifies that this Circular does not apply to claim of deduction relating to employee's contribution to welfare funds which are governed by Section 36(1)(va) of the I-T Act 1961. Moreover, SLP in the case of *ACIT vs Namdhari Seeds CA No. 1954 of 2015* and in the case of *Advanta India Ltd. vs CIT SLP C No. 4577/2015* on the issue are pending before the Supreme Court. In this background, the employees' contribution which has not been deposited in the relevant fund on or before the due date may be added back to the total income. The same is also pointed out by the auditor in Form 3CD. At the same time, it must be mentioned here that addition on this ground is contentious given the decision of Hon'ble Supreme Court in *Rajasthan State Beverage Corporation Ltd.* 84 taxmann.com 185 (SC) which provides that no disallowance be made on this ground. Nevertheless, there is lack of legal clarity on the issue and SLPs are pending as mentioned above.

Furthermore, disallowance on Interest on *late payment/ deduction of TDS* under Section 201(1A)/206C(7) is also commonly occurring issue in case of contractors. Interest under Section 201(1A)/ 206C(7) on late payment/ deduction of TDS/ TCS is not an allowable deduction under Section 37. This view derives support from the recent decision of the Hon'ble ITAT, Mumbai Bench, Mumbai in the case of *DCIT vs. Allied Media Network Pvt. Ltd.* in ITA No. 3545/MUM/2016 dated 27.06.2018, wherein the ITAT has, after considering the judgment in the cases

of *Bharat Commerce and Industries Ltd.* (1198) 230 ITR 733 (SC), *Ferro Alloys Corpn. Ltd. vs. CIT* (1992) 196 ITR 406 (Bom), *Martin & Harris (P) Ltd. vs. CIT* (1994) 73 Taxmann 555 (Cal.), *CIT vs. Chennai Properties & Investment Ltd.* (1999) 105 Taxmann 346 (Mad) and *DCIT vs. M/s Narayani Ispat Pvt. Ltd.* (ITA No. 2127/Kol/2014 for the AY 2010-11) has held, that interest paid takes colour from nature of principal amount required to be paid but not paid in time and this principal amount being income-tax, interest is in nature of a direct tax and settlement of income-tax payable under the Act and, therefore, same cannot be regarded as compensatory payment and allowed as business expenditure.

Now, we shall discuss the Assessment of *Joint Ventures (JV)* which is a common occurrence in case of contractors, especially construction contractors for specified purpose or work. Usually, the JV which is an AOP, is formed in such a way that one partner provides technical expertise while the other provides financial support, or one entity is non-resident in India and the other being a resident in India; or any other such arrangement to fulfill the tender requirements.

While assessing JVs, care should be taken to carefully study the Notes to Accounts of the Assessee. These provide various insights and might have several hidden useful statements in it which could be read thoroughly to understand if the JV is trying to evade taxes in some ways. This, along with *JV Agreement* provides various valuable information which are useful at the time of assessment.

For instance, in one case, it was noticed that assessee is claiming depreciation as per life of its project and not as per provisions of the Act. This was in total violation of the Act under Section

32. Thus, relevant disallowance is made and depreciation is allowed only as per provisions of the Act. In another case, the JV underwent cost escalation and did not disclose the new contract value and thus furnishing a faulty POCM calculation, thus addition was made based on the discrepancy found. In yet another case, the JV agreement specifically stated that the JV would not be incurring any indirect expenses apart from sub-contract expenses to its individual JV partners yet the JV had claimed indirect expenses which were then disallowed. Also, many times JV subcontracts the whole work to the individual JV partner in case JV is formed just to meet the tender requirements to fetch the contract. In such cases, JV itself undergoing purchases should be questioned since the JV is not doing any work by itself. Such issues are commonly noted in cases of assessments of Joint Ventures.

INVESTIGATION IN CASE OF CONTRACTORS

In this section, we shall deal with points of investigations while dealing with business of contractors. Various points of investigation can be identified from *P&L Account*. The AO may call for stock register, labour registers, salary registers etc. More often than not such registers are neither maintained nor updated regularly and in case they are presented to the AO, there is a high chance that they might have been fabricated at the very last moment. In such instances the AO should check for the discrepancies as in such circumstances the assessee is bound to make certain mistakes, e.g. in one case, it was found that the signature from same pen and of same type was made in front of names of many employees in the salary book. The AO may ask for identity cards like AADHAAR of such person and in case any such person is bogus it can

be easily known. While calling bills for various expenses AO should check if there are any GST numbers of the parties, their names, their addresses, do they have PANs or any such thing being mentioned on the bills. Many times forged bills appear to be slightly changed compared to one another for example, the font of the name of the party would change whereas the rest of the bill would remain the same; this is a clear indication that the party might not be genuine.

Further, *purchases* should be subjected to deep scrutiny. The bills and vouchers should be called on random basis and these should be verified. Moreover, suitable Sundry creditors may be identified, especially the ones which are more than three months old with whom purchases have been made and they should be asked to present a confirmed copy of account of assessee in their books to check in case assessee is not inflating purchases along with bills.

In case of expenses related to cartage, it should be checked whether TDS has been deducted on it. Similar exercise is required to be done in case the assessee is claiming commission expenses. If the said claim is made, the AO should go in deep towards the nature of service provided to assessee for which the assessee is claiming commission expenses. It should also be checked if the service is related to business purpose of the assessee. AO may enquire the recipient of services by use of summon under Section 131 or call for information under Section 133(6) of the Act. Similarly, AO should inquire in to the Misc. expense or Other expense claimed by the assessee to ascertain whether these are for business purposes. Further, while scrutinizing the expenses related to travelling and tour, telephone, vehicle and maintenance a personal component in use of these cannot be ruled out in case of sole proprietorship business.

Accordingly, disallowance may be made after verifying relevant registers like vehicle log book, telephone log book etc.

As far as Closing Stock is considered, special care should be taken. Contractor assessee can easily try to manipulate the figure of closing stock by valuing the closing stock as per his whims and fancies. It is a common trend in case of contractors that the closing stock is not maintained from time-to-time and it is mostly an afterthought or ad hoc estimation. This should not be allowed. AO should ask for item-wise ledger account showing the values of closing stock, then sources like the internet or local inquiries should be used to ascertain the degree of correctness with which the closing stock is valued. This should be checked because assessee can inflate closing stock to increase cost of goods sold and decrease the gross profit thus paying less and less taxes.

Now, we shall focus on the points of investigation emanating out of *balance sheet*. The introduction of fresh capital should be immediately flagged. Many times it is seen that contractor assessee are taking benefits of accommodation entries to introduce their own unaccounted cash into their books of accounts in the capital account head. The party from where credit entry is received may be summoned and statement should be recorded. They may be asked to submit documents establishing identity of the party, creditworthiness of the party and genuineness of the transaction (Hon'ble Supreme Court in *Commissioner of Income-Tax vs Precision Finance Pvt. Ltd.*) should be called for like bank statement, ITR, AADHAAR card, PAN etc. Similar exercise is required to be done in cases where there is fresh unsecured loan taken during the year or any loan taken and repaid i.e. squared up during the year. The audit report hints at this in one of its columns clearly. More importantly,

unsecured loans from family members like wife, son who might not have wherewithal to pay such loans should be carefully examined.

Further, many times it is also noticed that assessee has received loans from family members. Firstly, the assessee should be asked to furnish ITR and bank statement of such family members as very often this is actually assessee's money which is doing rounds. Care should also be taken to scrutinize the interest expenses claimed on unsecured loan taken. This may be a deal between related parties as can also be found from the Form 3CD just to take the benefit of claiming interest expenses.

Any new investments should be checked thoroughly and the source of the money to make such investment should also be inquired into by the AO. Regarding Debtors, it may be investigated whether old debtors are persisting in the balance sheet. New fixed assets should be identified. Their bills should be called. Proper proof of the installation of the fixed asset and date when it was put to use of the asset should be asked, this way excess depreciation claim used by various assesseees can be stopped.

One more point of investigation which should be inquired into in-depth is payment to *petty contractors*. Many times, the assessee deals with small contractors by subcontracting its work to small petty contractors. No TDS is deducted on such sub-contract. This is also a point which should make the AO careful. Many times it has been noticed that many such petty sub-contractors do the business in the name of the assessee contractor while being totally out of the purview of the Income-tax Department. Such petty contractors never file return of income and thus escape the tax base entirely. Moreover, these sub-contractors operate solely in cash mode and take payments in cash only. In this way, huge amounts of unaccounted wealth

is generated and promoted. Effort should be made to get a list of such petty contractors along with name, address and PAN etc., if any. Their bills/ proof of existence should be ascertained. It should be enquired if they are filing returns or not and inquiry should be made to estimate the extent of their income. Subsequently, they may be asked to file return through notice under Section 142(1) or any other action may be taken if applicable, like survey/ search (with the help of Investigation wing).

In case of JVs another, *modus operandi* has evolved whereby the *Contract Value* is revised upwards under the shelter of *escalation clauses* in the contract and the same are not disclosed to the Income-tax Department. Further, the revenue is not recognized many times on the basis of such revised contract values. This is relevant in case of construction-related contracts. One example of such a case can be given here in which the assessee was in contract to dig tunnels for the Delhi Metro Rail Project. Subsequently, due to circumstances like the Tunnel Boring Machine getting stuck underground where it was technically impossible to reclaim the Tunnel Boring Machine (TBM), the TBM had to be dismantled which resulted in losses for the assessee and cost escalation of the project. This led to revised contract value of the project, on the basis of which new calculation of Percentage of Completion (POC) of project had to be worked out. However, the assessee did not inform the AO of the fact that contract value has been revised and claimed excess expenses in a particular year. AO then has to, in cases where such *modus operandi* is suspected, call for information under Section 133(6) of the Act to ask for updated agreement if any. Then, afterwards in case something adverse is found, books of accounts have to be rejected and profit has to be estimated including estimation of POCM working based on a reasonable rate.

Another common issue which is found with contractors is that many times they do not maintain books of accounts on the regular basis, or may even maintain *parallel books of accounts*. Many such contractors often prepare informal books and only towards the end of the year when the time comes to file a return the assessee undergoes the exercise of fabrication of the books of accounts. This can be checked while checking the stock register, labour register and registers of other expenses which are not regularly maintained by many such contractors. Another interesting point which draws suspicion that books are being prepared at the end of the year at the time of filing of return of income is assessee paying *very high Self-Assessment Tax* every year while not paying any advance tax at all. Such cases should be suspected and may be identified for survey action. Hence, existence of parallel books, non-maintenance of stock/labour etc. registers are key risk points to be kept in mind to which a contractor business is prone to.

CONCLUSION

Hence, in the above discussion, various issues encountered in case of contractors at the time of assessment, investigation are discussed. The above comprehensive sector-specific discussion would help in increasing awareness of officers while dealing with business of contractors. It would further help in plugging loopholes and spotting tax evasion techniques while dealing with these types of assessees. Further, from the point of view of revenue, it would be of great importance because this sector involves huge refund claims, low net profit declaration, substantial unaccounted income and huge tax evasion. Thus, in the interest of revenue, it is critically important that the officers should be well-versed with various issues while dealing with the business of contractors.

Taxation of Share Premium



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Executive Summary

Taxation of share premium is a relatively new but litigated area of taxation. This article examines the two alternative approaches the AO should adopt while examining the issue where share premium received is in excess of its fair market value, i.e. the route of Section 68 or Section 56 (2)(viib).

Several case laws on the issue has been presented for better appreciation by the readers. Towards the end, the issue of angel tax which occupied quite a space in the public discourse till recently, has also been touched upon.

The assessment of share premium is always a contentious issue. Subscription received with huge premium, is a common issue in company assessments. The AO can verify the source of the subscription and also can apply the yardstick of Sec 56(2)(viib) of Income Tax Act 1961. In this article,we will look into the legal issues in invoking the provisions of Sec 56(2)(viib) of Income Tax Act 1961. The relevant portion of law is reproduced below.

RELATED PROVISIONS IN THE INCOME TAX ACT AND INCOME TAX RULE

INCOME FROM OTHER SOURCES

56. (1) Income of every kind which is not to be excluded from the total income under this Act shall be chargeable to income-tax under the head “Income from other sources”, if it is not

chargeable to income-tax under any of the heads specified in Section 14, items A to E.

(2) In particular, and without prejudice to the generality of the provisions of Sub-section (1), the following incomes, shall be chargeable to income-tax under the head “Income from other sources”, namely:—

.....

(viib) where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares:

Provided that this clause shall not apply where the consideration for issue of shares is received—

- i. by a venture capital undertaking from a venture capital company or a venture capital fund ⁶⁷[or a specified fund]; or
- ii. by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

Following second proviso shall be inserted after the existing proviso to clause (viib) of Sub-section (2) of Section 56 by the Act No. 23 of 2019, w.e.f. 1-4-2020:

Provided further that where the provisions of this clause have not been applied to a company on account of fulfilment of conditions specified in the notification issued under clause (ii) of the first proviso and such company fails to comply with any of those conditions, then, any consideration received for issue of share that exceeds the fair market value of such share shall be deemed to be the income of that company chargeable to income-tax for the previous year in which such failure has taken place and, it shall also be deemed that the company has under-reported the income in consequence of the misreporting referred to in Sub-section (8) and Sub-section (9) of Section 270A for the said previous year.

Explanation.—For the purposes of this clause,—

- a. the fair market value of the shares shall be the value—
 - i. as may be determined in accordance with such method as may be prescribed; or
 - ii. as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents,

copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, whichever is higher;

Following clauses (aa) and (ab) shall be inserted after clause (a) of *Explanation* to clause (viib) of Sub-section (2) of Section 56 by the Act No. 23 of 2019, w.e.f. 1-4-2020:

- (aa) “specified fund” means a fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which has been granted a certificate of registration as a Category I or a Category II Alternative Investment Fund and is regulated under the Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012 made under the Securities and Exchange Board of India Act, 1992 (15 of 1992);
- (ab) “trust” means a trust established under the Indian Trusts Act, 1882 (2 of 1882) or under any other law for the time being in force;

- b. “venture capital company”, “venture capital fund” and “venture capital undertaking” shall have the meanings respectively assigned to them in clause (a), clause (b) and clause (c) of *Explanation* to clause (23FB) of Section 10;

Clause (viib) of Sub-section (2) of Section 56 was inserted vide finance act, 2013 w.e.f. 01.04.2013 i.e for A.Y. 2013-14 to provide that where a closely held company issues its shares at a price which is more than its fair market value then the amount received in excess of fair market value of shares will be charged to tax in

the hand of the company as income from other sources. This amendment was made keeping in view the practice of closely held companies to bring undisclosed money of promoters/directors by issuing shares at high premium which is normally over and above the book value of share of the company, and moreover which escaped the provisions of Section 68. Moreover, in case of many closely held companies and even in new companies promoter used to issue share at premium with the main purpose of keeping share capital low, yet capital base stronger so that breakup value and market value is high. This leads to advantage of low cost of servicing share capital and also improved prospects to issue share at premium In future by way of initial issue of offering by promoters. One more practical advantage was to save on account of cost of fees payable on increase of authorized capital. When shares are issued at premium, number of shares and authorized capital increase lesser in comparison of capital raised by way of capital and premium. These provisions are deeming provisions as otherwise share premium and capital are capital receipts which cannot be taxed as income. However, w.e.f. A.Y. 2013-14 for closely held companies share premium or share capital is deemed to be normal income if shares are issued exceeding fair market value of shares.

The valuation rules are specified under Rule 11UA, Rule 11UAA and Rule 11UB for various provisions under the Income-tax Act, 1961 (the "Act") which cover valuation options in case of various assets including equity shares and other securities. These rules specify the methodology to be adopted at the time of arriving at fair market value in different scenarios and also the eligible person who can issue such valuation report. Among the various provisions of the Act, the provisions u/s 56(2)(viib) states that where a company other than a company

in which public are substantially interested, issue shares at more than fair market value to a resident person, then differential value between such issue price and fair market value will be considered as income for such company under provision of Section 56(2)(viib) of the Act.

DETERMINATION OF FAIR MARKET VALUE

11UA. [(1)] For the purposes of Section 56 of the Act, the fair market value of a property, other than immovable property, shall be determined in the following manner, namely,—

- a. valuation of jewellery,—
 - i. the fair market value of jewellery shall be estimated to be the price which such jewellery would fetch if sold in the open market on the valuation date;
 - ii. in case the jewellery is received by the way of purchase on the valuation date, from a registered dealer, the invoice value of the jewellery shall be the fair market value;
 - iii. in case the jewellery is received by any other mode and the value of the jewellery exceeds rupees fifty thousand, then assessee may obtain the report of registered valuer in respect of the price it would fetch if sold in the open market on the valuation date;
- b. valuation of archaeological collections, drawings, paintings, sculptures or any work of art,—
 - i. the fair market value of archaeological collections, drawings, paintings, sculptures or any work of art

- (hereinafter referred as artistic work) shall be estimated to be price which it would fetch if sold in the open market on the valuation date;
- ii. in case the artistic work is received by the way of purchase on the valuation date, from a registered dealer, the invoice value of the artistic work shall be the fair market value;
 - iii. in case the artistic work is received by any other mode and the value of the artistic work exceeds rupees fifty thousand, then assessee may obtain the report of registered valuer in respect of the price it would fetch if sold in the open market on the valuation date;
- c. valuation of shares and securities,—
- a. the fair market value of quoted shares and securities shall be determined in the following manner, namely,—
 - i. if the quoted shares and securities are received by way of transaction carried out through any recognized stock exchange, the fair market value of such shares and securities shall be the transaction value as recorded in such stock exchange;
 - ii. if such quoted shares and securities are received by way of transaction carried out other than through any recognized stock exchange, the fair market value of such shares and securities shall be,—
 - a. the lowest price of such shares and securities quoted on any recognized stock exchange on the valuation date, and
 - b. the lowest price of such shares and securities on any recognized stock exchange on a date immediately preceding the valuation date when such shares and securities were traded on such stock exchange, in cases where on the valuation date there is no trading in such shares and securities on any recognized stock exchange;
 - b. *the fair market value of unquoted equity shares shall be the value, on the valuation date, of such unquoted equity shares as determined in the following manner, namely:—*

the fair market value of unquoted equity shares = (A+B+C+D - L) × (PV)/(PE),
where,

A = book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) in the balance-sheet as reduced by,—

 - i. *any amount of income-tax paid, if any, less the amount of income-tax refund claimed, if any; and*
 - ii. *any amount shown as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset;*

B = the price which the jewellery and artistic work would fetch if sold in the open market on the basis of the valuation report obtained from a registered valuer;

C = fair market value of shares and securities as determined in the manner provided in this rule;

D = the value adopted or assessed or assessable by any authority of the Government for the purpose of payment of stamp duty in respect of the immovable property;

L = book value of liabilities shown in the balance sheet, but not including the following amounts, namely:—

- i. the paid-up capital in respect of equity shares;*
- ii. the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared before the date of transfer at a general body meeting of the company;*
- iii. reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation;*
- iv. any amount representing provision for taxation, other than amount of income-tax paid, if any, less the amount of income-tax claimed as refund, if any, to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto;*
- v. any amount representing provisions made for meeting liabilities, other than ascertained liabilities;*

- vi. any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares;*

PV = the paid up value of such equity shares;

PE = total amount of paid up equity share capital as shown in the balance-sheet;]

- c. the fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or an accountant in respect of which such valuation.*

[(2) Notwithstanding anything contained in sub-clause (b) of clause (c) of sub-rule (1), the fair market value of unquoted equity shares for the purposes of sub-clause (i) of clause (a) of Explanation to clause (viib) of Sub-section (2) of Section 56 shall be the value, on the valuation date, of such unquoted equity shares as determined in the following manner under clause (a) or clause (b), at the option of the assessee, namely:—

- a. the fair market value of unquoted equity shares =*

where,

A = book value of the assets in the balance-sheet as reduced by any amount of tax paid as deduction or

collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act and any amount shown in the balance-sheet as asset including the unamortized amount of deferred expenditure which does not represent the value of any asset;

L = book value of liabilities shown in the balance-sheet, but not including the following amounts, namely:—

- i. *the paid-up capital in respect of equity shares;*
- ii. *the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared before the date of transfer at a general body meeting of the company;*
- iii. *reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation;*
- iv. *any amount representing provision for taxation, other than amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act, to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto;*
- v. *any amount representing provisions made for meeting liabilities, other than ascertained liabilities;*
- vi. *any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares;*

PE = total amount of paid up equity share capital as shown in the balance-sheet;

PV = the paid up value of such equity shares; or

- b. *the fair market value of the unquoted equity shares determined by a merchant banker 2[***] as per the Discounted Free Cash Flow method.]*

The methodology to be adopted for the purpose of arriving at the fair valuation of such shares under this Section has been specifically stated under rule 11UA(2) separately for equity shares and shares other than equity shares. Sub clause (b) under this sub-rule states that the fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or a Chartered Accountant in respect of such valuation. This has been amended vide Notification No. 23/2018- Income Tax dated 24 May 2018 by CBDT which stated as follows:

1. In the Income-tax Rules, 1962(hereinafter referred to as the principal rules), in rule 11U, clause (a) shall be omitted
2. In the principal rules, in rule 11UA, in sub-rule(2), in clause(b), the words “or an accountant” shall be omitted.

The word accountant has been omitted under Rule 11U and Rule 11UA(2)(b) which implies

that for the purpose of Section 56(2)(viib), in case of shares other than equity shares, the fair valuation certified by only merchant bankers will be valid after the date of publishing of such notification.

The Net Asset Value (NAV) method is very straight forward and uncomplicated method for share valuation.

Therefore, in a number of cases the assessee prefers Discounted Free Cash Flow method to substantiate the share valuation. Since this method depends upon future revenue projections, the assessee indulges into various assumptions, which may be wrong and/or impossible. The data are generally supplied by the assessee to the valuer, who on the basis of such fictitious figures prepares projection in favour of the assessee. Common methods are

1. Projected income not commensurate with current trend of business.
2. No empirical data to support the industry future or trend
3. Projection of substantial income from non core business
4. Suppression of expenditure in projection
5. The GP/NP ratio not in tandem with the industry/line of business etc.

A new company, particularly in the service sector does not have sufficient capital base at the inception and hence NAV method sometimes becomes impractical to apply. Due to this reason, lot of companies adopt DCF method which requires lot of subjective analysis in terms of revenue projections, adoption of discounting factor, risk free rate of interest, inflation rate, etc.

IS IT A GENUINE TRANSACTION

Now let us discuss, how an AO will approach the issue of introduction/increase of share capital

in a company. Where the assessee company accepted share with high premium, the AO should examine the genuineness of this transaction first. If the source of fund, identity of the subscribers and the genuineness of the transaction are not proved beyond doubt, obviously it is a case of undisclosed income routed back in the guise of Share Capital. Therefore Sec 68 of I.Tax will apply and no need to apply or examine the applicability of Sec 56(2)(viib) of Income Tax Act. However the calculation of NAV may be utilized to strengthen the non genuineness of the transaction. Let's examine some judicial pronouncements in this issue:

- a. *Hon'ble Keral High Court in the case of Sunrise Academy Of Medical Specialities India Pvt Ltd Vs ITO [2018] 96 taxmann.com 43 (Kerala) decided that in a company in which public is not substantially interested, any premium received by said Company on sale of shares, in excess of its face value, would be treated as income from other sources, satisfactory explanation under Section 68 would not save Company from excess share premium taxability under Section 56(2)(viib).*
- b. *Hon'ble Mumbai ITAT in the case of Pratik Syntex (P.) Ltd. v. ITO [2018] 94 taxmann.com 12 (Mum. - Trib.), the taxpayer during FY 2011-12 raised a certain sum by issuance of shares of Rs. 10 per share face value at a premium of Rs 490 per share, from new shareholders. But on the question of substantiation of share valuation, it could not rely on its financial statements, business model and financial indicators as existed in its audited financial statements to justify the premium. The assessee could not bring on record project report or any other*

cogent material justifying issue of shares at huge premium which could reflect viability, higher profitability and bright future prospects of the assessee company by implementing project for which funds were raised at huge share premium to justify chargeability of such a huge share premium. It was observed that though s. 56(2)(viiib) r.w.s. 2(24)(xvi) comes into effect from AY 2013-14 does not mean that for earlier years the assessee is not required to justify the identity, genuineness and creditworthiness of the transaction. The burden is very high for closely held companies. Mere submission of name & address, Balance Sheet & bank statement of the subscribers is not sufficient to discharge the onus.

- c. *THE CASE OF M/S NRA IRON & STEEL PVT. LTD. (SC) DATED 5TH MARCH 2019* It was decided by Hon' Supreme Court.....

“13. The lower appellate authorities appear to have ignored the detailed findings of the AO from the field enquiry and investigations carried out by his office. The authorities below have erroneously held that merely because the Respondent Company – Assessee had filed all the primary evidence, the onus on the Assessee stood discharged.

The lower appellate authorities failed to appreciate that the investor companies which had filed income tax returns with a meagre or nil income had to explain how they had invested such huge sums of money in the Assessee Company - Respondent. Clearly the onus to establish the credit worthiness of the investor companies was not discharged. The entire transaction seemed bogus, and lacked credibility.

The Court/Authorities below did not even advert to the field enquiry conducted by the AO which revealed that in several cases the investor companies were found to be non-existent, and the onus to establish the identity of the investor companies, was not discharged by the assessee.

14. The practice of conversion of unaccounted money through the cloak of Share Capital/Premium must be subjected to careful scrutiny. This would be particularly so in the case of private placement of shares, where a higher onus is required to be placed on the Assessee since the information is within the personal knowledge of the Assessee. The Assessee is under a legal obligation to prove the receipt of share capital/premium to the satisfaction of the AO, failure of which, would justify addition of the said amount to the income of the Assessee.

15. On the facts of the present case, clearly the Assessee Company - Respondent failed to discharge the onus required under Section 68 of the Act, the Assessing Officer was justified in adding back the amounts to the Assessee's income. ”.

Therefore, it is important to examine the real transactions under the hood of share capital. Financial strength of investors are a real indicators. AO to examine on oath the investors,

1. What is their source of income and income for last 3 years to justify such huge investment in unquoted shares.
2. Why they are investing in a company which does not justify premium (NAV calculation will come handy in this case)

These confrontations coupled with identity of investors, may expose the sham transaction instead of real investment in share capital. The

investors in most of the cases are shell companies. Therefore, AOs are advised to examine this aspect before applying Sec 56(2)(viib) of Income Tax Act 1961.

APPLICATION OF SEC 56(2)(VIIB) OF INCOME TAX ACT 1961

Once the AO is satisfied with genuineness of the transaction, next step is to apply Sec 56(2)(viib) of Income Tax Act 1961.

The assessee must have submitted the Fair Market Value (FMV) of shares based on NAV or DCF method. The AO must satisfy that the valuation certificate is from Merchant Banker and not from an accountant if it is done after 24 May 2018. Otherwise it can be rejected and own valuation can be done.

Now the AO has to examine, whether the FMV calculation is acceptable or not based on the facts and figures on the record.

In case of valuation done on the Net Asset Value (NAV) method, it is straight forward. The AO must make sure that the method prescribed in Rule 11UA of Income-tax Rules 1962 is applied properly, otherwise own valuation can be made.

Most litigated part is, if assessee applies Discounted Cash Flow Method (DCF). The AO must examine the methodology, facts and figures used to calculate the future projections. Most of the times the valuer (Merchant Banker and/or the Accountant) simply relies on the data provided by the Assessee, without going into the genuineness of facts or reliability.

The AO has all the power to question the methods as well as the figures used in calculation under Rule 11 UA of Income Tax Rules 1962.

Now let us examine the judicial decisions in this regard.

CAN THE AO CHANGE THE METHOD OF VALUATION?

1. *The Hon'ble ITAT Delhi in the case of M/s Agro Portfolio (P) Ltd. –vs- Income Tax officer, Ward-1(4), New Delhi [2018] 94 taxmann.com 112 (Delh-Trib) has the occasion to go through a similar issue. Assessee was allotted shares to a company and fair market value of shares was done by a Merchant bankers only on basis of Direct Cash Flow (DC) method, only depending on data supplied by assessee and no evidence was produced for verifying the correctness of data supplied by assessee. The Hon'ble ITAT, Delhi found the action of the AO justified in rejecting DCF method and adopting Net Asset Value method.*
2. *In the case of M/s TUV Rheinland NIFE TUV Rheinland NIFE v. ITO (IT Appeal No. 3160 (Bang,) of 2018, dated 27-2-2019 (Bangalore ITAT) while dealing with this issue, the Bangalore ITAT upheld the order of the tax officer who had rejected the DCF method of valuation adopted by the taxpayer and made addition under Section 56(2)(viib) of the IT Act basis the NAV method. The tax officer, upon examining the valuation report concluded that the valuation report had solely relied on the values provided by the management of the Taxpayer, which were adopted to arrive at the FMV to justify the high premium. The tax officer recomputed the FMV of the shares of the Taxpayer using the NAV method and made relevant additions, which were upheld by the CIT(A).*

The ITAT addressed the argument of the Taxpayer that it has the statutory right to

select one of the two methods prescribed for the purposes of Section 56(2)(viib), one of them being DCF method. In addressing this argument as well as the contention that the right of a tax officer was limited to verifying the arithmetical accuracy of the method selected by the Taxpayer, the ITAT clarified that the tax officer had not questioned the right of the Taxpayer to choose the method of valuation, but after examining the projections, he had questioned the projections/numbers. Thus, in absence of any justifications for the projections used in determining FMV under DCF method, the ITAT agreed with the decision of the tax officer to deploy NAV method. The ITAT thus upheld the authority of the tax officer to override the choice of valuation method adopted in certain circumstances.

However, in the following case change of method of valuation was not approved.

1. *The Hon'ble ITAT in the case of M/ Rameshwaram Strong Glsss (P) Ltd vs- The Income Tax Officer (ITA 884/JP/2016 dated July 12, 2018) has observed that the tax authorities can scrutinize the valuation report to the extent of finding any arithmetical mistakes. The ITAT also observed that the tax authorities are entitled to scrutinise the valuation report and determine a fresh valuation either by themselves or by calling for a final determination from an independent valuer to confront taxpayers if the tax authorities find that the working of the valuer or the assumptions made are erroneous or contradictory. In such case, the tax authorities may suggest necessary modifications and alterations to the valuation report provided the same are based on sound reason and rationale.*

However it, has upheld the right of the company issuing shares to choose the valuation methodology under the provisions of the Income Tax Act, 1961 read with the rules framed there under for the purposes of determining the 'fair market value' (FMV) of such shares at premium. It held that the tax authorities cannot require the taxpayer to change the valuation method adopted by it, when the Tax Law grants an option to select either the Net Asset Value (NAV) method or the Discounted Cash Flow (DCF) method.

The Hon'ble ITAT relied on the case of ITO Vs M/s Universal Polysack (India) Pvt. Ltd. [I.T.A. 609/JP/2017 dated January 31, 2018] wherein the Coordinate Bench of ITAT Jaipur held that the exercise of such an option by the taxpayer is not subject to fulfillment of any specified conditions and it is left to the sole discretion of the taxpayer.

2. *In the case of M/s Innoviti Payment Solutions Pvt. Ltd. v. ITO [2019] 102 taxmann.com 59/175 ITD 10 (Bang - Trib.) the Hon'ble ITAT held that it would be pertinent for the Taxpayer to substantiate the basis of the projections and estimates, used for the purpose of computing the FMV under the DCF method. However, if the tax officer is not satisfied with the valuation report provided by the Taxpayer, he may make additions basis his own estimates, but he would have to follow the same method which has been chosen by the Taxpayer for the purpose of such valuation.*

The Hon'ble ITAT in this case considered the technical guide on share valuation issued by the Institute of Chartered

Accountants of India, and laid down few principles in relation to 56(2)(viib) valuations:

Firstly, only the data and facts available on the date of valuation should be considered for scrutinizing valuation reports and reliance should not be placed upon actual result of future to judge the veracity of the projections/estimates. Secondly, the primary onus of proving the correctness of the valuation report would be on the Taxpayer as he/ she possess special knowledge pertaining to the business of the company. Lastly, if the tax officer is not satisfied with the valuation, he should record the reason for the same and only then he should obtain a fresh valuation report.

CAN THE AO CHANGE THE VALUATION?

As we have already observed in above mentioned judgements it is a big Yes. Unless and until the assessee provides the evidence justifying the facts and figures provided to the merchant banker with their justification it would not be possible either to consider the merits of the DCF method adopted by the assessee or to make suitable adjustments to the same for correct determination of the share price.

Let us go through some other judgments also.

1. *In a case where valuation report by a CA on valuation of shares is filed by the assessee as per requirement made by AO, assessee is not precluded from filing another report from registered valuer which may give higher figure of valuation. The AO is required to give opportunity to assessee and thereafter he can reject or adopt any valuation. [refer- ASG Leather*

(P) Ltd. v. ITO [2018] 95 taxmann.com 151 (Kolkata - Trib.)

2. *In the case of M/s Sadhvi Securities P. Ltd. Vs. ACIT (ITA No.1047/Del/2018) Delhi, ITAT dated 16.07.2019, the valuation was not done properly, hence AO's action was confirmed.*

"12. We do not find any merit in the argument of the ld. counsel for the assessee. A perusal of the Rule 11U(b) as reproduced by CIT(A) at para 5.6 of his order makes it clear that the balance sheet means the balance sheet as drawn up on the balance sheet date which has been audited by the auditor of the company and where the balance sheet on the valuation date has not been drawn up the balance sheet drawn up as on a date immediately preceding the valuation date which has been approved and adopted in the AGM of the shareholders of the company. We find in the instant case, on the date of receipt of the consideration the balance sheet of the assessee company was not drawn up as the same was drawn up only on 31st July, 2014 which is evident from the audited balance sheet filed. Clause (b) and clause (j) of Rule 11UA makes it clear that for computing fair market value of the shares the value of the assets and

liabilities as stated in the audited balance sheet immediately prior to the receipt of consideration should be adopted. If, on the date of receipt of the consideration, the balance sheet was not drawn up, then, the balance sheet drawn up as on a date immediately preceding the valuation date should be adopted i.e., the balance sheet of the immediately preceding year should be adopted. We find, in the instant case, on the valuation date i.e., on 31.03.2004,

the balance sheet was not drawn up by the auditor as audited financials were drawn up only on 31st July, 2014 and, therefore, we concur with the observation of the Id.CIT(A) that the valuation of assets and liabilities in the balance sheet of the immediately receding year i.e., 31.03.2013 should have been adopted. Since the valuation done by the assessee was not in accordance with the Rule framed for valuation of unquoted shares i.e., the assessee has not taken the value of assets before introduction of share capital received through fresh allotment and since the Assessing Officer has correctly determined the valuation of the unquoted equity shares which has been upheld by the CIT(A), therefore, we do not find any infirmity in the order of the CIT(A). Accordingly, the same is upheld and the grounds raised by the assessee are dismissed.”

3. In the case of M/s Kottaram Agro Foods (P) Ltd. TS-762-ITAT-2018(Bang) 102 taxmann.com 183

The Hon'ble ITAT affirmed the AO's NAV based valuation. ITAT ruled that the auditor cannot be an accountant for the purposes of Rule 11UA (2) [dealing with share valuation for the purpose of excess share-premium taxability u/s 56(2)(viib). It noted that though the assessee had filed share valuation report certified by auditor (valuing shares at Rs. 400/- as on March 31, 2014) which was rejected, AO had accepted the earlier valuation report of 2012 by an 'Accountant' in terms of Rule 11UA valuing shares as on March 31, 2012 (at Rs. 100/-); ITAT remarks that, "when an auditor cannot be accepted as an accountant for the purposes of Rule

11UA (2)...there is no option available to the AO but to accept the earlier report ... valuing the shares at Rs.100/- per share instead of Rs. 400/- per share...”, further highlights the rise in valuation 4 times when the valuation is certified by an auditor, thereby vindicating the restriction contained in Rule 11UA on auditor's acceptance as accountant.

Therefore, the AOs must ascertain the actual nature of transaction. If it does not attract provisions of Sec 68, then proceed to examine the applicability of Sec 56(2)(viib) in the light of above judicial pronouncements. Also keep in mind Section 56(2)(viib) of the Income-tax Act, 1961 is an anti-abuse provision which seeks to tax excessive premium received from Indian residents by closely held companies (i.e. monies received in excess of the Fair market value of the shares) on issue of shares - popularly known as the 'Angel Tax'. However, to restrict the wide tax net of this provision which also applies to start-ups that thrive on high value angel funding, the Department, for Promotion of Industry and Internal Trade, through a notification dated February 19, 2019, has defined start-ups who should be exempt from Angel Tax, subject to such entities satisfying the prescribed conditions. This exemption regime was formalized by the Central Board for Direct Taxes, through a notification dated March 5, 2019.

CONCLUSION

To conclude, the AO should first examine whether the case in hand is one of genuine transactions. If the answer is in the negative, he shall have to investigate the case to bring the appropriate sum under Section 68 of the Act. If it is a genuine transaction, the matter becomes a technical issue requiring in depth study of the valuation methods.

Issue of Notice/ Assessment Order in the Name of ‘Deceased Person’ or ‘Amalgamated/ Merged Company’



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Satpal Gulati IRS 1993 Batch Presently posted as CIT-DR (International Tax Bench)-ITAT Delhi Experience:

Worked as AO and Range Head in assessment wing for 7 years, as DDIT in Investigation wing for 6 years, as Additional Director & CIT(CPC-TDS) in Systems Directorate for 8 years, as CIT(A) in International Taxation for 4 years. Special Achievement: -Won PM award as a team member of System Directorate for contribution in setting up CPC-TDS. Won e-governance Gold award for government process reengineering in rolling out CPC-TDS.

Executive Summary

It is noticed that the department has lost the revenue in number of cases mainly on account of fatal mistake made by the AO in issuance of notice to dead person/ non-existent entity or in framing the assessment order in the name of dead person/non-existent entity. This article is to sensitize the AOs to take serious note of the event of death of person or incidence of amalgamation or merger of company as and when the same is reported to assessing officer and to take on record the legal heir(s) in the case of deceased person. This article delineates the action to be taken by the AO in handling various scenario arising in such cases which is based on the judicial precedents on the issue.

SCHEME OF THE ACT TO ASSESS AN ‘INDIVIDUAL’ IN CASE OF HIS DEATH:

The Provisions of Section 159 Read as Under:

1. ‘159. (1) Where a person dies, his legal representative shall be liable to pay any sum which the deceased would have been liable to pay if he had not died, in the like manner and to the same extent as the deceased.
2. For the purpose of making an assessment (including an assessment, reassessment or recomputation under Section 147) of the income of the deceased and for the purpose of levying any sum in the hands

of the legal representative in accordance with the provisions of Sub-section (1),—

- a. Any proceeding taken against the deceased before his death shall be deemed to have been taken against the legal representative and may be continued against the legal representative from the stage at which it stood on the date of the death of the deceased;
- b. Any proceeding which could have been taken against the deceased if he had survived, may be taken against the legal representative; and

- c. All the provisions of this Act shall apply accordingly.
3. The legal representative of the deceased shall, for the purposes of this Act, be deemed to be an assessee.
4. Every legal representative shall be personally liable for any tax payable by him in his capacity as legal representative if, while his liability for tax remains undischarged, he creates a charge on or disposes of or parts with any assets of the estate of the deceased, which are in, or may come into, his possession, but such liability shall be limited to the value of the asset so charged, disposed of or parted with.
5. The provisions of Sub-section (2) of Section 161, Section 162, and Section 167, shall, so far as may be and to the extent to which they are not inconsistent with the provisions of this section, apply in relation to a legal representative.
6. The liability of a legal representative under this section shall, subject to the provisions of Sub-section (4) and Sub-section (5), be limited to the extent to which the estate is capable of meeting the liability.'

Further, Section 2(29) defines 'legal representative' and assigns its meaning to Clause 11 of Section 2 of Code of Civil Procedure 1908 which reads as under:

1. (11) "legal representative" means a person who in law represents the estate of a deceased person, and includes any person who intermeddles with the estate of the deceased and where a party sues or is sued in a representative character the person on whom the estate devolves on the death of the party so suing or sued."
2. Section 2(7) of the Act defines assessee which includes person who is deemed to be an assessee under any provision of the Act. Section 159(3) of the Act provides that the legal representative of the deceased shall be deemed to be an assessee.
 3. It is important to note that Section 159(2) empowers the Assessing Officer to take the proceedings against the legal representatives which he should have taken against the deceased if he had survived. Section 159(2) nowhere authorizes the Assessing Officer to take the proceedings against the individual who has already expired, that is why the legal representative under Section 2(7) is regarded to be an assessee.

LEGAL POSITION

The notice issued in the name of a dead person is not a valid notice. This position has been upheld in a number of decisions which include:

- *CIT vs. Amarchand Shroff* [1963] 48 ITR 59 (SC)
- Hon'ble Andhra Pradesh High Court in the case of *Deccan Wine & General Stores vs. CIT*, 106 ITR 111
- Delhi High Court in *Vipin Walia vs. ITO*, W.P.(C) 8273/2015
- *Durlabhai Kanubhai Rajpara vs. ITO* [R/ Special Civil Application No. 16125 of 2010, dated 26.03.2019]
- Delhi High Court in case of *Rajender Kumar Sehgal* 101 taxmann.com 233 (Delhi) W.P. (C) NO. 11255/2017

The basis of the aforesaid legal position is that an individual under the Income-tax Act, 1961 has

ordinarily to be a living person. Consequently, a dead person will not fall within the scope of the expression 'person' under Section 2(31) of the 1961 Act. Therefore, any notice issued to a dead person for making assessment or reassessment will be invalid in the eyes of law.

'PROCEEDINGS' COVERED IN SCOPE OF SECTION 159 OF THE ACT

Section 159(2) does specify that any proceeding taken against the deceased before his death shall be deemed to have been taken against the legal representative and may be continued against the legal representative from the stage at which it stood on the date of the death of the deceased. Further, it provides that any proceeding which could have been taken against the deceased if he had survived, may be taken against the legal representative.

Based on the above, 'any proceeding' say assessment, reassessment, review of order, rectification of order, 133(6), penalty and recovery proceedings can be taken against the legal heir in case of deceased assessee. Any proceeding initiated in the name of deceased person after his death is fatal in nature and is not curable defect. In case of any proceeding is initiated before the death of the deceased person but carried out after the death of such person, then, the concerned authority must bring the legal representative(s) on record, otherwise it will create an irregularity.

As regards recovery proceedings pending against the deceased assessee at the time of the death, the same can be taken up against legal representative(s) as per Rule 85 of Schedule II of the Income Tax Act 1961 (*except arrest and detention*). The liability of legal heir is limited only to the extent to which the estate left by the deceased is capable of meeting the tax liability. Tax liability imposed upon the deceased assessee

cannot be recovered from the legal heirs to whom the notice for the assessment proceedings was not issued. The courts have held that Section 292BB of the Act does not protect such cases.

SCHEME OF THE ACT TO ASSESS ENTITY IN CASE OF SUCCESSION TO BUSINESS OTHERWISE THAN ON DEATH

The provisions of Section 170 read as under:

'170. (1) Where a person carrying on any business or profession (such person hereinafter in this Section being referred to as the predecessor) has been succeeded therein by any other person (hereinafter in this section referred to as the successor) who continues to carry on that business or profession,—

(a) *the predecessor shall be assessed in respect of the income of the previous year in which the succession took place up to the date of succession;*

(b) *the successor shall be assessed in respect of the income of the previous year after the date of succession.*

(2) Notwithstanding anything contained in Sub-section (1), when the predecessor cannot be found, the assessment of the income of the previous year in which the succession took place up to the date of succession and of the previous year preceding that year shall be made on the successor in like manner and to the same extent as it would have been made on the predecessor, and all the provisions of this Act shall, so far as may be, apply accordingly.

(3) When any sum payable under this section in respect of the income of such business or profession for the previous year in which the succession took place up to the date of succession or for the previous year preceding that year, assessed on the predecessor, cannot

be recovered from him, the [Assessing] Officer shall record a finding to that effect and the sum payable by the predecessor shall thereafter be payable by and recoverable from the successor and the successor shall be entitled to recover from the predecessor any sum so paid.

(4) Where any business or profession carried on by a Hindu undivided family is succeeded to, and simultaneously with the succession or after the succession there has been a partition of the joint family property between the members or groups of members, the tax due in respect of the income of the business or profession succeeded to, up to the date of succession, shall be assessed and recovered in the manner provided in Section 171, but without prejudice to the provisions of this section.

Explanation.—For the purposes of this Section, “income” includes any gain accruing from the transfer, in any manner whatsoever, of the business or profession as a result of the succession.’

Section 170(1) provides that the predecessor shall be assessed in respect of the income of the previous year in which the succession took place upto the date of succession. For example, if one business of a company A is hived off to other company B, then company A still exists after hiving off one line of business. Thus, the predecessor (company A) shall be assessed in respect of income of the previous year in which the succession took place up to the date of succession. However, where the predecessor does not exist due to merger/ amalgamation, then, Section 170(2) would be applicable and in such a case the assessment of the income of the previous year in which the succession took place upto the date of succession and of the previous year preceding that year shall be made on the successor in like manner and to

the same extent as it would have been made on the predecessor, and all the provisions of this Act shall, so far as may be, apply accordingly. Section 170(3) provides for recovery of sum payable by the predecessor from the successor and the successor shall be entitled to recover from the predecessor any sum so paid. Section 170(4) deals with succession of business in the case of HUF.

LEGAL POSITION BASED ON JUDICIAL PRECEDENTS

Hon’ble Supreme Court in the case of *Pr. CIT vs. Maruti Suzuki India Ltd.* (416 ITR 613) held that the basis on which jurisdiction was invoked was fundamentally at odds with the legal principle that the amalgamating entity ceases to exist upon the approved scheme of amalgamation. Participation in the proceedings by the appellant in the circumstances cannot operate as an estoppel against law. Hon’ble Court also relied on the decision in case of *CIT vs. Spice Entertainment*, Civil Appeal No. 285 of 2014, dated 02.11.2017. Hon’ble Supreme Court also distinguished decision in case of *Skylight Hospitality LLP W.P.(C) 10870/2017* where the Delhi High Court took specific note of the fact that though the notice to reopen had been issued in the name of the erstwhile entity, all the material on record including the tax evasion report suggested that there was no manner of doubt that the notice was always intended to be issued to the successor entity. Accordingly, protection under Section 292B was granted in the case of *Skylight Hospitality* by Delhi High Court. However, Hon’ble Supreme Court observed that there is no conflict between the decisions in *Spice Entertainment (supra)* on the one hand and *Skylight Hospitality LLP* on the other hand.

ACTION POINTS AT THE END OF THE AO TO AVOID THE FATAL MISTAKE

Situation 1: Where the legal heir filed the return of income and the same has been taken up for scrutiny.

Action Point: To ensure that all legal heirs of the appellant stand identified and the notice must be served on all such legal heirs including the legal heir who filed the return for taking up the case under scrutiny. Hon'ble Supreme Court in the case of *CIT vs. Jai Prakash Singh* (1996) 219 ITR 737 (SC) held that if the return was filed voluntarily by one out of 10 legal heirs disclosing entire income and the legal heirs complied with the notices under Sections 142(1) and 143(2) and thereafter assessment was completed and in case the legal heirs raising the objection for the first time in appeal that notice had not been issued to other legal heirs, the assessment was irregular and not null and void. Thus, it is clear that the AO must identify all legal heirs and take them on record for issuance of notice in the given case. Finally, the assessment order must be passed only in the name of legal heir(s).

Situation 2: Where the event of death/ amalgamation/ merger has been informed by the representative on *suo-moto* basis to the AO without pendency of any proceedings before the AO.

Action Point: To do 'event marking' of concerned PAN in PAN database so that at later stage if the case of deceased assessee/ amalgamated company is taken up for assessment/ reassessment/ any other proceeding, the AO would get alerted. This alert facility is not yet rolled out in ITBA. Assessing Officer is required to take on record all legal heirs after making necessary enquiry and the notice in such case must be issued in the name of all legal heirs. There are decisions which hold that defect of not

sending notices to all the legal representatives is not curable under this Act (refer ITAT Jodhpur decision in the case of *Assistant Commissioner Of Income ... vs Late Mangi Lal Through L/H Badri* 83 TTJ Jodh 590). Finally, the assessment order must be passed only in the name of legal heir(s).

Situation 3: Where the event of death/ amalgamation/ merger has been informed to the Assessing Officer only AFTER issuance of the notice for initiation of proceedings in the name of the deceased assessee whereas such event (death/ amalgamation/ merger) took place PRIOR to the date of issuance of notice.

Action Point: Since the notice issued for initiation of the proceedings in this case is after the event of death/ amalgamation/ merger, therefore, such notice is not valid in the eyes of law. At this stage, when the information regarding the event of death/ amalgamation/ merger has been received by the AO, the AO needs to issue fresh notice to initiate the proceedings against legal heirs, if the same is not barred by time limitation. However, if the issuance of fresh notice to legal heirs to initiate the proceedings is barred by time limitation on the date of receipt of information in the office of the AO regarding the event of death/ amalgamation/ merger, then, the only recourse left to the AO is to issue subsequent notices in the name of legal heirs after identifying all legal heirs of the appellant. Finally, the assessment order must be passed only in the name of legal heir(s) and the AO must mention the date of receipt of information in the office regarding the event of death/ amalgamation/ merger in the assessment order. Where AO issues the notice in the name of deceased person and compliance is made in the name of deceased person and subsequently it is informed on behalf of assessee about his death/ amalgamation, AO must mention in his

order about compliance made in the name of deceased person.

Madhya Pradesh High Court in *Smt. Kaushalyabai vs. CIT* [1999] 238 ITR 1008 held that once the legal heir of the deceased assessee had participated in the proceedings, the defect in the notice stood automatically cured. However, this principle has not been followed by the Hon'ble Supreme Court in the case of *Pr. CIT vs Maruti Suzuki India Ltd.* (416 ITR 613) where it is held that participation in the proceedings by the appellant in the circumstances cannot operate as an estoppel against law.

Situation 4: Where the event of death/ amalgamation/ merger has been informed to the Assessing Officer after initiation of proceedings in the name of the deceased assessee and such event (death/ amalgamation/ merger) is AFTER the date of issuance of notice to initiate the proceedings.

Action Point: Since the notice issued for initiation of the proceedings in this case is before the event of death/ amalgamation/ merger, therefore, such notice is valid in the eyes of law. After the date of receipt of information in the office of the AO regarding the event of death/ amalgamation/ merger, the AO may issue subsequent notices in the name of legal heirs after identifying all legal heirs of the appellant and taking them on record. The assessment order must be passed only in the name of legal heir(s).

Situation 5: Where the event of death/ amalgamation/ merger was BEFORE the initiation of the proceedings and the same was not informed to the Assessing Officer at any stage during the assessment proceedings and the plea was taken for the first time at appellate stage then the order is null and void as the notice

was issued in the name of deceased person.

3.5.1 Action Point: Since the notice issued for initiation of the proceedings in this case is after the event of death/ amalgamation/ change in name of company, therefore, such notice is not valid in the eyes of law. At this stage, when the information regarding the event of death/ amalgamation/ merger has been received by the AO, the AO needs to issue fresh notice to initiate the proceedings against the legal heirs, if the same is not barred by time limitation. The AO may also refer para 3.3.1 and para 3.3.2 above which deal with similar issues.

To save above situation of proceedings in hands of legal heir/ successor etc. having been barred by limitation, during representation before appellate authority, plea be made to issue directions under Section 150 of the Act by drawing attention to the conduct of assessee in not disclosing the fact about death etc.

Situation 6: Where the event of death/ amalgamation/ change in the name of the company was after the initiation of the proceedings and the same was not informed to the Assessing Officer at any stage during the assessment proceedings and the plea was taken for the first time at appellate stage that the order is null and void as the ORDER was passed in the name of the deceased person.

Action Point: The matter will be decided by the appellate authority. As per judicial precedents, if the legal representative has responded before the taxing authority upon service not addressed to him but to the deceased assessee, and does not object to the continuance of the proceeding against the deceased person, and has been heard by the Assessing Officer in regard to the tax liability of the deceased and invites an assessment on merits, such a legal representative must be taken to have exercised

the option of abandoning the technical plea that the proceeding has not been continued against him, although in substance and reality it has been so continued. It would not be open to him to take up a plea at the appellate stage as an afterthought that the proceeding taken and the assessment order made against the deceased are a nullity. This position has been upheld in *CIT vs. Sumantbhai C. Munshaw* (1981) 128 ITR 142 (Guj).

However, there are set of decisions which do not give emphasis on the discharge of onus to report the event of death/ amalgamation/ merger. Hon'ble Supreme Court in the case of Pr. *CIT vs. Maruti Suzuki India Ltd.* (416 ITR 613) held that participation in the proceedings by the appellant in the circumstances cannot operate as an estoppel against law. Thus, in order to protect the interest of revenue, at the stage when the information regarding the event of death/ amalgamation/ merger has been received by the AO, the AO needs to issue fresh notice to initiate the proceedings against legal heirs, if the same is not barred by time limitation.

Situation 7: Where the event of death/ amalgamation/ change in the name of the company was after the initiation of the proceedings and the same was informed to the Assessing Officer after passing the draft assessment order in the name of the deceased person and DRP proceedings were in progress.

Action Point: The AO should immediately bring it to the notice of DRP so that DRP may pass order/ direction in the name of legal heir(s)/ succeeding entity. In the case when DRP has passed direction in the name of deceased person and the AO has the information about death before passing of final order, he should request DRP to pass direction in proper name as AO cannot *suo moto* change the name in final order.

PECULIAR SITUATIONS

Whether statement of deceased assessee in search proceedings is binding on legal representative:

The legal representatives of the deceased assessee is a trust and not an individual. The trust being a beneficiary cannot contest or retract from the admitted position. However, the position can be challenged only on legal ground. A retraction can be made only on error or law and not on facts. [refer *CIT vs. Late H. Basavraj* (2012) 251 CTR 300 (Kar.)]

Whether search warrant can be issued in the name of deceased person or not?

Search warrant issued under Section 132 in the name of a dead person is invalid and void *ab initio*.

Whether assessment in pursuance to the invalid search warrant issued in the name of deceased person is valid?

Invalid search warrant under Section 132 issued in name of deceased person cannot invalidate consequential block assessment under Section 158BD on legal heir of deceased, as legal heir had participated in proceedings of assessment initiated under Section 158BC (Refer SC decision in the case of *Gunjan Girishbhai Mehta* [2017] 80 taxmann.com 23 (SC)).

Whether notice under Section 133(6) of the Act in the name of the deceased assessee is valid?

Where notice under Section 133(6) was issued against a deceased person, wife of said deceased person would have to comply with said notice for furnishing requisite information under said section – Yes (refer 89 taxmann.com 341 (Karnataka) in the case of *Mrs S Savithri*).

Where the Assessing Officer for both amalgamating as well as amalgamated companies are same, whether the Assessing Officer has to

pass two orders in the year of amalgamation i.e. one for the income of amalgamated company and another for the income of amalgamating company?

It is important to note that there are two separate ITRs filed in this case based on separate books of account because the amalgamating company existed only upto the date of amalgamation in the relevant year and thereafter, the amalgamated company is in existence from the date of amalgamation. Therefore, the AO is required to pass two separate orders in response to two separate returns (one for the period upto the date of amalgamation, and other for period from date of amalgamation to the end of year). Both the orders have to be passed with the PAN of amalgamated company (existing entity). The AO has to handle it manually as the ITBA system does not allow passing two separate orders against single PAN, so far. In the case of assessment of income of amalgamating company (non-existent entity), its erstwhile name and PAN may be mentioned alongwith PAN and name of amalgamated company (existing entity).

Where the Assessing Officer for both amalgamating (Company A) as well as amalgamated company (Company B) are same. Whether the Assessing Officer has to issue single notice or two separate notices, for reopening of case of both entities, based on certain information received after the date of amalgamation, in respect of both companies A & B, for the period when both entities were in existence?

Since the information has been received after the date of amalgamation, therefore, Company A does not exist on the date of issuance of notice under Section 148 of the act. Accordingly, question of issuance of notice to Company A does not arise. The Assessing Officer should issue one notice on Company B's PAN. However, the reason to believe must contain the escapement of income in respect of both entities (erstwhile

Company A and existing Company B). This position has been accepted by Hon'ble Delhi High Court in the case of *Experion Developers Pvt. Ltd. (EDPL) vs. ACIT & Ors.* in W.P. (C) No. 11302/2019 and 11303/2019. It is also relevant to add that ITBA system as on date does not allow simultaneous issuance of two notices under Section 148 of the Act against single PAN.

Identification of Legal heir (legal representative) and taking them on record:

1. Legal heir, in the eyes of law, is the person who represents the assets of deceased. The step of identifying all possible legal heirs is very critical procedural step. There are judicial precedents which render the assessment order irregular if the proceedings have not been initiated against all possible legal heirs. The irregular assessment order is curable. However, there are certain decisions which consider the assessment order null and void if the notice under Section 148 of the Act has not been issued to all legal heirs (refer para 3.2.1 above).
2. In this regard, the AO may ask for certificate of surviving family members issued by the local revenue authorities (Municipality, Nagarpalika) from the representative. The AO may also look for the following documents which are acceptable as legal heir certificates:
 - a. The legal heir certificate issued by the court of law.
 - b. The certificate of the surviving family members issued by the local revenue authorities.
 - c. The registered Will of the deceased person.
 - d. The family pension certificate issued by the State/Central government.

It is relevant to add that Hindu Succession Act 1956 provides that Class I heirs are sons, daughters, widows, mothers, sons of a pre-deceased son, widows of a pre-deceased son, son of a pre-deceased son of a predeceased son, and widows of a pre-deceased son of a predeceased son.

PROTECTION UNDER SECTION 292B

Delhi High Court in the case of *Spice Infotainment Ltd. vs. CIT* [2012] 247 CTR (Del.) 500 held that once it was found that the assessment was framed in the name of a non-existent entity, it did not remain a procedural irregularity of the nature which could be cured by invoking the provisions of Section 292-B. Further, in case of *Skylight Hospitality LLP*, the revenue could show that reason to believe clearly recorded the fact of conversion of company into LLP. Thus, Delhi High court in this case considered the issuance of notice under Section 148 in the name of erstwhile company as curable mistake and held that:

'Re-assessment notice issued in name of erstwhile private limited company despite company ceasing to exist as it had been converted into LLP would not invalidate re-assessment proceedings as same was not a jurisdictional error, but an irregularity and procedural/technical lapse which could be cured under Section 292B.'

Based on judicial precedents, it transpires that if notice to assume jurisdiction (say notice under Section 143(2)/ Section 148/ Section 263 etc.) by the officer concerned was issued to a non-existent entity/ dead person, then, it is a case of substantive illegality and not a procedural violation of the nature adverted to in Section 292B.

In the case of *Rudra Gouda* (Karnataka High Court- IT APPEAL NO. 100042 OF 2017), subsequent to death of original assessee, appellant, as a legal heir of deceased assessee, filed return of income and the assessment was completed in the name of deceased assessee. Hon'ble Karnataka High Court, in this case, held that it is correct to remand the matter back to the Assessing Officer for *de novo* assessment order on legal representative of deceased assessee. Thus, effectively, the court considered it to be a case of curable mistake. However, the AO must avoid such mistakes as most of the courts are not considering it to be curable mistake.

To sum up, the AO must take serious note of information related to death of person/ incidence of amalgamation or merger of company as and when the same is received in the office. Such information, if pending for action, must be handed over to the successor of the AO in case of transfer of the AO. Further, the AO is required to strictly adhere to the action points (refer para 3.1 to 3.7.1 above) in the case of death of person/ incidence of amalgamation or merger of company because any lapse in compliance to the same is a fatal mistake in the eyes of law. The above discussion also dealt with peculiar situations at para 4 (4.1 to 4.6.1) which are quite relevant for the AO. The following points are reiterated as the same are vital in nature:

- Notice issued in the name of a dead person is invalid and therefore, the AO has to ensure the issuance of notice to initiate the proceedings only in the name of legal heir of the deceased person.
- Where the person died during the course of Income-tax proceedings, the AO has to continue with the proceedings after taking on record all legal heirs and the assessment order must be passed in the name of legal heir.

Assessment

- Identification of all possible legal heirs and taking them on record is very important step(refer para 5 above).
- Notice to assume jurisdiction (say notice under Section 143(2)/ Section 148/ Section 263 etc.) by the officer concerned in respect of a non-existent entity/ dead person is a case of substantive illegality and not a procedural violation of the nature adverted to in Section 292B (refer para 6 above).
- Notice issued in the name of non-existent entity is invalid and therefore, the AO has to ensure the issuance of notice to initiate the proceedings only in the name of succeeding entity carrying on the business of the non-existent entity.
- Where the company got merged/ amalgamated during the course of Income-tax proceedings, the AO has to continue with the proceedings in the name of succeeding entity carrying on the business of the non-existent entity and the assessment order must be passed in the name of succeeding entity.
- The above action points related to assessment equally apply to all types of proceedings say reassessment, review of order, rectification of order under Section 133(6), penalty and recovery proceedings which can be taken against the legal heir in case of deceased assessee or in case of non-existent entity(refer para 1.7 to 1.9 above).

Issues Related to Section 14A



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Executive Summary

This Paper is on the Topic 'Issues related to Section 14A'. Provisions of Section 14A and Rule 8D are invoked in a large number of cases. The tax laws of India treats certain income as not taxable such as agricultural income, dividend received from an Indian company, income of eligible charitable institution, and tax-free interest.

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There has been a debate between the taxpayers and income tax authorities on whether the expenditure earned on exempted income should be allowed as expenditure or not. Section 14A and Rule 8D ever since they were brought on the statute book in 2001 and 2008 respectively have, on one hand been subject matter of litigation and on other hand undergone multiple changes through legislative amendments and judicial decisions of the Supreme Court, several High Courts and ITATs. Guidance for Assessing Officers on application of Section 14A and Rule 8D was therefore identified as one of the key areas, while listing topics for the Series of Technical Notes. This Paper covers important aspects such as recording of satisfaction before applying Section 14A & Rule 8D, disallowance of expenses under Section 14A in situation of no exempt income during the year, disallowance of expenses under Section 14A beyond exempt income, disallowance of interest element in situations of mixed funds, adding back of disallowance under Section 14A for book profit computation under Section 115JB etc. It is hoped that the Paper would be useful guidance for Assessing Officers and their supervisory authorities.

LEGISLATIVE EVOLUTION OF SECTION 14A & RULE 8D

Certain incomes are not includible while computing the total income, as these are exempt under various provisions of the Act. There have been cases where deductions are claimed in respect of such exempt income. This, in effect, means that the tax incentive given by way of exemptions to certain categories of income is being used to reduce the tax payable even on the non-exempt income by debiting the expenses incurred to earn the exempt income against taxable income.

Section 14A was introduced in the year 2001 with retrospective effect from 01.04.1962 to clarify the intention of the legislature with respect to expenses relating to earning of an exempted income. This was done after the Supreme Court decision in *Rajasthan Warehousing Corporation* [242 ITR 450 (2000)], held that in case of an indivisible business, some income wherefrom is taxable while some exempt, entire expenditure would be permissible deduction and the

principle of apportionment would apply only for a divisible business.

With effect from 24.03.2008, Rule 8D was inserted which prescribes the mechanism for allocating expenses to exempt income. The important limbs of extant Rule 8D read as under:

- [Rule 8D(2)(i)]-Expenditure directly incurred to earn exempt income.
- [Rule 8D(2)(ii)]-The interest expense worked out on the basis of a prescribed formula (in the proportion of average value of investments yielding exempt income, to average value of total asset) which is not directly attributable to any exempt income.
- [Rule 8D(2)(iii)] - On presumptive basis, i.e. 0.5% of the annual average value of investments yielding exempt income

The table below summarises various amendments in respect of Section 14A of the Act:

Table 1

Amending Act	Specific Amendment	Impact
Finance Act 2001	Section 14A inserted (w.e.f. 01.04.1962)	Provided for disallowance for expenses incurred in relation to income exempt from income-tax.
Finance Act 2002	Proviso to Section 14A inserted (w.e.f. 11.05.2001)	Clarification that Section 14A cannot be used to reopen/rectify completed assessment.
Finance Act 2006	Sub-sections (2) and (3) inserted (w.e.f. 01.04.2007)	Provided the methodology for computing the disallowance under Section 14A.
I-T (Fifth Amendment) Rules 2008	Rule 8D inserted (w.e.f. 24.03.2008)	Prescribes the mechanism for allocating expenses to exempt income.

With a view to rationalize the formula in Rule 8D, a revised method for determining the amount of disallowance of expenditure on earning exempt income was notified by the CBDT on 2nd June, 2016 where Sub-Rule (2) which prescribes method of determining the expenditure in relation to exempt income was amended. Comparative summary of the new rule with the existing rule is as under:

- No change in Rule 8D(2)(i) which includes expenditure directly incurred to earn exempt income
- Existing Rule 8D(2)(ii) (the interest expense worked out on the basis of a prescribed formula which is not directly attributable to any exempt income) got deleted in the revised rule set
- New Rule 8D(2)(ii) introduced which provides for 1% of the annual average of the monthly averages of value of investments yielding exempt income. This rule is a replacement against the existing Rule 8D(2)(iii) with a modification where (a) rate of presumptive expenditure has been increased to 1% from 0.5%; and (b) as against annual average value of investment, the new rule provides for the annual average of the monthly averages of value of investments.

- New rule provides that the disallowance amount as computed under Rule 8D shall not exceed total expenditure claimed by the taxpayer. [Proviso to Rule 8D(2)] Thus, the new rule puts a cap on upper limit on disallowance as total expenditure claimed by taxpayer.

ISSUES EMANATING FROM JUDICIAL PRONOUNCEMENTS

A. Recording of Satisfaction before Making any Disallowance under Section 14A in the Assessment Order

A.1 In view of specific language of Sub-section (2) of Section 14A and Sub-rule (1) of Rule 8D, the recording of satisfaction is a necessary pre-requisite for invoking disallowance under Section 14A. Sub-section (3) of Section 14A provides that provisions of Sub-section (2) of Section 14A would apply where an assessee claims that no expenditure has been incurred in relation to exempt income. Rule 8D of the Income-tax Rules also uses the same language as in Sub-sections (2) and (3) of Section 14A of the Act. Accordingly, in cases where either the assessee claims that no expenditure has been incurred or where the assessee makes disallowance on the basis of his own calculations or determinations, Rule 8D can be applied by the Assessing Officer only if he is not satisfied as regards the correctness of claim of the assessee.

A.2 The Bombay High Court in the case of *PCIT v/s. Reliance Capital Asset Management Ltd.* [2017] 86 taxmann.com 200 (Bombay) held that where Assessing Officer had not commented upon correctness or otherwise of assessee's working of expenditure in respect of income not chargeable to tax, the formula prescribed in Rule 8D(2)(iii) of the Income-tax Rules 1962 could not have been applied to work out disallowance under Section 14A of the Act. Department preferred SLP before Supreme Court which was dismissed due to low tax effect.

A.3 Delhi High Court in the case of *Eicher Motors Ltd vs. CIT* (2017) 398 ITR 51/ 250 Taxman 532 (Delhi) (HC) held that recording of satisfaction is mandatory. once this mandatory aspect was itself not fulfilled, the question of remanding the matter to the Commissioner (Appeals) and to call for a remand report from the Assessing Officer for the purposes of rectifying this jurisdictional defect would not arise.

A.4 Thus, in view of the language of Section 14A and various judicial pronouncements, AO needs to examine whether the taxpayer is able to justify the basis of its claim of amount to be disallowed or that no disallowance is required. In the scenario of not being satisfied with such claims of assessee, AO needs to record his specific satisfaction describing the reasons thereof. Such satisfaction needs to be recorded in a speaking manner, clearly delineating the facts and reasons for the same. The following points emanating from judicial precedents are relevant while recording satisfaction by the AO:

- Mere recording of satisfaction in a mechanical manner without discussing the exempt income and nature and source of expenditure in relation to the

exempt income will render the case of the AO weak.

- Proximate cause between expenditure and exempt income is condition precedent for disallowance of expenditure. A proximate cause shall mean that the amount disallowed has a relationship with the exempt income. AO should address this aspect while recording satisfaction.
- Mere assertions that the Section is applicable and/ or assessee's claim that no expenditure had been incurred is not acceptable are not sufficient. AO needs to elaborate upon the same.
- Satisfaction is to be recorded by the Assessing Officer and it cannot be substituted by recorded satisfaction of Commissioner of Income-tax (Appeals) - *Arnav Gruh Ltd. vs. DCIT* (2018) 168 ITD 518(Mum.) (Trib.)

A.5 In order to provide clarity to the Assessing Officers, the CBDT has issued a Standard Operating Procedure (SOP) on 10.01.2018 for applying provisions under Section 14A of the Income-tax Act. The focus of SOP is to guide the AO to carry out necessary due diligence by following step-wise process in order to record satisfaction while making disallowance under Section 14A of the Act. SOP factors in judicial position emerging on account of various decisions pronounced on the issue of recording the satisfaction by the AO while making disallowance under Section 14A. Various steps as per the SOP by the CBDT are listed in first column of the Table below. In the second column of the Table, documents to be referred to and related actions/ verifications are suggested for AO on the issue of making disallowance under Section 14A/ Rule 8D:

TABLE 2

Step No. of SOP	Action to be Taken by AO as per SOP	Documents which may be Referred to by AO, for Verification/ Examination
1	Whether the assessee has investment or stock-in-trade which yield or are capable of yielding exempt income? If yes, details be obtained and scrutinised.	<ul style="list-style-type: none"> ● ITR, Balance Sheet Schedules/ Notes of Long term and Short term Investments/ Assets, as enclosed in Audit Report ● Accounting policies, Related Party disclosures and transactions with related parties ● Cash Flow Statement/ Fund Flow Statement, enclosed with the Audit Report, esp. Cash flow from investing/ financing activities and adjustments. ● Further information/ documents obtained/ provided from/ by the assessee
2	Reasons for making the investment be obtained to have insight into the nature of the transaction and the related expenditure	<ul style="list-style-type: none"> ● Notes/ Observations of the Auditors enclosed with the Audit Report ● Notes of Auditors enclosed with Cash Flow Statement/ Fund Flow Statement ● Information received/ provided from/by the assessee
3	It may be summarized in the assessment order whether the assessee has received interest-free income during the year or has accrued interest-free income which has not been received during the year.	<ul style="list-style-type: none"> ● ITR, Profit and Loss Account/ Other Income Schedules/ Notes along with Computation Chart filed along with the ITR and Audit Report ● Summary to elucidate on facts and figures as culled from audited accounts
4	Identify all direct and indirect expenditure.	<ul style="list-style-type: none"> ● P&L A/c Schedules/ Notes of various heads/ sub-heads of Expenditure ● Further details obtained from assessee including mutual fund(s) statement, if any
5	Scrutinize the correctness of claim of expenditure incurred to earn exempt income or the claim of no expenditure incurred to earn exempt income.	<ul style="list-style-type: none"> ● P&L A/c Schedules/ Notes of various heads/sub-heads of Expenditure
6	Recording of satisfaction by AO in the assessment order regarding the claim of expenditure in relation to income not includible in total income to bring on record relevant facts and reason for application of Rule 8D.	<ul style="list-style-type: none"> ● Relevant facts and figures obtained from Audited Accounts, Audit Report and other sources
7	Computing disallowance as per Sub-Rule 2 of Rule 8D.	<ul style="list-style-type: none"> ● Computation to be elaborate and detailed in the assessment order
8	Ensuring that total disallowance does not exceed the total expenses debited by the assessee to the P&L account w.e.f. AY 2016-17.	<ul style="list-style-type: none"> ● P&L A/c Expenditure heads ● Expenditure claimed in relevant Schedule of ROI

A.6 It is also pertinent to note that in those cases where the assessee is making a suo moto disallowance under Section 14A of the Act in the return, the AO must ask for working/computation of such disallowance. The AO has to objectively pinpoint the gaps in such working based on his analysis as discussed in SOP. In case, the assessee does not provide for such working for arriving at suo moto disallowance, recording to this effect must be made part of the satisfaction to be recorded in the order.

A.7 The Assessing Officer should specifically examine the direct expenses such as brokerage expenses, professional charges and manpower expenses which may throw light on expenses related to earning of exempt income on investments, to arrive at proper satisfaction. It is noteworthy that senior management including directors would be involved in deciding the timing and extent of surplus funds in the business and the duration for which the funds need to be invested in mutual funds etc. Thus, certain portion of salary of senior management is directly related to expenditure in relation to income not includible in total income. In case of exempt income from mutual funds, the Assessing Officer should call for complete statement of mutual funds which contain the details of person placing the order and other expenses before arriving at the satisfaction. There can be a situation where the mutual investments may be at zero value at the start and end of the year and therefore, the same may not be appearing in the balance sheet. Thus, the AO needs to specifically question about the mutual investments made and closed during the year.

A.8 Section 14A would take within its ambit not only direct expenses but also indirect expenses. The judicial position in this regard is that, the expression 'in relation to' appearing in Section

14A is not to be given a narrow or constricted meaning. Thus, while recording satisfaction about the expenditure incurred in relation to exempt income as per assessee being not correct, the AO may also take note of indirect cost elements such as postage & telegram, printing & stationery, general administrative expenses, telephone expenses, audit fees, director sitting fees, miscellaneous expenses etc. The AO can invoke Rule 8D only after recording satisfaction as discussed above.

B. Whether in Absence of Exempt Income Earned/ Claimed during the Concerned Year, Disallowance could be made under Section 14A Read with Rule 8D.

B.1 A controversy has arisen in certain cases as to whether disallowance can be made by invoking Section 14A of the Act even in those cases where no income has been earned by an assessee which has been claimed as exempt during the financial year.

B.2 In this regard, Central Board of Direct Taxes, in exercise of its powers under Section 119 of the Act clarified vide Circular No. 5/2014 on 11th February 2014 that Rule 8D read with Section 14A of the Act provides for disallowance of the expenditure even where taxpayer in a particular year has not earned any exempt income. The clarification is based on the following:

- legislative intent is to allow only that expenditure which is relatable to earning of income and it therefore follows that the expenses which are relatable to earning of exempt income have to be considered for disallowance, irrespective of the fact whether any such income has been earned during the financial year or not.
- The above position is further clarified by the usage of term 'includible' in the

Heading to Section 14A of the Act and also the Heading to Rule 8D of I-T Rules 1962 which indicates that it is not necessary that exempt income should necessarily be included in a particular year's income, for disallowance to be triggered.

- Also, Section 14A of the Act does not use the word 'income of the year' but 'income under the Act'. This also indicates that for invoking disallowance under Section 14A, it is not material that assessee should have earned such exempt income during the financial year under consideration.
- The above position is further substantiated by the language used in Rules 8D(2)(ii) & 8D(2)(iii) of I-T Rules.

B.3 However, Hon'ble Delhi High Court in the case of *Cheminvest Ltd. vs. CIT (2015) 61 taxmann.com 118 (Del)* dated 02.09.2015 held that Section 14A envisages that there should be an actual receipt of income which is not includible in total income; hence, Section 14A will not apply where no exempt income is received or receivable during relevant previous year. It has been noted by the Hon'ble High Court that decision of Hon'ble Supreme Court in the case of *Rajendra Prasad Moody (115 ITR 519 (SC))* was rendered in the context of allowance of deduction under Section 57(iii) of the Act, where the expression used is 'for the purpose of making or earning such income'. Section 14A of the Act, on other hand, contains the expression 'in relation to income which does not form part of the total income'. The court held that the decision in *Rajendra Prasad Moody* cannot be used in reverse to contend that even if no income has been received, the expenditure incurred can be disallowed under Section 14A of the Act. In *Cheminvest case*, SLP before

Supreme Court was not approved due to low tax effect.

B.4 Further, Hon'ble Delhi High Court in the case of *CIT vs. Holcim India (P.) Ltd. (2014) 272 CTR 282 (Delhi)* also held that there can be no disallowance under Section 14A in the absence of exempt income. This position has been followed by other courts as well, by following the aforesaid decisions of the Delhi High Court.

B.5 In *PCIT vs IL&FS Energy Development Company Ltd. [2017] 84 taxmann.com 186 (Delhi)* dated 16.08.2017, the Delhi High Court held that CBDT Circular No. 5/2014 dated 11.02.2014 cannot override express provisions of Section 14A, read with Rule 8D and where no exempt income was earned in relevant assessment year, merely because tax auditor had suggested in tax audit report that there ought to be such disallowance, it could not be a ground to make disallowance in terms of Section 14A, read with Rule 8D. In *Redington (India) Ltd. vs. Addl. CIT [2017] 392 ITR 633/77 taxmann.com 257 (Mad.)*, a similar contention of the Revenue was negated. The court there declined to apply the CBDT Circular by explaining that Section 14A is 'clearly relatable to the earning of the actual income and not notional income or anticipated income.'

B.6 Courts have decided the issue against the Department so far in other cases as below, mainly by following Delhi High Court decision in case of *Cheminvest etc.*:

- *PCIT vs. Rattan India Infrastructure Ltd.* (ITA no. 312 of 2018) dated 19.03.2018 Delhi High Court held that 'having regard to the statutory mandate that there ought to be exempt income, as a pre-condition for disallowance, this Court is in agreement

- and follows the principles declared in *Cheminvest Ltd. (supra)* etc. and no question of law arises.’ The Supreme Court dismissed the revenue’s SLP in *PCIT-7 vs. Rattan India Infrastructure Ltd.* [SLP no. 44853/2018] (SC) dated 04.01.2019 on the ground of low tax effect, leaving the question of law open.
- *CIT (Central-I), Chennai vs Chettinad Logistics Pvt. Ltd.* [2017] 80 taxmann.com 221 (Madras) dated 13.03.2017 where it is held that Section 14A can only be triggered, if assessee seeks to square off expenditure against income which does not form part of total income under Act; Rule 8D only provides for a method to determine amount of expenditure incurred in relation to income, which does not form part of total income of assessee and it cannot go beyond what is provided in Section 14A. Thus, where no exempt income i.e., dividend, was earned in relevant assessment year by assessee, Section 14A cannot be invoked. Supreme Court dismissed Department’s SLP in *CIT (Central) 1 vs. Chettinad Logistics (P.) Ltd.* [2018] 95 taxmann.com 250 (SC) dated 02.07.2018 through a summary order, on delay as well as merits.
 - *CIT vs. GVK Project & Technical Services Ltd.* (ITA No. 646 of 2018) [2019] 106 taxmann.com 180 (Del). The Supreme Court in *PCIT vs. GVK Project and Technical Services Ltd.* [2019] 106 taxmann.com 181 (SC) dated 03.05.2019 dismissed SLP of Department through a summary order, on delay as well as merits.
 - *PCIT vs. Oil Industry Development Board* (ITA No. 197 of 2018) [2019] 103 taxmann.com 325 (Delhi). SLP of Department in *PCIT vs. Oil Industry Development Board* [2019] 103 taxmann.com 326 (SC) dated 08.02.2019 was dismissed.
 - *Commissioner of Income-tax– I vs. Corrtch Energy (P.) Ltd.* [2014] 45 taxmann.com 116 (Gujarat) dated 24.03.2014 that where assessee did not make any claim for exemption of any income from payment of tax, disallowance under Section 14A could not be made.
 - *Redington (India) Ltd. vs. Additional Commissioner of Income-tax, Co. Range-V, Chennai* [2017] 77 taxmann.com 257 (Madras) dated 23.12.2016 that provision of Section 14A is relatable to earning of actual income and not notional or anticipated income, hence, where there is no exempt income in a year, there cannot be a disallowance of expenditure in relation to an assumed income. In this case, SLP before Supreme Court was not approved due to low tax effect.
 - *CIT vs. Gujarat State Petronet Ltd.* (ITA no. 543 of 2016) (Gujarat) dated 11.07.2016 holding that the sole question arising in the appeal was squarely covered by decision of that court in case of *CIT vs. Corrtch Energy (P.) Ltd.* reported in [2015] 372 ITR 97. SLP filed by revenue in this case before Supreme Court, vide SLP (C) No. 5147/2017, SLP (CC) No. 2919/2017 and Civil Appeal No. 9702/2018 was dismissed on 05.09.2018 by Supreme Court on the ground of low tax effect.

- *Ballarpur Industries Ltd.* (ITA No. 51 of 2016) (Bombay High Court, Nagpur Bench) dated 13.10.2016 the High Court decided the issue against revenue by following the judgment of Delhi High Court in the case of *M/s. Cheminvest Ltd.*
- *Reliance Capital Asset Management Ltd.* (ITA No. 487/2015) (Bombay) Revenue had challenged the order of ITAT by taking a ground of appeal that for invoking disallowance under Section 14A, it is not material that the assessee should have earned such exempt income during the financial year under consideration as per CBDT Circular No. 5/2014. The Bombay High Court, however, dismissed the appeal of revenue. SLP filed in this case before Supreme Court vide SLP (CC) No. 11379/2018 was dismissed on 07.09.2018 on the ground of low tax effect though question of law was kept open.

B.7. On this issue, SLP before Supreme Court is pending in certain cases namely: (a) SLP filed by the revenue before Supreme Court vide Dy. No. 12145/2018 in case of *PCIT vs. IL&FS Energy Development Company Ltd.* [2017] 84 taxmann.com 186 (Delhi), SLP filed vide Dy. No. 4145/2019 in case of *PCIT-1, Chandigarh vs. Vardhman Chemtech (P.) Ltd.* [2019] 102 taxmann.com 132 (Punjab & Haryana) and Dy. No. 28323/2019 against the order of High Court in *PCIT vs. Apollo Infrastructure Projects Finance Co. Ltd.* in TCA No. 567 of 2008 (Madras).

C. Whether Disallowance under Section 14A can Exceed the Quantum of Exempt Income

C.1 This aspect has been decided against the Revenue in the case of *Caraf Builders &*

Constructions (P.) Ltd. [2019]101 taxmann.com 167 (Delhi). The court held that upper disallowance under Section 14A cannot exceed the exempt income of that year as held in *Pr. CIT vs. McDonalds India (P.) Ltd.* ITA 725/2018 decided on 22nd October, 2018, where the court followed the ratio and judgment of the Supreme Court in the case of *Maxopp Investments Ltd. vs. CIT* [2018] 402 ITR 640/254 Taxman 325/91 taxmann.com 154 and the earlier judgments of the Delhi High Court in *Cheminvest vs. CIT* [2015] 378 ITR 33/234 Taxman 761/61 taxmann.com 118 and *CIT vs. Holcim (P.) Ltd.* [2015] 57 taxmann.com 28 (Delhi). Department's SLP (Dy. No. 25130 of 2019) against the decision of High Court in *PCIT-2 vs. Caraf Builders & Constructions (P.) Ltd.* (2019) (101 taxmann.com 167) (Delhi), where this issue was involved, has been dismissed by the Supreme Court on 30.08.2019 in a summary manner and without any speaking order.

C.2 In the case of *Principal Commissioner of Income-tax, Patiala vs. State Bank of Patiala* (ITA No. 270 of 2016) (F/2) [2017] 88 taxmann.com 667 (Punjab & Haryana), the issue decided was that Assessment order could not be held to be erroneous under Section 263 where the Assessing Officer restricted disallowance under Section 14A to amount of exempt dividend income, even though he had computed disallowance under Rule 8D to be at a higher figure.

C.3 In the case of *Principal Commissioner of Income-Tax, Patiala v. State Bank of Patiala* (ITA No. 359 of 2017) [2018] 99 taxmann.com 286 (Punjab & Haryana), where the amount of disallowance under Section 14A was restricted to the amount of exempt income only and not at a higher figure, the High Court did not consider it appropriate to discuss the scope of Section 263 of the Act holding that the same has been

rendered academic in view of the issue being answered in favour of the assessee. SLP against this High Court decision in ITA No. 359/2017 was dismissed by the Supreme Court on ground of delay and merits by a summary and non-speaking order in SLP(C) Diary No. 24323 of 2018 reported in [2018] 99 taxmann.com 286 (SC).

C.4 In the case of *Indiabulls Capital Services Ltd.* [2020]114 taxmann.com 647 (SC), Hon'ble Supreme Court has dismissed departmental SLP against High Court's decision that disallowance calculated under Section 14A could not exceed amount of tax-free income. The court held that the question of law urged in respect of Section 14A in this case is squarely covered by the decision of this court in *ACB India vs. Assistant Commissioner of Income Tax*, [2015] 374 ITR 108 (Delhi). Furthermore, the disallowance calculated exceeded the amount of tax-free income and was therefore held to be contrary to the ruling in *Cheminvest Ltd. vs. Commissioner of Income-tax* [2015] 378 ITR 33 (Delhi).

D. Disallowance of Interest-Owned Funds vs. Borrowed Funds

D.1 The issue involved here is whether interest can be disallowed under Section 14A in cases where the assessee is unable to justify one-to-one use of borrowed funds for business purposes.

D.2 In this regard, it is relevant to note that Hon'ble Gujarat High Court in the case of *PCIT vs. Sintex Industries* (ITA No. 268/2017) held that where assessee had surplus funds against which minor investment was made, no question of making any disallowance of expenditure under Section 14A of the Act arose and therefore, there was no question of any estimation of expenditure under Rule 8D of the Income-tax Rules 1962. Hon'ble Supreme Court dismissed

the SLP of the Revenue without discussing the facts or laying down any specific ratio.

D.3 Further, Income-Tax Appellate Tribunal – Delhi in the case of *T&T Motors Ltd., DLF Ltd. and Oriental Bank of Commerce Ltd.* followed the ratio decidendi laid down in the case of Hon'ble Bombay High Court in *CIT vs. HDFC Bank Ltd.* (2014) 366 ITR 505 (Bom) and held that the disallowance of interest in case of mixed funds is not appropriate. The relevant extracts in this regard are as under:

'where assessee's capital, profit reserves, etc., were higher than the investment in tax-free securities, it would have to be presumed that the investment made by the assessee would be out of interest-free funds available with the assessee and, consequently, no disallowance could be made under Section 14A of the Act. In view of the fact that the assessee's share capital with reserves and surpluses is far in excess of the amount invested in securities fetching exempt income, there can be no question of disallowance of interest amounting to Rs. 8,22,725. The disallowance to this extent is deleted.'

D.4 In view of the above cited judicial decisions, onus is on AO to establish with evidence that interest bearing funds have been invested in the investments, which have generated the tax-exempt income. Mere satisfaction note unsubstantiated by underlying factors/ reasons may not stand the test of appeal. AO should not limit to the balance sheet for source of investment in the year of investment but should also look for cash flow statement. AO also needs to differentiate between cash flow on account of operating activities and finance/ investment activities. AO will need to examine cash-flow statement to ascertain whether on the date of investment,

the assessee was having sufficient funds to source the investment yielding tax-free income, which would require thorough examination of balance sheet vis-a-vis the cash flow statement of the assessee. On such examination, the AO needs to establish that interest bearing funds have gone into making investments, which have generated the tax-exempt income. Accordingly, the AO may make necessary disallowance under Section 14A in such cases. It is relevant to add that while making aforesaid examination, the AO needs to be extra cautious particularly in respect of fresh investments made during the year irrespective of the fact as to whether exempt income has been earned on the same or not during the relevant year. This investigation in first year of investment(s) will set the base for making disallowance not only in the first year of investment but also in subsequent years till such investment is in existence. This assumes further significance because if the AO fails to investigate and pinpoint the sourcing of investment out of borrowed funds in the first year of the investment, which are capable of generating tax-free income, disallowance in subsequent years may also not hold good.

D.5 The AO must record in his order in case there is non-compliance at the end of the assessee in providing such details required for investigation. In a case where the assessee did not provide the requisite details, the Hon'ble Calcutta High Court, in the case of *CIT vs. RKBK Fiscal Services (P.) Ltd.* [2013] 214 Taxman 89 upheld the position that the onus to provide one-to-one correlation between the funds available and the funds deployed is on the assessee as separate accounts for the purpose of the exempt income have not been maintained. On this ground, the court confirmed the order under Section 263 of the Act with an observation that:

'We are of the opinion that the Assessment Officer in its order dated 28th January, 2005 did not make provision for disallowance of expenditure in terms of Section 14A of the I-T Act. The assessee has paid interest of Rs. 4,49,02,775 out of which only a sum of Rs. 1,33,51,132 was shown to be relatable to the non-taxable income....'

E. Whether Section 14A is Applicable to Investments Capable of Yielding Taxable Income/ Shares Held as Stock-in-trade/ Investments Made in Group Companies/ Investments Made Due to Commercial Expediency

E.1 In *Maxopp Investment Ltd. vs. CIT* [2018] 91 taxmann.com 154 (SC), Hon'ble Supreme Court held that while determining the disallowance, the dominant purpose or the intention while making the purchase of such investment is not relevant irrespective of whether shares are held to gain control or as stock-in-trade. Further, SC while defining the scope of the term 'in relation to' as used in Section 14A, further interpreted the dominant purpose test and upheld the principle of apportionment of expenses as that is the principle which is engrained in Section 14A of the Act. The Apex Court held that once a particular income itself is not to be included in the total income and is exempted from tax, there is no reasonable basis for giving benefit of deduction of the expenditure incurred in earning such an income.

E.2 With the above decision of Hon'ble SC, the issue is now settled. The AO may make disallowance irrespective of whether shares are held to gain control or as stock-in-trade because the dominant purpose or the intention while making the purchase of such investment is not relevant.

F. Whether Rule 8D is Prospective

F1 Rule 8D were notified to come into force on March 24, 2008. The retrospective operation of Rule 8D was upheld by the Special Bench in the case of *ITO vs. Daga Capital Management Private Limited* (2008) 26 SOT 603 (Mum) on the ground that Rule 8D being in the nature of procedural law are applicable retrospectively. The same was also upheld in *ACIT vs. Citicorp Finance (India) Limited* [300 ITR 398(AT Mum)].

F2 However, the Bombay High Court judgment in *Godrej & Boyce Manufacturing Company Ltd.* 234 CTR 1 decided that Rule 8D would only have prospective effect from AY 2008-09. Bombay High Court observed in this regard, 'unless expressly or by necessary implication, or contrary provision is made, no retrospective effect is to be given to any rule so as to prejudicially affect the interests of the assessee'.

F3 It is only the prescription with regard to the method of determining such expenditure which is new and which will operate prospectively. The same was upheld by the Supreme Court in the judgment dated 31.01.2018 in the case of *Essar Teleholdings Ltd.* (CA No. 2165/2012) reported in [2018] 90 taxmann.com 2 (SC).

G. Whether Revision under Section 263 can be Invoked on the Issue of Disallowance under Section 14A of the Income-tax Act

G.1 The reopening of the case on account of making disallowance under Section 14A is barred in view of the proviso to Section 14A for any assessment year beginning on or before 1st April, 2001. However, the issue of revision of the order involving Section 14A disallowance came up for consideration before the Hon'ble Delhi High Court in the case of *Goetze India Ltd.* (ITA No. 1179, 1366, 1979 and 2106 of 2010). The

contention of the respondent-assessee in that case was that in view of the proviso to Section 14A, the said provision could not have been invoked in a revision under Section 263 of the Act. The Court did not accept the contention of the respondent-assessee with an observation that the assessment order was made on 28th February, 2003, which is after Section 14A was enacted. The court noted that the Assessing Officer should have applied the said section and failure to invoke Section 14A had resulted in an order both erroneous and prejudicial to the interest of the revenue.

G.2 It flows from the above decision that as such there is no bar on revision under Section 263 on the issue of disallowance under Section 14A of the Income-tax Act.

H. Whether Disallowance under Section 14A is to be Added Back for the Purpose of Computing Book Profits under Section 115JB

H.1 The revenue has taken a position that Section 14A is applicable while computing book profit under MAT.

H.2. The above position has been contested by the assessee based on the decision of Hon'ble Supreme Court in the case of *Apollo Tyres Ltd.* wherein it is held that the Assessing Officer is not entitled to tinker with the book profits as determined as per provisions of Company's Act unless the amount is specified in Clauses (a) to (h) of the Explanation.

H.3. Delhi High Court in the case of *CIT vs. Goetze (India) Ltd.* (2014) 361 ITR 505/97 DTR 169 (Delhi) (HC) decided the issue in favour of the Revenue and held that the AO can make disallowance under Section 14A while computing book profit under Section 115JB of the Income-tax Act 1961.

H.4. Further, the Delhi High Court in the case of *Bhushan Steel Limited (ITA 593/2015)* held that the ITAT has rightly held that this being in the nature of disallowance, and with Explanation to Section 115JB not specifically mentioning Section 14A of the Act, the addition was not justified. The court observed that this stand is consistent with the decision in *Apollo Tyres Ltd. vs. Commissioner of Income-tax 255 ITR 273 (SC)* which held that: 'the Assessing Officer does not have the jurisdiction to go behind the net profit shown in the profit and loss account except to the extent provided in the Explanation to Section 115J.'

H.5 It may be relevant to add that the decision in the case of *Bhushan Steel (supra)* has been rendered without taking into consideration the decision in the case of *Goetze (India) Ltd. (supra)* of co-ordinate bench of equal strength.

H.6 In such a situation of two conflicting decisions of Delhi High Court, ITAT Delhi in the case of *ACIT vs. Vireet Investment Pvt. Ltd. (2017) 165 ITD 27/ 154 DTR 241/ 188 TTJ 1 (SB) (Delhi) (Trib.)* decided the issue in hand in favour of the assessee on this issue by following the decision of Hon'ble Supreme Court in the case of *CIT vs. Vegetable Products Ltd. [1973] 88 ITR 192* which provides that where two reasonable constructions of a taxing provision are possible, that construction which favours the assessee must be adopted.

H.7 For the purpose of adding back disallowance of expenditure under Section 14A to the book profits, as per Clause (f) of Explanation 1 below Section 115JB, it is important that Clause (ii) of Explanation 1 below Section 115JB provides for reduction of exempt income under Section 10, 11 or 12 from the book profits being computed under Section 115JB. Disallowance of expenditure under Section 14A is in relation

to income which does not form part of total income under the Act. Majority of such income would not be forming part of total income due to Sections 10, 11 or 12. Hence, expenditure disallowable under Section 14A should squarely fall under Clause (f) of Explanation 1 below Section 115JB. Further, the phrase 'expenditure relatable to' as used in Clause (f) of Explanation 1 to Section 115JB(2) is similar to the phrase in 'in relation to', used in Section 14A. Furthermore, the legislative intent regarding disallowance of expenditure relating to earning of exempt income was same, whether under normal provisions or under the MAT provisions.

I. Whether Disallowance under Section 14A is Applicable in the case of Dividend Income Covered by Section 115-O

I.1 In the case of *Godrej & Boyce Manufacturing Company Ltd. vs. DCIT [2017] 81 taxmann.com 111 (SC)*, the Supreme Court ruled in favour of Revenue and held that Section 14A of the Act would apply to dividend income on which tax is payable under Section 115-O with following observations:

- The dividend income under Section 115-O of the Act is a special category of income which has been treated differently by the Act making the same non-includible in the total income of the recipient assessee as tax thereon had already been paid by the dividend distributing company.
- The other species of dividend income which attracts levy of income tax at the hands of the recipient assessee has been treated differently and made liable to tax under the aforesaid provisions of the Act.
- In fact, if the argument is that tax paid by the dividend paying company under Section 115-O is to be understood to

be on behalf of the recipient assessee, the provisions of Section 57 should enable the assessee to claim deduction of expenditure incurred to earn the income on which such tax is paid. Such a position in law would be wholly incongruous in view of Section 10(34) of the Act.

I.2 The dividend declared by a foreign company is not covered under Section 10(34) and therefore is not an exempted income. It becomes apparent that the provisions of Section 14A cannot extend to dividends received from investments made in the shares of foreign companies. The same was upheld in 2012-TIOL-453-ITAT-MUM and in *ITO vs. Stides Acrolab Ltd* 138 ITD 323 Mumbai ITAT.

I.3 It is to be noted that position on dividend distribution tax to be paid under Section 115-O and on exemption of DDT related dividend under Section 10(34) has got changed by Finance Act 2020 from AY 2021-22 onwards. Correspondingly, disallowance under Section 14A would not be required for that dividend income which is no longer exempt.

J. With Reference to Rule 8D(2)(iii), Whether 'Average Value of Investment' would Include all Investments or Investments Yielding Non-Taxable Income

J.1 Hon'ble Delhi High Court in the case of *ACB India Ltd vs. ACIT (ITA No. 615/2014) (2015-374 ITR 108 Delhi)* vide order dated 24.03.2015 held that as per Section 14A and Rule 8D(2)(iii) for computing the 'average value of investment', only the investments yielding non-taxable income have to be considered and not all investments.

J.2 Special Bench of ITAT Delhi in the case of *ACIT vs Vireet Investment (P.) Ltd. [2017] 82 taxmann.com 415 (Delhi-Trib) (SB)* held that

disallowance under Rule 8D(2)(iii) of the Rules shall be computed only on those investments which yielded tax-free income during the year. There is no High Court decision so far on the issue of considering only the investments yielding tax-free income during the year for the purpose of computing 'average value of investment' as per Rule 8D.

J.3 In the case of *ITO vs. LGW Ltd. (2016) 130 DTR 201 (Kol.) (Trib.)*, it is held that share application money cannot be included while working out average value of investment for the purpose of Rule 8D. This decision is on the ground that the share application money is only in the nature of an offer to buy shares made by the assessee and the right to claim dividend is not there till the offer is accepted by the company resulting in a concluded contract.

K. Whether the Expression 'Expenditure Incurred' in Section 14A Refers Only to Actual Expenditure

K.1 The Delhi High Court in the case of *Maxopp Investment Ltd. vs. CIT [(2012) 347 ITR 272(Del)]* observed: 'While we agree that the expression "expenditure incurred" refers to actual expenditure and not to some imagined expenditure, we would like to make it clear that the "actual" expenditure that is in contemplation under 14A (1) of the Act is the actual expenditure in relation to or in connection with or pertaining to exempt income. The corollary to this is that if no expenditure is incurred in relation to the exempt income, no disallowance can be made under Section 14A of the said Act.' A reference was also made to a similar finding by Punjab & Haryana High Court in the case of *CIT-II vs. Hero Cycles Ltd. [(323 ITR 518)]*. A similar view was taken in *Metalman Auto P. Ltd. [(336 ITR 434)]*.

L. Whether Section 14A is Applicable with Respect to Income Exempted under Section 50 of the SIDBI Act 1989

L.1 In the case of *Commissioner of Income Tax-3, Mumbai vs. Small Industries Development Bank of India (Bombay High Court) ITA No. 2108 of 2010*, date of Order: 12.09.2012, the facts of the case are that the assessee was a statutory corporation established under the SIDBI Act 1989 which was engaged in the business of promotion, financing and development of small scale industries to meet the emerging challenges of the liberalized economy. The income of the assessee (SIDBI) was exempted from payment of income-tax by virtue of Section 50 of the SIDBI Act 1989.

L.2 The Assessing Officer disallowed the deduction on account of bad debts as claimed by the assessee and added the same to the income for the assessment year 2003-04 on the ground that for the assessment year 2001-02 and earlier the assessee was not chargeable to income tax. The High Court held that Section 14A of the Act would have no application to the present facts. The court observed that it is not the Revenue's case that bad debts have been incurred in relation to income which does not form part of the total income. Further, the court noted that Section 50 of SIDBI Act 1989 only exempts payment of income-tax and it does not provide that such income of the SIDBI Bank will not be a part of the total income as in a case of income specified in Sections 10 and 10A of the Act.

M. Whether Section 14A is Applicable with Respect to Insurance Business

M.1 Pune ITAT in the case of *Bajaj Alliance General insurance Co. Ltd. vs. Addl. CIT 38 Oriental Insurance Co. Ltd [130 TTJ 388 (Del.)*

(Trib.)] held that Section 14A of the Income-tax Act 1961 is not applicable to an insurance business as the same is governed under the specific provisions of Section 44 of the Income-tax Act 1961. A Bench of ITAT Delhi observed that the income of the insurance companies had to be computed under Section 44 read with Rule 5 of the First Schedule to Income-tax Act, which is a specific provision overriding Section 14A. Since, as per Section 44, no head-wise bifurcation of income was required to be made in case of insurance companies, Section 14A disallowance could not be made. ITAT observed: 'It is not permissible to the Assessing Officer to travel beyond Section 44 and First Schedule of the Income-tax Act.' This position has been upheld by the Mumbai Tribunal in *Birla Sunlife Insurance Co. Ltd.* [TS-23-ITAT-2010(Mum)].

CONCLUSION

As discussed in sub-paragraphs A.1 to A.8 of paragraph 2 of this paper, Assessing Officer should record a speaking satisfaction for invoking 14A and Rule 8D where he is not satisfied with correctness of assessee's claim in respect of expenditure in relation to income not forming part of total income having regard to assessee's accounts or with assessee's claim of no expenditure having been incurred in relation to such income. AO may follow the CBDT issued Standard Operating Procedure for the AOs while invoking Rule 8D as per the provisions of Section 14A. Applicability of Rule 8D is not automatic.

As discussed at sub-paragraphs B.3 to B.7 of paragraph 2 above, courts have so far not upheld the disallowance of expenditure under Section 14A of the Act in cases where taxpayer has not earned any exempt income in that particular year. The principle emanating from such judicial precedents has also been followed by the courts

while deciding the issue on (a) restriction of disallowance to the quantum of exempt income, and (b) taking average value of investments in Rule 8D by considering only such investments which have yielded tax-free income during the year. The aforesaid issues are yet to be decided on merit by the Apex Court. Accordingly, while making disallowance under 14A read with Rule 8D in cases having no exempt income during the year, the AO may follow the CBDT Circular No. 5/2014 dated 11th February 2014. Where disallowance under Section 14A read with Rule 8D exceeds the exempt income, the aforesaid CBDT Circular may be referred to. Lastly, while taking all investments capable of yielding income not includible in total income (including those not actually yielding such income during the year) for the purpose of computing disallowance under Rule 8D(2)(ii), the aforesaid CBDT Circular be referred to.

As per the SOP issued by the CBDT, it has been clarified that the total disallowance under Section 14A shall not exceed the total expenses debited by the assessee to the P&L account. Proviso to Rule 8D(2) be also referred to in this regard.

Onus is on AO to establish with evidence that interest bearing funds have been invested in the investments, which have generated the tax-exempt income. Mere satisfaction note unsubstantiated by underlying factors/ reasons may not stand the test of appeal. AO should not

limit to the balance sheet for source of investment in the year of investment but should also look for cash flow statement. Further, in the case of mixed funds (own funds as well as borrowed funds) being utilized towards investment generating exempt income, AO needs to thoroughly examine the source of funds invested. As held by the Hon'ble Calcutta High Court in the case of *CIT vs. RKBK Fiscal Services (P.) Ltd.* [2013] 214 Taxman 89, where the assessee does not provide the requisite details, there is a failure on his part to discharge initial onus to provide one-to-one correlation between the funds available and the funds deployed, as separate accounts for the purpose of the exempt income have not been maintained.

The decision of Hon'ble SC in the case of *Maxopp Investment Ltd. vs. CIT* 402 ITR 640 (SC) has put to rest the controversy regarding the relevance of dominant purpose or the intention while making the purchase of such investment. Disallowance under Section 14A be made irrespective of whether shares are held to gain control or as stock-in-trade because the dominant purpose or the intention while making the purchase of such investment is not relevant.

For computing book profits under Section 115JB, while adding back expenditure disallowable under Section 14A under Clause (f) of Explanation 1 below Section 115JB, guidance in this paper in para H.7 may be useful.

Issues in Respect of Reopening of Assessment



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Executive Summary

Reopening of assessment is an issue that has been constantly under litigation. The reopened assessments are quashed by the appellate authorities, High Courts and Supreme Court on technical grounds. Apart from proper recording of satisfaction, there are various dimensions to reopening of assessment. This Article attempts to cover the procedural and substantive aspects on one hand and entire gamut of relevant and up-to-date case laws on this vast subject on the other. After dealing with particular aspects, Action Points are provided for assessing officers and their supervisory officers. At the end, Key Takeaways are again summarized.

Reopening of a completed assessment vitiates against the 'principle of finality'. This principle of finality is the concept that certain disputes must achieve a resolution from which no further appeal may be taken, and from which no collateral proceedings may be permitted to disturb that resolution, otherwise there would

be no certainty as to the meaning of the law, or the outcome of any legal process. Hence, the courts have held that reopening of assessment after lapse of many years is a serious matter and therefore, it is essential that before such action is taken, the requirements of the law should be satisfied [ITO vs. Lakhmani Mewal Das [1976]

103 ITR 437(SC)]. Provisions in respect of assessment/ reassessment of income chargeable to tax which has escaped assessment are given in Sections 147 to 153 of the Income-tax Act 1961. 'Reason to believe' under Section 147 is a jurisdictional requirement while provisions contained in Sections 148 to 153 are procedural requirements. It has to be understood that these provisions are not to revise, review or rectify the mistakes committed in the original assessment. Assessment orders passed under Section 147 read with Section 143(3)/144 are quashed by the ITAT on technical grounds. In this Technical Note, various issues pertaining to reopening have been discussed along with relevant case laws so that the officers may appreciate the judicial precedent and minimize the mistakes in reopening of assessment under Section 147/148 of the Act.

BACKGROUND

Major changes were brought in the existing provisions of Section 147 by the Direct Tax Laws (Amendment) Act 1987 w.e.f. 01.04.1989. Post-amendment, cases in which income chargeable to tax has escaped assessment can be broadly classified in two categories. In the first category, the following cases can be listed:

- a. Where no return of income is filed by the assessee.
- b. Where return was processed under Section 143(1) and no regular assessment was made under Section 143(3)/ 147 of the Act.
- c. Where regular assessment was made under Section 143(3)/147 and a period of 4 years from the end of the relevant assessment year has not expired.

As per the amended provisions, in respect of the abovementioned cases, only requirement is that the AO has reason to believe that any income chargeable to tax has escaped assessment. It is a jurisdictional requirement.

Second category of cases are those cases in which regular assessment was made under Section 143(3)/147 and a period of 4 years has expired from the end of the relevant assessment year in which income chargeable to tax has escaped assessment (first proviso to Section 147). For such cases, there are two conditions provided in the Act:

- a. Reason to believe that any income chargeable to tax has escaped assessment.
- b. There is failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment.

These are also jurisdictional requirements.

STANDARD PROCEDURE FOR RECORDING SATISFACTION UNDER SECTION 147 ISSUED BY THE CBDT

In view of the plethora of litigation in respect of reopening of assessment and problems being faced by the Assessing Officers in recording the satisfaction, the CBDT has issued an exhaustive 'Standard Procedure for Recording Satisfaction under Section 147' dated 10.01.2018 along with four separate 'Sample Templates' for the guidance of the assessing officers. A copy of the aforesaid 'Standard Procedure' and the 'Sample Templates' is enclosed herewith for ready reference. There are separate 'Sample Templates' given for recording reasons for reopening of the assessment for the guidance of the AO in respect of following four category of cases:

- Where no return of income is filed by the assessee;
- Where no regular assessment was made under Section 143(3)/147 of the Act.
- Where regular assessment was made under Section 143(3)/147 and a period of 4 years from the end of the relevant assessment year has not expired.
- Where regular assessment was made under Section 143(3)/147 and a period of 4 years has expired from the end of the relevant assessment year.

Each of the said templates contains the following 8 paragraphs:

- a. Brief details of the assessee.
- b. Brief details of information collected/ received by the AO.
- c. Analysis of information collected/ received.
- d. Enquiries made by the AO as sequel to the information collected/ received.
- e. Findings of the AO.
- f. Basis of forming reason to believe and details of escapement of income.
- g. Escapement of income chargeable to tax in relation to any asset.
- h. Applicability of the provisions of Section 147/ 151 to the facts of the case.

The Assessing Officers must go through the aforesaid 'Standard Procedure' and the 'Template'. If the same is followed diligently, mistakes in recording satisfaction for reopening of assessment can be completely avoided.

The abovementioned 'Standard Procedure' and 'templates' are based on provisions of the Act as well as on judicial pronouncements.

Further, there are other important issues relating to reopening also which need to be analyzed. Therefore, there is a need to properly understand the relevant provisions of the Act along with judicial pronouncements. Hence, various issues pertaining to reopening of assessment have been discussed along with important case laws in the following paragraphs.

REASON TO BELIEVE

For making assessment/ reassessment of all the cases in which income chargeable to tax has escaped assessment, valid 'reason to believe' is sine qua non for assuming jurisdiction under Section 147. Hence, if the 'reason to believe' is not valid, or is mere pretense, or there is lack of due application of mind by the Assessing Officer, the re-assessment proceedings initiated under Section 147 of the Act would not be valid. The expression 'reason to believe' does not mean subjective satisfaction of the AO. The belief must be held in good faith and should not be merely reason to suspect. The reason to believe is more than 'satisfaction' of the AO. It should not be extraneous or irrelevant to the purpose of the Section. The AO must have tangible material on the basis of which he can record his reasons to believe. The courts have held that at the time of reopening, the AO should have prima facie some material to form reason to believe and at that stage the sufficiency or correctness of the material is not required to be proven. [*Central Provinces Manganese Ore Co. Ltd. vs. CIT* [1991] 191 ITR 662(SC); *Sri Krishna (P) Ltd. vs. CIT* [1996] 221 ITR 538(SC)]. In the landmark decision of *Raymond Woolen Mills Ltd. vs. ITO* [1999] 236 ITR 34, the Supreme Court held that:

'We have only to see whether there was prima facie some material on the basis of which the Department could reopen the case. The

sufficiency or correctness of the material is not a thing to be considered at this stage.’

Further, in the case of *ACIT vs. Rajesh Jhaveri Stock Brokers (P.) Ltd.* [2007] 291 ITR 500 (SC), it was observed by the Hon’ble Supreme court that:

‘...at the initiation stage, what is required is “reason to believe”, but not the established fact of escapement of income. At the stage of issue of notice, the only question is whether there was relevant material on which a reasonable person could have formed a requisite belief. Whether the materials would conclusively prove the escapement is not the concern at that stage.’

It is now settled that reason to believe has to be recorded prior to issue of notice under Section 148. It has also been held by the courts that material/ information which may come to the possession of the AO subsequent to the reopening cannot be held to be a valid basis for reopening. The said reason to believe cannot be supplemented or added by further reasons or by filing an affidavit and/ or making oral submission, once it is recorded and notice under 148 is issued. [*Hindustan Lever Ltd. vs. R.B. Wadkar* [2004] 268 ITR 322 (Bombay); *Aroni Chemicals Ltd. vs. DCIT* [2014] 362 ITR 403 (Bombay)].

However, in the case of *Aayojan Developers vs. ITO* [2011] 335 ITR 234 (Guj.) and *Purnima Komalkant Sharma vs. DCIT* [2020] 114 taxmann.com 718 (Guj.), it has been held by the Gujarat High Court that the Assessing Officer in his affidavit filed in the court can explain or elaborate or clarify the reasons recorded by him, but cannot thereby introduce new grounds, or new reasons, or new materials, which were not to be found in the recorded reasons either expressly or by implication.

LIVE LINK

Courts have held that reason to believe must have a ‘live link’ or a ‘direct nexus’ with the information or material available with the AO. The ‘reason to believe’ should be self-speaking and self-contained reflecting his independent application of mind. In the case of *ITO vs. Lakhmani Mewal Das* [1976] 103 ITR 437, it was held by the Hon’ble Supreme Court that: Rational connection postulates that there must be a direct nexus or live link between the material coming to the notice of the Income Tax Officer and the formation of his belief that there has been escapement of the income of the assessee. Further, in the landmark case of *CIT vs. Kelvinator of India Ltd.* [2010] 320 ITR 561 (SC), the Hon’ble Supreme Court held that: ‘Hence, after 01.04.1989, an Assessing Officer has the power to reopen, 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.’

TANGIBLE MATERIAL

Courts have held that the AO must have ‘tangible material’ on the basis of which AO can form reason to believe that income has escaped assessment. The Income-tax Act does not impose any restriction on the sources from which ‘tangible material’ could emanate, forming the basis for reopening of assessment. What could be the ‘tangible material’ has been explained in various decisions.

In *Kalyani Mawji & Co. vs. CIT*, West Bengal (1976) 1 SCC 985, the Supreme Court held that the word ‘information’ was to be construed in its widest amplitude. It was also held that information could emanate from external sources as well as material already on record.

INFORMATION COMING INTO POSSESSION DURING PROCEEDINGS OF SUBSEQUENT YEAR

When during the course of the assessment proceedings of a subsequent assessment year, certain information comes into the possession of the AO from which he can form reason to believe that income has escaped assessment in a prior assessment year, he would be entitled to invoke Section 147 [*Mahabir Prasad Munna Lal vs. CIT* 15 ITR 393(All.); *Clagget Brachi Co. Ltd. vs. CIT*, Andhra Pradesh 1989 Supp (2) SCC 182; *Ess Kay Engineering Co. P. Ltd vs. CIT* (2001) 10 SCC 189; *Siemens Information Systems Ltd vs. ACIT* (2012) 343 ITR 188 (Bom.)]. Further, in the recent decision of Hon'ble Supreme Court in the case of *New Delhi Television Ltd. vs. DCIT* [2020] 116 taxmann.com 151(SC), it was held that: 'Information which comes to the notice of the assessing officer during proceedings for subsequent assessments years can definitely form tangible material to invoke powers vested with the Assessing Officer under Section 147 of the Act.'

REPORT FROM INVESTIGATION WING AND TEP

In various decisions including the case of *AGR Investments vs. Addl. CIT* 333 ITR 146 (Delhi), it was held that on the basis of information received from the Investigation Wing assessment can be reopened. Further, reopening on the basis of Tax Evasion Petition (TEP) where the AO has applied his mind to the TEP has been held to be valid. It was held that substance of the contents of the TEP has to be examined to ascertain prima facie reason to believe [*Sumana Sen vs. CIT* [2013] 356 ITR 29(Delhi)]. In the case of *Sonia Gandhi vs. ACIT* [2018] 407 ITR 594 (Delhi),

it has been held that the TEP and investigation reports constituted tangible material.

AUDIT OBJECTION

The intimation which the AO received from the audit department would constitute 'information' [*R.K. Malhotra ITO vs. Kasturbhai Lalbhai* [1977] 109 ITR 537 (SC)]. Findings of the audit department pertaining to facts may be the basis for reopening of assessment [*CIT vs. PVS Beedis P. Ltd.* [1999] 237 ITR 13(SC)]. However, comments of the audit department pertaining to point of law could not be considered as 'information'. [*India & Eastern Newspapers Society vs. CIT* [1979] 199 ITR 996(SC)].

VALUATION REPORT

In various judicial pronouncements, it has been held that valuation report as such is not enough to reopen assessment. For a valuation report to be considered as 'tangible material' and form the basis for reopening, there must be an independent application of mind by the AO and a belief must be formed thereon.

In the case of *Smt. Amala Das vs. CIT* [1984] 146 ITR 216(P&H), it was held that valuation report was a mere opinion and a change in opinion could not be a ground for reopening assessment. In *Smt. Tarawati Devi Agarwal vs. ACIT* [1986] 162 ITR 606 (Calcutta), it was held that variation is always a question of opinion and unless there is a clear finding on the basis of materials that the assessee invested in the construction of house property more than what has been shown by her in the course of the assessment proceedings, the ITO cannot proceed merely on the basis of the valuation report of the Departmental Valuer. On the basis of the difference in estimate, it cannot be said that the assessee actually invested more than what has been shown by her.

The Hon'ble Supreme Court in *ACIT vs. Dhariya Construction Company* [2010] 15 SCC 251 held that opinion of a Departmental Valuation Officer per se is not an 'information' for reopening of assessment. AO has to apply his mind to the information collected, if any, and must form a belief thereon. Delhi High Court in *ACC Ltd. Vs. DVO & Ors.* [2013] 357 ITR 160 reiterated the ratio of Dhariya Construction (supra).

CHANGE OF OPINION

Post-amendment w.e.f. 01.04.1989, for the first category of cases, as mentioned in para 2.1 above, only requirement for reopening of the case is 'reason to believe'. However, in the landmark decision of *CIT vs. Kelvinator of India Ltd.* [2010] 320 ITR 561(SC), the Hon'ble Supreme Court held that: 'One must treat the concept of 'change of opinion' as an in-built test to check abuse of power by the Assessing Officer.' Therefore, one more condition was added by the Supreme Court to the effect that assessment cannot be reopened merely on change of opinion.

CASES IN WHICH RETURN IS PROCESSED UNDER SECTION 143(1)

Where return of income has been processed under Section 143(1), there cannot be change of opinion as there was no occasion for the AO to form any opinion being no assessment/reassessment made under Section 143(3)/147. In the case of *ACIT vs. Rajesh Jhaveri Stock Brokers (P.) Ltd.* [2007], 291 ITR 500 (SC), notice under Section 148 was issued in a case where intimation under Section 143(1) (a) was issued and the Hon'ble SC observed that: 'Therefore, there being no assessment under Section 143(1)(a), the question of change of opinion, as contended, does not arise.' Further, the Hon'ble Supreme Court held that: 'So long

as the ingredients of Section 147 are fulfilled, the Assessing Officer is free to initiate proceeding under Section 147 even when intimation under Section 143(1) had been issued.' The same was reiterated in *Dy. CIT vs. Zuari Estate Development & Investment Co. Ltd.* [2015] 373 ITR 661 (SC) (Mag.).

However, reopening of cases where return is processed under Section 143(1) has to meet the ingredients of Section 147 and the AO does not have unbridled powers to reopen such cases without having tangible material [*Inductotherm (India) P. Ltd. vs. DCIT* [2013]356 ITR 481(Gujarat)].

In the case of *CIT vs. Orient Craft Ltd.* [2013] 354 ITR 536 (Del), Delhi High Court held that: 'it is open to the assessee to contend that notwithstanding that the argument of "change of opinion" is not available to him, it would still be open to him to contest the reopening on the ground that there was either no reason to believe or that the alleged reason to believe is not relevant for the formation of the belief that income chargeable to tax has escaped assessment.'

In the case of *Indu Lata Rangwala vs. DCIT* [2017] 384 ITR 337 (Del), Hon'ble Delhi High Court extensively analyzed the decisions of *Rajesh Jhaveri (supra)*, *Zuari Estate (supra)* and *Orient Craft (supra)* and held that: 'where reopening is sought of an assessment in a situation where the initial return is processed under Section 143(1) of the Act, the AO can form reasons to believe that income has escaped assessment by examining the very return and/or the documents accompanying the return. It is not necessary in such a case for the AO to come across some fresh tangible material to form "reasons to believe" that income has escaped assessment.'

CASES IN WHICH NO RETURN IS FILED

In the case of *Ingram Micro* [2017] 78 taxmann.com 140 (Bombay), it was held that income which has escaped assessment does not arise simpliciter on non-filing of return. For Explanation 2(a) to Section 147 to apply, there must be (i) non-filing of return, and (ii) satisfaction of AO that income chargeable to tax has escaped assessment.

ACTION-POINT

It has been noticed that in those cases where return was processed under Section 143(1), or where return was not filed, satisfaction note is recorded casually without bringing facts and material on record. In such cases also, the AO has to record his reasons carefully based on the tangible material available with him so that the requirements of 'reason to believe' are met.

Cases where assessment has earlier been made under Section 143(3)/147 within 4 years from the end of the relevant assessment year

In the cases in which assessment was made earlier and 4 years have not yet expired from the end of the relevant assessment year, the AO has to meet the basic requirement of recording of reasons to believe on the basis of tangible material. Further, in the light of decision of *Kelvinator of India Ltd.* (*supra*), assessment cannot be reopened on the basis of 'mere change of opinion'.

The term 'change of opinion' has been examined and explained by different courts. In the case of *ITO vs. Tech Span India (P.) Ltd.* [2018] 404 ITR 10 (SC), the Supreme Court held that change of opinion implies formulation of opinion and then a change thereof. It means formulation of belief by an Assessing Officer resulting from what he thinks on a particular question. It was further held that:

'12. .The Court ought to verify whether the assessment earlier made has either expressly or by necessary implication expressed an opinion on a matter which is the basis of the alleged escapement of income that was taxable. If the assessment order is non-speaking, cryptic or perfunctory in nature, it may be difficult to attribute to the assessing officer any opinion on the questions that are raised in the proposed re-assessment proceedings. Every attempt to bring to tax, income that has escaped assessment, cannot be absorbed by judicial intervention on an assumed change of opinion even in cases where the order of assessment does not address itself to a given aspect sought to be examined in the re-assessment proceedings.'

In the case of *Dalmia (P.) Ltd. vs. CIT* [2011]348 ITR 469 (Del), the Hon'ble Delhi High Court held that: 'Question of change of opinion arises when an Assessing Officer forms an opinion and decides not to make an addition and holds that the assessee is correct.'

In the case of *CIT vs. Usha International Ltd.* [2012] 348 ITR 485 (Delhi), Delhi High Court held that: 'Thus if a subject matter, entry or claim/ deduction is not examined by an Assessing Officer, it cannot be presumed that he must have examined the claim/ deduction or the entry, and therefore, it is the case of 'change of opinion'. When at the first instance, in the original assessment proceedings, no opinion is formed, principle of 'change of opinion' cannot and does not apply. There is a difference between change of opinion and failure, or, omission of the Assessing Officer to form an opinion on a subject-matter, entry, claim, and deduction. When the Assessing Officer fails to examine a subject-matter, entry, claim or deduction, he forms no opinion. It is a case of no opinion.'

In *Consolidated Photo & Finvest Ltd. vs. Asstt. CIT* [2006] 281 ITR 394 (Delhi), Delhi High Court held that: ‘there can be no presumption that even when the order of assessment is silent, all possible angles and aspects of a controversy had been examined and determined by the Assessing Officer....’

In *Gruh Finance Ltd. vs. Jt. CIT* [2000] 243 ITR 482 (Guj.), Gujarat High Court held that: ‘though the material was available on record, at the time of first assessment, when no conscious consideration of the material is made and a mistake has been committed, it would not, in any case, create an embargo or a ban on the competent officer to exercise powers under the amended Section 147, as prima facie, there could not be “change of opinion” in that factual scenario.’

Further, in the case of *Chetan Sabharwal* 11 taxmann.com (Delhi), it was held that: ‘in view of the fact that the original assessment orders are totally silent on this aspect of the matter, it cannot be said that the ‘reason to believe’ constitutes a “change of opinion”.’

Courts have often held that the reopening would be bad on account of change of opinion where questionnaires have been issued and the subject-matter, which is later the subject-matter of reassessment, was in fact examined by the AO in the original assessment proceedings. [*Best Cybercity (India) Pvt. Ltd vs. ITO* [2019] 414 ITR 385 (Delhi); *Bharati Infratel Ltd. vs. DCIT* [2019] 411 ITR 403 (Delhi)].

However, in the case of *Honda Siel Power Products Ltd. vs. DCIT & Ors.* [2012] 340 ITR 53(Delhi), the AO issued notice under Section 148 on the ground that the assessee had earned tax-free dividend income exempt under Section 10(33) but various administrative

expenses for earning said dividend income were claimed and allowed as expenditures and, thus, income had escaped assessment. The assessee had admitted that it had not given details with regard to proportionate expenses relatable to tax-free or exempt income, which were claimed as a deduction under the cumulative head ‘Expenditure’. It was contended that the assessee was not required to disclose the said fact, as when it had filed the return Section 14A was not in the statute book and consequently, there was no omission and failure on the part of the assessee to make full and true disclosure. The court held that the term ‘failure’ on the part of the assessee is not restricted only to the income-tax return and the columns of the income-tax return or the tax audit report. This is the first stage. The said expression ‘failure to fully and truly disclose material facts’ also relates to the stage of the assessment proceedings, the second stage. There can be omission and failure on the part of the assessee to disclose fully and truly material facts during the course of the assessment proceedings. This can happen when the assessee does not disclose or furnish to the Assessing Officer complete and correct information and details which it is required to disclose under an obligation. Burden is on the assessee to make full and true disclosure. The court further held that merely because material lies embedded in material or evidence, which the AO could have uncovered but did not uncover, is not a good ground to deny or strike down a notice for reassessment. Whether the Assessing Officer could have found the truth but he did not, does not preclude the Assessing Officer from exercising the power of reassessment to bring to tax the escaped income.

ACTION-POINT

The AO cannot reopen an assessment merely on the ground that a wrong view was taken in the

facts of the case in the original assessment order. Recourse to correct that mistake is revision under Section 263 and not the reopening under Section 148 of the Act. Particularly in the case of audit objections, a very careful view has to be taken as regards remedial action to be taken under Section 148 or Section 263. On the same set of facts, once a view has been taken by the AO not to make an addition, the AO cannot reopen the said assessment to add the same income holding that an erroneous view was taken earlier. Hence, questionnaire should be issued carefully. The AO is required to demonstrate in his satisfaction note that the material on the basis of which he is going to reopen the case was not considered in the original assessment order and also that no opinion was formed by the AO in respect of the said material. The judicial precedents cited above may be referred to by the AO to appreciate the law in this regard.

CASES WHERE ASSESSMENT HAS EARLIER BEEN MADE UNDER SECTION 143(3)/148 AND 4 YEARS HAVE EXPIRED FROM THE END OF THE RELEVANT ASSESSMENT YEAR

First Proviso to Section 147 provides that where an assessment under Section 143(3) or 148 has previously been made for the relevant assessment year, no action shall be taken under Section 147 after the expiry of four years from the end of the relevant assessment year unless any income chargeable to tax has escaped assessment by reason of the failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment.

In the cases where assessment has earlier been made under Section 143(3)/ 148 and 4 years have expired from the end of the relevant assessment year, following three conditions are required to be met:

- 'Reason to believe' is based on the tangible material.
- Reopening is not based on 'mere change of opinion'.
- There is failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment.

On perusal of the assessment records, AO may come across some material which was not disclosed fully and truly by the assessee and on the basis of that material/ information, the AO may have prima facie reason to believe that income chargeable to tax has escaped assessment. The assessee can always raise the issue that all the facts and material were available before the AO at the time of original assessment. In that case, AO may refer to Explanation 1 to Section 147 of the Act. However, the AO has to record his reasons in such a manner that failure on the part of the assessee to disclose fully and truly all material facts is prima facie established.

The AO may also receive information from other sources including information/ material from the DIT (Investigation), which was not available with him at the time of making original assessment. In such cases, AO has to establish live link or close nexus with such information/ material with the return of income and/ or details filed by the assessee during original assessment and on independent application of mind, he should arrive at the finding that the assessee failed to disclose fully and truly all material facts necessary for his assessment. The AO has to examine that not only all material facts were disclosed before the AO during the original assessment, but the same were disclosed fully and truly also. Disclosure of all material facts fully does not mean per se that it was disclosed truly also.

MATERIAL FACTS

A 'material fact' is a fact that a reasonable person would recognize as germane to a decision to be made, as distinguished from an insignificant, trivial, or unimportant detail. In other words, it is a fact, the suppression of which would reasonably result in a different decision. In the case of *CIT vs. Usha International Ltd.* [2012] 348 ITR 485 (Delhi), Hon'ble Delhi High Court has explained the expression 'material facts' as, 'The expression 'material facts' means those facts which if taken into account would have an adverse effect on the assessee by a higher assessment of income than the one actually made. They should be proximate and not have remote bearing on the assessment. The omission to disclose may be deliberate or inadvertent.'

FAILURE TO DISCLOSE FULLY AND TRULY ALL MATERIAL FACTS NECESSARY FOR ASSESSMENT

The expression 'failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment' has been examined and considered by different courts. In the landmark decision of *Phool Chand Bajrang Lal vs. ITO* [1993] 203 ITR 456 (SC), the Supreme Court held that: 'He may start reassessment proceedings either because some fresh facts come to light which were not previously disclosed or some information with regard to the facts previously disclosed comes into his possession which tends to expose the untruthfulness of those facts.' The Court further held that: It would be immaterial whether the ITO at the time of making the original assessment could, or could not, have found by further enquiry or investigation, whether the transaction was genuine or not.

In the landmark decision of *Calcutta Discount Co. Ltd. vs. ITO* [1961] 41 ITR 191 (SC), the Hon'ble Supreme Court noted:

'There can be no doubt that the duty of disclosing all the primary facts relevant to the decision of the question before the assessing authority lies on the assessee. To meet a possible contention that when some account books or other evidence has been produced, there is no duty on the assessee to disclose further facts, which on due diligence, the Income-tax Officer might have discovered, the Legislature has put in the Explanation, which has been set out above. In view of the Explanation, it will not be open to the assessee to say, for example, I have produced the account books and the documents: You, the assessing officer examine them, and find out the facts necessary for your purpose: My duty is done with disclosing these account-books and the documents.' His omission to bring to the assessing authority's attention these particular items in the account books, or the particular portions of the documents, which are relevant, amounts to 'omission to disclose fully and truly all material facts necessary for his assessment.' Nor will he be able to contend successfully that by disclosing certain evidence, he should be deemed to have disclosed other evidence, which might have been discovered by the assessing authority if he had pursued investigation on the basis of what has been disclosed. The Explanation to the section, gives a quietus to all such contentions; and the position remains that so far as primary facts are concerned, it is the assessee's duty to disclose all of them, including particular entries in account books, particular portions of documents and documents, and other evidence, which

could have been discovered by the assessing authority, from the documents and other evidence disclosed.”

In the case of *Consolidated Photo & Finvest Ltd vs. ACIT* [2006] 281 ITR 394, Delhi High Court referred to Explanation 1 of Section 147 and held that: ‘The argument that production of the account books and other documentary evidence relevant for assessment must imply a full and true disclosure of all material facts must be rejected out of hand in the light of the provisions of Explanation, according to which mere production of the books of account or other evidence from which the Assessing Officer could have, with due diligence, discovered the material evidence does not necessarily amount to a disclosure within the meaning of the proviso.’

In the case of *Dalmia (P.) Ltd. vs. CIT* [2011] 348 ITR 469 (Delhi), the assessee submitted only the part details of sundry creditors. Assessment was reopened in respect of those creditors details of which were not filed in the original assessment proceedings. The Hon’ble Delhi High Court held the reopening valid and observed that: ‘The assessee was called upon and asked to furnish names and addresses of the sundry creditors and since when the amount was outstanding. The assessee was also asked to explain details of each creditor. There is nothing on record and it is not even the stand of the assessee that those details in respect of all parties were furnished. If there is no disclosure and details were not furnished, there cannot be full and true disclosure. In such circumstances, it cannot be held that there was full and true disclosure by the assessee.’

In the case of *Shri Krishna (P.) Ltd. vs. CIT* [1996] 221 ITR 538 (SC), it was held by the Supreme Court that: ‘Every disclosure is not and cannot be treated to be a true and full disclosure.

The disclosure must not only be true but must be full—‘fully and truly’. A fake assertion, or statement, of material fact, therefore, attracts the jurisdiction of the ITO under Section 147.’

In *SC Johnson Products Ltd vs. ACIT* 400 ITR 426 (Delhi), it was held by the Delhi High Court that; ‘the material can also include subsequent years’ assessments, which receive scrutiny during the course of whose proceedings the AO has occasion to see if the same, or same pattern of returns or claims were made. If so, the notice of reassessment would be justified... where it is felt that returns were “dressed up” or improper claims were made, that escaped inquiry, reassessment is warranted.’

In *Money Growth Investment & Consultants (P.) Ltd. vs. ITO* [2012] 21 taxmann.com 438 (Delhi), Delhi High Court held that failure of assessee to disclose at time of assessment that it had received share capital from bogus companies providing accommodation entries, was sufficient to initiate reassessment.

Different benches of the ITAT have annulled the reopening of assessment in many cases on the ground that while recording reason to believe the AO has not specifically mentioned in so many words that there was failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment. Therefore, the AO needs to specifically mention in the satisfaction note that there was failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment.

However, in the case of *CIT vs. India Terminal Connector System Ltd.* [2012] 21 taxmann.com 69 (Delhi), the AO had described the facts from which it could be drawn conclusion that the assessee had not made full and true disclosure of all material facts. However, in the

satisfaction note, it was not recorded in so many words that there was failure on the part of the assessee to make full and true disclosure of all the material facts necessary for his assessment. Hon'ble Delhi High Court reversed the order of the ITAT, Delhi holding that: 'Reasons recorded by the Assessing Officer have to be read as a whole in entirety and in a holistic manner. Mere reproduction of the language of the Section is not sufficient. We have to read and understand the reasons recorded and whether on the basis of said reasons the Assessing Officer had come to the conclusion or drawn an inference that the assessee had not made full and true disclosure of material facts.'

ACTION POINT

In those cases, where assessment is reopened after expiry of four years from the end of the relevant assessment year, on the basis of information received from the Investigation Wing regarding accommodation entry etc., the AO must record in the satisfaction note that the information/ material received from the Investigation Wing was not available at the time of original assessment. It should also be brought on record that even though information regarding such transactions was submitted during the original assessment proceedings, the same was not true in light of the material or information subsequently available with the AO particularly with respect to specific transactions which were not disclosed fully and truly. Further, considering various decisions of the ITAT and to avoid unnecessary litigation, after describing the facts of the case, the AO must specifically mention in the satisfaction note that: 'there was failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment.'

REOPENING OF ASSESSMENT ON THE BASIS OF INFORMATION RECEIVED FROM INVESTIGATION WING-BORROWED SATISFACTION

Information/ material received from the Investigation Wing or other sources, should be linked and correlated with the return of income/ assessment records and particularly with specific transactions. In many cases, the AO mechanically copies and pastes the findings of the DDIT (Inv.) in the satisfaction note without demonstrating his independent application of mind on the information received, which is patently wrong. While recording his satisfaction, the AO is required to show his application of mind after receiving the information/ material in order to form his reason to believe that income liable to tax has escaped assessment.

In the case of *Signature Hotels Ltd vs. ITO* (2011) 338 ITR 51 (Delhi), information regarding accommodation entry was received by the AO from the Investigation Wing. The AO recorded the satisfaction as under:

'Information received from the office of the DIT (Inv.)-VI, New Delhi, revealed that M/s. Signature Hotels (P) Ltd. has introduced unaccounted money in its books of account during the financial year 2002-03 through accommodation entry from M/s. Swetu Stone PV for Rs. 5 lakhs. In view of the above, I have reasons to believe that the taxable income to the tune of Rs. 5 lakhs has escaped assessment within the meaning of Section 147 of the Income-tax Act 1961.'

The AO, in a separate annexure, mentioned the details of transactions as intimated by the Investigation Wing. Further, the reasons recorded by the Assessing Officer for approval of the Commissioner of Income-tax in paragraph

11 of the said form/ proforma read as under:

'11. Reasons for the belief that income has escaped assessment.—Information is received from the DIT (Inv.-I), New Delhi, that the assessee has introduced money amounting to Rs. 5 lakhs during the financial year 2002-03 relating to the assessment year 2003-04. Details are contained in annexure. As per the information amount received is nothing but accommodation entry and the assessee is a beneficiary.'

The Hon'ble Delhi High Court observed that the last sentence records that as per the information, the amount received was nothing but an accommodation entry and the assessee was the beneficiary. The reasons and the information referred to was held as extremely scanty and vague. There is no reference to any document or statement, except the annexure. The annexure cannot be regarded as a material or evidence that prima facie shows or establishes nexus or link which discloses escapement of income. Further, it is apparent that the Assessing Officer did not apply his own mind to the information and examine the basis and material of the information. The Assessing Officer accepted the plea on the basis of vague information in a mechanical manner. The reasons recorded reflect that the Assessing Officer did not independently apply his mind to the information received from the Director of Income-tax (Investigation) and arrive at a belief whether or not any income had escaped assessment.

In recent cases, reopening of assessment has been challenged by the assessee on the ground that the reopening was not on the basis of the satisfaction recorded by the AO on his independent application of mind, but was based merely on a 'borrowed satisfaction'. In the case of *PCIT vs. Meenakshi Overseas (P.)*

Ltd. [2017] 395 ITR 677 (Del), the AO received certain information from the DIT (Investigation) in respect of accommodation entry taken by the assessee from an entry operator. The return in this case was processed under Section 143(1). The AO reproduced the findings of the DIT (Investigation) in the satisfaction note apparently without independent application of his mind. It was argued by the assessee that 'reason to believe' recorded by the AO was mere reproduction of the finding of the DIT (Investigation) and there was no independent application of mind by the AO to arrive at the finding that income has escaped assessment. It was claimed by the assessee that since the satisfaction was not of the AO but was merely a reproduction of the findings of the DDIT (Investigation), it was a borrowed satisfaction. Hon'ble Delhi High Court observed that:

'There is no independent application of mind by the AO to the tangible material which forms the basis of the reasons to believe that income has escaped assessment. The conclusions of the AO are at best a reproduction of the conclusion in the investigation report. Indeed it is a "borrowed satisfaction". The reasons fail to demonstrate the link between the tangible material and the formation of the reason to believe that income has escaped assessment.'

In *Pr. CIT vs. RMG Polyvinyl (I) Ltd.* [2017] 83 taxmann.com 348 (Delhi), information was received from Investigation Wing. While recording satisfaction, the AO wrongly mentioned that no return was filed by the assessee and also the incorrect amount of accommodation entry taken was mentioned. Hon'ble Delhi High Court pointed out the said glaring mistakes to show non-application of mind by the AO and further observed that there was no link between the tangible material and the formation of the reasons to believe that income had escaped assessment. Relying upon the decision of

Meenakshi Overseas Ltd. (supra), the court quashed the reopening.

In respect of information received from Investigation Wing regarding accommodation entry taken by the assessee in the case of which order was passed under Section 143(3), Delhi High Court in the case of *Haryana Acrylic Manufacturing Co. v. CIT* [2008] 175 Taxman 262 [2009] 208 ITR 38 (Delhi) held that since all the information regarding share/ share application money/ unsecured loan taken was submitted before the AO during the original assessment proceedings, it cannot be held that there was failure on the part of the assessee to disclose the material fully and truly. In that case, the High Court noticed that the AO has not mentioned in his satisfaction note that there was failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment and the reopening of assessment was quashed. The aforesaid decision has been followed by high courts and different benches of the ITAT.

In recent decisions, different high courts have considered and distinguished the abovementioned decisions of *Meenakshi Overseas* (supra) and *Haryana Acrylic Manufacturing Co* (supra). The courts have held reopening to be valid in the cases where the AO has properly brought out the facts on record including specific information received from the Investigation Wing and has shown independent application of mind by way of analyzing the said information and linking the specific transactions contained therein with the return of income/ assessment records.

In a recent decision of *RDS Projects Ltd. vs. ACIT* [2020] 113 taxmann.com 534 (Delhi), the assessment was completed under Section 143(3) which was reopened on the basis of

information received from the Investigation Wing in respect of share capital received by the assessee from accommodation entry providers. In the above decision, the court also considered and distinguished the decision of *Haryana Acrylic Manufacturing Co. (supra)*. The Hon'ble Delhi High Court has referred to the recent decision of the Supreme Court in *Pr. CIT vs. NRA Iron & Steel (P.) Ltd.* [2019] 412 ITR 161 in respect of addition made under Section 68 on account of bogus share capital. The Hon'ble Court also referred to Explanation 1 to Section 147. The court observed that in the original assessment order, there is absolutely no examination or discussion with regard to the genuineness of the transactions undertaken by the assessee with entry provider companies. The court referred to the decision of *CIT vs. Burlop Dealers Ltd.* [1971] 79 ITR 609 (SC), wherein the Supreme Court had observed that: 'having created and recorded bogus entries of loans, the assessee could not say that it had truly and fully disclosed all material fact necessary'. The Court also relied on the decision of *AGR Investment Ltd. vs. Addl. CIT* [2011] 333 ITR 146 (Delhi), where similarly specific information regarding accommodation entries was received from the office of the Directorate of Investigation. The Court further held that:

'It is neither a change of opinion nor does it convey a particular interpretation of a specific provision which was done in a particular manner in the original assessment and sought to be done in a different manner in the proceeding under Section 147 of the Act. The reason to believe has been appropriately understood by the assessing officer and there is material on the basis of which the notice was issued.'

In the case of *Aravali Infrapower Ltd. vs. DCIT* [2017] 390 ITR 456 (Delhi) and *PCIT vs.*

Paramount Communication (P.) Ltd. [2017] 79 taxmann.com 409 (Delhi), the decision of *Haryana Acrylic Manufacturing Co. (supra)* has been considered and distinguished.

In a very recent decision dated 20.12.2019 in the case of *Vedanta Ltd. vs. ACIT* in WP(c) No. 13036 of 2019, assessment was reopened on the basis of information received from the Investigation Wing regarding accommodation entry. Hon'ble Delhi High Court considered and distinguished the decision of *Meenakshi Overseas Ltd. (Supra)* holding that there was proper application of mind and analysis of facts by the AO pursuant to information received from the Investigation Wing. Further, the court followed the decision of *RDS Projects Ltd. (supra)*. In the said case, the AO has followed the format of the Sample Template of the CBDT while recording satisfaction for reopening. Detailed analysis of the transactions of the assessee with the entry providing entities was made by the AO to arrive at his conclusion regarding escapement of income. The AO could establish live link between the tangible material and reason to believe.

In *Rakesh Gupta vs. CIT* [2018] 93 taxmann.com 271(P&H), decision of *Meenakshi Overseas Ltd. (Supra)* was distinguished and reopening was treated as valid by Punjab & Haryana High Court observing that the AO has shown independent application of mind in respect of information received from Investigation Wing and live link between the tangible material and reason to believe was shown.

Also, reopening of assessment on the basis of information received from the Investigation Wing regarding accommodation entry has been upheld by Delhi High Court in *JMD Global (P) Ltd. vs. PCIT* [2019] 112 taxmann.com 204 (Delhi).

INQUIRIES UNDER SECTION 133(6) BEFORE RECORDING REASON FOR REOPENING

In the case of *Aishwarya Dyeing Mills (P) Ltd. vs. DCIT* 94 taxmann.com 430 (Guj), AO received information from Investigation Wing regarding accommodation entry taken by the assessee. The court considered and rejected the argument of 'borrowed satisfaction'. Further, the court held that there are no fetters on the AO on making certain inquiries under Section 133(6) before recording reasons for reopening of assessment. It was held by the Gujarat High Court as under: '...there are no fetters on Assessing Officer carrying out preliminary inquiries even before issuance of notice of reopening in order to collect information on basis of which, he may either form a belief that income chargeable to tax had escaped assessment or abandon any further inquiry, upon being satisfied that no such belief could be formed.'

ACTION POINT

Information/ material received from the Investigation Wing or other sources, should be linked and correlated with the return of income/ assessment records and particularly specific transactions. It has been noticed that in many cases the AO mechanically copies and pastes the reason recorded in another case mentioning the name of the concerned parties/ transactions wrong and in few cases even the name of the assessee is also wrongly mentioned. Such mistakes are fatal and reopening is quashed at first instance. Further, the reasons to believe should not be mere reproduction of findings of the DDIT (Inv.) etc. but should demonstrate independent application of mind of the AO in respect of material/ information available with him. There are no fetters on the AO to make

inquiry under Section 133(6) before recording satisfaction for reopening of assessment. In fact, Para 4 of the 'sample template' issued by the CBDT covers the aspect of inquiries made by the AO as sequel to the information collected/received. It should also be brought on record that in the light of fresh material available with the AO, there was failure on the part of the assessee in disclosing fully and truly all materials necessary for his assessment.

SERVICE OF NOTICE

Issue and service of statutory notices forms an important part of all the proceedings under the Income-tax Act. The proceedings are initiated by issue of proper notice and valid service of that notice and end with proper service of the order. In case of any deficiencies in the issue or service of the notice, the assessment order is quashed on technical grounds by the appellate authority without going into the merits of the case. Valid issue and service of notice under Section 148 is also mandatory for reopening of assessment. In a number of cases, reopening of assessment is quashed on the ground of invalid service of notice. Hence, relevant provisions in respect of service of notice have briefly been touched upon in this note. Provisions in respect of service of notice are given in Section 282(1) of the Act which are to be read with Rule 127 of the Income-tax Rules 1962. The said Rule 127 has been amended w.e.f. 02.12.2015, which may be referred to by the AO.

SERVICE BY POST

Rule 127(2) (a) contains provisions regarding correct address for service of notice by post. Further, the procedure for service by post is given in Section 27 of the General Clauses Act 1897. The service of notice is effected when the

letter is delivered in the ordinary course by post (with registered AD or through Speed Post). The presumption is that the delivery on the assessee has been effected. This is so, even if a third person receives the post. The onus of proving otherwise is on the assessee. If the notice comes back with the postal remark 'refused', it will still have the effect of a valid service. However, if the assessee denies such refusal on oath, the postman must be examined. But if the notice is returned with the postal remarks 'Left', 'Not found' or 'Not known', then valid service cannot be presumed. Further, if more than one notices are sent in one envelope, then the envelope should bear the details of all the notices inside it and the dispatch register should be marked with value of stamp covering all dispatches as one. This is necessary because in case of any dispute, the same may be used as an evidence. However, to avoid any future litigation on this matter, and where so possible, every notice may be sent in separate envelope and that separate receipts are pasted in file.

SERVICE BY AFFIXTURE

Rule 17 of Order V of the Code of Civil Procedure contains the provisions regarding service by affixture. It provides that service by affixture is resorted to when the addressee or his agent refuses to sign the acknowledgement for service or when the serving official, after using all due and reasonable diligence, cannot find the addressee at his residential or business premises within a reasonable time and there is no likelihood of the addressee being found at the residence or business premise within a reasonable time and when there is no agent/authorized person empowered to accept the notice on behalf of the addressee.

After affixture of the notice, on the outer door or some other conspicuous part of the building,

the serving officer shall return the notice with a report stating that he has affixed the copy and the circumstances under which he did so and the name and address of the person by whom the house was identified (if any) and in whose presence the copy of the notice was affixed.

In respect of requirement of independent witness, it is better to get the signature of a witness as provided in Rule 17 of Order V of CPC. However, in the case of *CIT vs. Samir Kumar Aditya* [2012]17 taxmann.com 128(Delhi), Hon'ble Delhi Court relied on the decision of *Sahara Deposits & Investments (I) Ltd. vs. Karan Singh* [1996] 63 DLT 377 and held that it is not mandatory to get the signature of independent witness at the time of affixture. In the aforesaid case of *Sahara Deposits (supra)*, it was held that if the court is not satisfied with the service by affixture, the court may issue necessary directions to serve the notice afresh.

However, in the case of *CIT vs. Avi-Oil India (P.) Ltd.* [2010] 323 ITR 242 (P&H), it was held that:

'Before affixture, the serving officer of the summons, must use his due and reasonable diligence to find out the defendant/ respondent and if the circumstances as mentioned in Rule 17 exist, then and only then, the notice may be served by affixture and that too in the presence of witnesses by whom the house was identified and in whose presence the copy was affixed. Merely because the noticee in this case had not been found at the given address is not sufficient to establish that he could not be found, when there is nothing to show that reasonable efforts to find the person on whom the service was to be effected had been made.'

SERVICE OF NOTICE ELECTRONICALLY

As per Rule 127(2)(b), communication can be delivered or transmitted electronically at the email address available in the income-tax return or in the last income-tax return or email address of the company as available on the website of Ministry of Corporate Affairs; or any email address made available by the addressee to the income-tax authority. Further, as per Section 13 of the Information Technology Act 2000, dispatch of an electronic record occurs when it enters a computer resource outside the control of the originator.

ACTION POINT

In the case of service by post, correct address of the assessee must be obtained in terms of Rule 127(2)(a). Service by affixture is 'substituted service' as provided in Rule 20 of Order V of CPC. It should be remembered that service by affixture is not a regular mode of service and can be effected only as a last resort. Courts have held that it is the duty of the Department to discharge the onus by showing that the authority concerned is satisfied that the assessee was keeping out of the way for the purpose of avoiding service or that there were other good reasons to come to the conclusion that the notice could not be served in the ordinary way. The AO should take recourse to service by affixture only when the assessee is intentionally avoiding service and/ or that for any reason, the notice cannot be served in the ordinary way. The court may not treat the issue as well as service of notice by affixture on the time-barring date of service of notice as valid. There must be reasonable effort by the AO to serve the notice on the assessee in ordinary way. Further, it is better to get the signature of a witness as provided in Rule 17 of Order V of CPC to avoid litigation. In case of electronic service

of notice, it must be ensured that the notice is dispatched from the official email address of the AO at the correct email address of the assessee in terms of Rule 127(2)(b) well before the time-barring date.

ISSUE OF NOTICE UNDER SECTION 148 ON THE ASSESSEE IS MANDATORY BEFORE THE DUE DATE

As per the provisions of Section 148(1), notice to the assessee requiring him to furnish return shall be served on him before making the assessment/reassessment. However, Section 149(1) speaks of issue of notice. The issue is whether service of notice under Section 148 on the assessee is mandatory before the due date or whether notice under Section 148 is only to be issued before the due date.

The Hon'ble Supreme Court has analyzed the relevant provisions of the Act in the landmark decision of *R.K. Upadhyaya vs. Shanabhai P. Patel* [1987] 166 ITR 163 (SC) and held that 'once a notice is issued within the period of limitations, jurisdiction becomes vested in the ITO to proceed to reassess and service under the 1961 Act is not a condition precedent to conferment of jurisdiction in the ITO.' The relevant portion of the order is further extracted as under:

'A clear distinction has been made out between "issue of notice" and "service of notice" under the 1961 Act. Section 149 prescribes the period of limitation. It categorically prescribes that no notice under Section 148 shall be issued after the prescribed limitation has lapsed. Section 148(1) provides for service of notice as a condition precedent to making the order of assessment. Once a notice is issued within the period of limitations, jurisdiction

becomes vested in the ITO to proceed to reassess. The mandate of Section 148(1) is that reassessment shall not be made until there has been service. The requirement of issue of notice is satisfied when a notice is actually issued. Service under the 1961 Act is not a condition precedent to conferment of jurisdiction in the ITO to deal with the matter but it is a condition precedent to making of the order of assessment.'

In this regard, decision of Hon'ble Delhi High Court in the case of *Mayawati vs. CIT* [2010] 321 ITR 349(Del) has reiterated the aforesaid decision in *R.K. Upadhyaya (supra)* after discussing all the important decisions on the issue. In the case of *Abab Offshore Ltd. vs. DCIT* [2017] 78 taxmann.com 37(Mad), it was held by Madras High Court that reassessment notice collected from Revenue by postal department on last date of expiry of six years from the end of relevant assessment year, though served on assessee later, was not barred by limitation. In the case of *Kanubhai Patel HUF vs. Hiren Bhatt or His Successors to Office* [2011] 334 ITR 25 (Gujarat), it was held that for purposes of Section 149, the expression 'notice shall be issued' means that the notice should go out of the hands of the AO. Merely signing the notice on 31.03.2010 cannot be equated with 'issuance of notice' as contemplated under Section 149.

In the case of *CIT (Central-1) vs. Chetan Gupta* [2015] 382 ITR 613(Del), it has been held by Delhi High Court that:

- i. Under Section 148 of the Act, the issue and service of such notice upon the assessee are jurisdictional requirements that must be mandatorily complied with. They are not mere procedural requirements.

- ii. For the AO to exercise jurisdiction to reopen an assessment, notice under Section 148 (1) has to be mandatorily issued to the assessee.
- iii. Further, the AO cannot complete the reassessment without service of the notice so issued upon the assessee in accordance with Section 282 (1) of the Act read with Order V Rule 12 CPC and Order III Rule 6 CPC.

In the case of *CIT vs. Three Dee Exim P. Ltd.* [2012] 20 taxmann.com 146 (Del), notice under Section 148 was issued to the assessee at the address given by it in the return of income for the relevant assessment year. The counsel for the assessee had also appeared before the AO in response to notice under Section 142(1) and was given copy of the notice under Section 148. The assessee had also written letter within a few days thereafter, stating that the return as originally filed under Section 143 be treated as return in pursuance to notice under Section 148. Not only this, various queries were also raised to which detailed replies were filed by the assessee. It was only thereafter that the assessment was framed. The court held that: ‘The participation by the assessee in the assessment proceedings on receipt of the copy of the notice can be deemed to be service of notice within the ambit of Section 148(1). That is what is the legislative intent of “service of notice” on assessee under this section that no assessment under Section 147 can be finalized before the assessee has sufficient notice thereof.’”

In the case of *Sonia Gandhi vs. ACIT* [2018] 407 ITR 594 (Delhi), notice under Section 148 was issued electronically through email just before the end of limitation period. Hon’ble Delhi High Court held as under:

‘52. The object of imposing time limits is to ensure that both the assessee and the tax administrators have the same standard on which the extended period available under the law are to be judged. Therefore, if it is shown that the AO issued and the assessee received notice, which was within the period of limitation, the form of the notice or the fact that it was through a channel not deemed ‘regular’ is not relevant. The violation of the circulars relied on at best can bespeak of irregularity.’

In the recent judgement of the Supreme Court in the case of *PCIT vs. M/s. I-Ven Interactive Ltd.* [2019] 418 ITR 66 (SC), it has been held that scrutiny notice issued to assessee under Section 143(2) at address available as per PAN database was justified as change in address had not been intimated to the Assessing Officer. However, when the change in address is notified by the assessee, the AO should get the notice served at the new address given.

ISSUE OF NOTICE UNDER SECTION 143(2) AFTER A RETURN IS FILED IN RESPONSE TO NOTICE UNDER SECTION 148 IS MANDATORY

It is now settled that issue of notice under Section 143(2) is mandatory after a return is filed in response to notice under Section 148. Taking clue from the decision in the case of *ACIT vs. Hotel Blue Moon* [2010] 321 ITR 362 (SC), Delhi High Court has held in the case of *PCIT vs. Shri Jai Shiv Shankar Traders P. Ltd.* [2016] 383 ITR 448 (Del) that failure to issue notice under Section 143(2) is fatal to the reassessment order. In the aforesaid order, the court also considered the decision of *CIT vs. Madhya Bharat Energy Corporation Ltd.* [2011] 20 taxmann.com 557(Del) and distinguished.

Further, in the case of *PCIT vs. Silver Line* [2016] 383 ITR 455 (Delhi), Delhi High Court held that notice under Section 143(2) is mandatory and even if assessee participated in reassessment proceedings, it would not obviate the mandatory requirement of service of notice under Section 143(2). In the case of *PCIT vs. Paramount Biotech Ind Ltd.* 398 ITR 701 (Delhi) also, it was reiterated that service of notice under Section 143(2) is mandatory.

In the case of *Alpine Electronics Asia Pte Ltd. vs. DGIT* [2012] 18 taxmann.com 246/ 341 ITR 247(Delhi), Delhi High Court reiterated that service of notice under Section 143(2) is mandatory within the stipulated time limit. It was also held that principle of estoppel incorporated in Section 292BB would not apply, if assessee has raised objection in reply to notice before completion of assessment or reassessment. The court further held that where only a draft assessment order had been passed, principle of estoppel under Section 292BB would not apply.

ISSUE OF NOTICE UNDER SECTION 143(2) ON THE SAME DATE OF FILING OF RETURN OF INCOME

Recently, another dispute has arisen in respect of issue of notice under Section 143(2) on the same date on which return of income is filed in response to notice under Section 148. The origin of the dispute goes to the decision in *DIT vs. Society for Worldwide Interbank Financial Communications* [2010] 323 ITR 249 (Delhi). In the said case, the AO issued notice under Section 143(2) on 23.03.2000 while return of income was filed on 27.03.2000 which was treated as invalid by the CIT (A) and the ITAT. Before the High Court, Revenue took the stand that date of issue was mistakenly mentioned as 23.03.2000 and actually notice under Section 143(2) was issued

and handed over to the assessee on 27.03.2000 only. High Court observed that service of notice under Section 143(2) was invalid holding that,

'The provisions of Section 143(2) make it clear that the notice can only be served after the Assessing Officer has examined the return filed by the assessee. Whereas what paragraph 3.4 indicates is that when the assessee came to file the return, the notice under Section 143(2) was served upon the authorized representative by hand. Thus, even if we take the statement of the Assessing Officer at face value, it would amount to gross violation of the scheme of Section 143(2) of the said Act.'

Taking clue from the abovementioned observation of the High Court, the ITAT has quashed the reopening under Section 148 in a number of cases in which notice under Section 143(2) was issued on the same date on which return in response to notice under Section 148 was filed. In fact, in those cases, the assessee submitted a letter to the effect that return filed under Section 139(1) may be treated as compliance to notice under Section 148 and the AO issued notice under Section 143(2) on the same date. The ITAT, Delhi Bench has quashed the assessment proceedings holding issue of notice under Section 143(2) invalid inter alia in the following cases:

- *Harsh Bhatia vs. ITO* (ITA No. 1262-1263/Del/2017; Order dated 17.10.2017)
- *Micron Enterprises P. Ltd vs. ITO* (ITA No. 801/Del/2016; Order dated 14.05.2018)
- *Ajay Sharma vs. DCIT* (ITA no 3555/Del/2015; Order dated 05.03.2019)
- *Satish Kumar vs. ITO* (ITA No. 3586/Del/2018 ' Order dated 14.01.2019)

No notice under Section 143(2) where no return is filed in response to notice under Section 148

In the case of *PCIT vs. Broadway Shoe Co.* [2018] 99 taxmann.com 83 (J&K), Hon'ble J&K High Court held that: 'The Notice under Section 143(2) is required to be given only when return is furnished. Furnishing of the return is a sine qua non for issuance of notice under Section 143(2) of the Act. If no return is furnished by the assessee, there can be no reason for issuance of notice under Section 143(2) of the Act.'

ACTION POINT FOR SERVICE OF NOTICE UNDER SECTION 148 AND 143(2)

The following points emerge from the above discussion:

- i. Service of notice under Section 143(2) is mandatory after return is filed in response to notice under Section 148. This is jurisdictional requirement and mistake is not curable under Section 292 BB.
- ii. Issue of notice, not service of notice, under Section 148 is mandatory before the limitation period. Notice under Section 148 must be handed over to postal authorities for dispatch before the limitation period.
- iii. Valid service of notice under Section 148 is mandatory before the reassessment proceedings. During the assessment proceedings, it must be ascertained that notice under Section 148 has been received by the assessee. In case it is claimed by the assessee that notice under Section 148 has not been received by him, a photocopy of the original notice under Section 148 should be given. In such case, the AO

should not issue a fresh notice under Section 148.

- iv. To avoid litigation, notice under Section 143(2) should be issued after a few days of filing return of income in response to notice under Section 148 is filed.

ISSUE OF NOTICE UNDER SECTION 148 WHILE RECTIFICATION PROCEEDING UNDER SECTION 154 IS PENDING

Sometimes, notice under Section 154 is issued and before completion of the rectification proceedings, notice under Section 148 is issued on the same issue. It may so happen that once assessee objects to the proposed rectification on the ground that mistake is not apparent from record, the AO initiates reassessment proceedings without dropping/ closing proceedings under Section 154. Various benches of the ITAT have held that if rectification proceedings are pending, issue of notice under Section 148 is invalid. On the aforesaid ground, notice under Section 148 has been quashed in the following cases:

- *Mahinder Freight Carriers vs. DCIT 129 ITD 278 (ITAT- Mumbai)*
- *Rajasthan State Industrial Development & Investment Corporation Ltd. vs. ACIT (ITA No. 92/JP/2015; order dated 20.02.2018 of ITAT, Jaipur)*
- *Ram Kishore Rathore vs. ACIT (ITA No. 308/ Del/ 2019; order dated 03.04.2020 of SMC Bench, ITAT Delhi)*
- *Ananda Paul vs. ACIT 9 ITA No 165/ Kol/2015; order dated 20.04.2018 of ITAT, Kolkata*

However, different high courts have held in various decisions that proceedings under Section 154 and 148 are separate proceedings

and once rectification proceedings are dropped by the AO, he is not precluded from reopening the assessment provided the conditions under Section 147 are met. In the case of *Honda Siel Power Products Ltd. vs. DCIT* [2012] 340 ITR 53 (Del) Delhi High Court has held as under:

‘It was submitted that as a legal proposition; that once a notice under Section 154 of the Act is issued, proceedings under Section 147 of the Act on the same ground or reasons cannot be taken. It is not possible to accept the said proposition in broad terms as propounded or as one having universal application. Scope and ambit of Sections 154 and 147/148 of the Act are different. Under Section 154 of the Act, the Assessing Officer can only rectify mistakes and errors. Section 154 is not a substitute for Section 147/148. In a given case, resort to provisions of Section 154 of the Act may be an appropriate remedy but in other cases resort to Section 147/148 may be required.’

However, in the case of *Berger Paints India Ltd vs. ACIT* [2010] 322 ITR 369(Cal), it was held by the Calcutta High Court that: ‘If the Assessing Officer is of the view that income has escaped assessment by reason of a mistake apparent from records, and takes recourse to Section 154, but finds later, that there is no apparent mistake, then he cannot, in the absence of any other ground on the basis of which he still has reason to believe that the income has escaped assessment, start reassessment proceedings under Section 147. In other words, the Assessing Officer cannot again start reassessment proceedings on the basis of the same reasons.’

13.4 In the case of *Mahinder Freight Carrier vs. DCIT* 129 ITD 278, it was held by ITAT, Mumbai Bench that: ‘Admittedly, in this case,

the mandate of Section 147 is not fulfilled for the reasons that the Assessing Officer himself was not sure whether the issue in controversy could be the subject-matter of Section 154 or the same can be the subject-matter of proceedings under Section 147.’

ACTION POINT

Scope and ambit of Sections 154 and 147/148 of the Act are different. Under Section 154 of the Act, the Assessing Officer can only rectify mistakes and errors. Section 154 is not a substitute for Section 147/148. Therefore, notice under Section 154 should not be issued in such cases where mistake is not apparent from record as it may weaken the Revenue’s case when the assessment is subsequently reopened on the same point. Further, if any pending rectification is there on the issue concerned, the same should necessarily be first closed/ dropped and after that only notice under Section 148 should be issued.

APPROVAL FOR ISSUE OF NOTICE UNDER SECTION 148

The provisions regarding authority for according sanction for issue of notice under Section 148 are contained in Section 151. Courts have held that sanction has to be given by the specific authority only as specified in Section 151 and any mistake in this regard has been held to be fatal.

In *CIT vs. Soyuz Industrial Resources Ltd.* [2015] 58 taxmann.com 336 (Delhi) and *CIT vs. SPLS Siddhartha Ltd.* [2012] 345 ITR 223 (Delhi), sanction from the Commissioner was taken instead of Joint Commissioner as required under Section 151(2) and on that ground the reopening under Section 148 was held to be invalid.

In the case of *CIT vs. Aquatic Remedies (P.) Ltd.* [2018] 406 ITR 545 (Bombay), sanction for

issue of notice was taken from Commissioner, instead of Additional Commissioner and the reopening was held to be invalid. SLP filed by Revenue was dismissed by the Supreme Court in *CIT vs. Aquatic Remedies (P.) Ltd.* [2020] 113 taxmann.com 451(SC). The same view was reiterated in *Miranda Tools P. Ltd. vs. ITO* [2020] 114 taxmann.com 584 (Bombay) also.

Where Joint Commissioner had, in clear terms, expressed his satisfaction that on basis of reasons recorded by Assessing Officer, it was a fit case for issuance of notice for reopening assessment under Section 148, merely because for some erroneous reason, papers were also placed before Commissioner who also recorded similar satisfaction, reassessment proceedings would not be vitiated [*Mayurbhai Mangaldas Patel vs. ITO* [2018] 93 taxmann.com 220 (Gujarat)].

APPLICATION OF MIND WHILE GRANTING SANCTION FOR ISSUE OF NOTICE UNDER SECTION 148

In respect of sanction, another dispute is whether there was application of mind of the sanctioning authority while according sanction. In few of the decisions, it has been held that even writing 'yes' or 'I am satisfied' meets the conditions of Section 151, while in other decisions the courts have held that satisfaction of the approving authority cannot be in a routine or mechanical manner.

DECISIONS IN FAVOUR OF REVENUE

Where Joint Commissioner nodded in favour of Assessing Officer by writing 'yes' to the reasons recorded and accorded permission for reopening of assessment, notice of reopening on that count alone cannot fail holding that assumption of jurisdiction under Section 147 was valid, if application of mind is otherwise demonstrable

from material on record [*Lalita Ashwin Jain vs. ITO* [2014] 45 taxmann.com 404/363 ITR 343 (Guj.)]

In the case of *Prem Chand Shaw (Jaiswal) vs. ACIT* [2016] 67 taxmann.com 339(Cal.), Hon'ble Calcutta High Court held as under:

'The mere fact that the Additional Commissioner did not record his satisfaction in so many words would not render invalid the sanction granted under Section 151(2) when the reasons on the basis of which sanction was sought for could not be assailed. Even an appellate authority is not required to give reasons when it agrees with the finding unless statute or rules so requires.'

In the above order, the Court relied on (Central) v. T.O. Abraham & Co. [2011] 333 ITR 182 (Ker.) Further, the Court relied on *R.P. Bhatt vs. Union of India* AIR 1986 SC 1040 in which reliance was made on *Som Datt Datta vs. Union of India* AIR 1969 SC 414 wherein it was held as follows:

'Apart from any requirement imposed by the statute or statutory rule either expressly or by necessary implication, there is no legal obligation that the statutory tribunal should give reasons for its decision. There is also no general principle or any rule of natural justice that a statutory tribunal should always and in every case give reasons in support of its decision.' '15.4 In the case of *Virbhadra Singh vs. DCIT* [2017] 88 taxmann.com 888 (HP), it was held that: 'I am satisfied that it is a fit case for issue of notice under Section 148 is a valid approval.'

The abovementioned decisions of *Prem Chand Shaw (supra)* and *Virbhadra Singh (supra)* have been followed by the Delhi High Court in a very recent decision in the case of *Experion Developers P Ltd vs. ACIT* [2020] 115 taxmann.

com 338 (Delhi) wherein it was held that: 'there is no requirement to provide elaborate reasoning to arrive at a finding of approval when the Principal Commissioner is satisfied with the reasons recorded by the AO.'

In the case of *Baldevbhai Bhikhabhai Patel vs. DCIT* [2018] 94 taxmann.com 428 (Gujarat), the Addl. Commissioner, in his own hands, put the remarks: 'I am satisfied that it is a fit case to issue Notice under Section 148 of the Income-tax Act 1961.' Further, the Addl. Commissioner forwarded such approval to the Dy. Commissioner with the remarks; 'The reasons recorded by you for initiating proceedings under Section 147 of the I-T Act 1961 are perused. After perusal, I am satisfied on the basis of above reasons and considered opinion that this is a fit case for issue of the notice under Section 148 of the I-T Act.' The court held the said approval as valid.

In the case of *Sonia Gandhi vs. ACIT* [2018] 407 ITR 594/ 97 taxmann.com 150 (Delhi), Delhi High Court in para 49 of the order relied on the decision of Delhi High Court in the case of *Meenakshi Overseas (P.) Ltd.* The relevant portion of the order is extracted as under:

'49. As far as the question of satisfaction recorded by the Principal Commissioner, under Section 151(1) is concerned, the legal requirements were spelt out by the Division bench ruling in (supra), in the following terms:

"For the purpose of Section 151(1) of the Act, what the Court should be satisfied about is that the Additional CIT has recorded his satisfaction 'on the reasons recorded by the Assessing Officer that it is a fit case for the issue of such notice. In the present case, the court is satisfied that by recording in his own writing the words: "Yes, I am satisfied", the

mandate of Section 151(1) of the Act as far as the approval of the Additional CIT was concerned, stood fulfilled."

Mere non-mentioning of sanction accorded by authority in notice issued under Section 148 would not, in any way, be fatal to process of reopening [*Sword Global India P. Ltd. vs. ACIT* [2015]60 taxmann.com 73 (Madras)].

DECISIONS IN FAVOUR OF THE ASSESSEE

In the case of *PCIT vs. N.C. Cables Ltd.* [2017] 391 ITR 11 (Delhi), the CIT mentioned –"Approved" while recording his sanction under Section 151. The Hon'ble Delhi High Court observed that:

"The mere appending of the expression "approved" says nothing. It is not as if the Commissioner of Income-tax (Appeals) has to record elaborate reasons for agreeing with the noting put up. At the same time, satisfaction has to be recorded of the given case which can be reflected in the briefest possible manner.'

In the case of *CIT vs. S. Goyanka Lime & Chemicals Ltd.* [2015] 56 taxmann.com 390 (MP), while according sanction, the Joint Commissioner only recorded 'Yes, I am satisfied.' The MP High Court held the said sanction as mechanical. Hon'ble Supreme Court dismissed the Writ Petition of the Revenue in *CIT vs. S Goyanka Lime & Chemicals Ltd.* [2015] 64 taxmann.com 313 (SC).

ACTION POINT

The following points emerge out of the above discussion on Section 151:

- i. Sanction for issue of notice under Section 148 has necessarily to be granted by the authority as mentioned

in Section 151. Approval by the authority other than as specified under Section 151, is fatal and will make the reopening invalid.

- ii. To avoid litigation, the sanction granted for issue of notice under Section 148 should be self-speaking reflecting due application of mind and satisfaction of the sanctioning authority. It would be better if the satisfaction is recorded in own hand by the sanctioning authority.

SUPPLY OF REASONS OF REOPENING AND DISPOSAL OF OBJECTIONS

As held by the Hon'ble Supreme Court in the landmark decision of *GKN Driveshafts Ltd vs. ITO* [2002] 259 ITR 19 (SC), the AO has to provide reasons recorded for reopening within a reasonable time. Further, when the assessee files objections against the reopening in a reasonable time, the AO is required to dispose of the said objection by way of a speaking order in a reasonable time.

In the case of *CIT vs. Safetag International India P. Ltd.* [2011] 332 ITR 622 (Del), it has been held by Delhi High Court that if assessee does not ask for the reasons recorded or raised objections thereto before AO, Tribunal could not have restored matter back to file of Assessing Officer and give another opportunity to assessee to raise objections to 'reasons to believe' recorded by AO.

In the case of *AG Holdings P. Ltd vs. ITO* [2012] 21 taxmann.com 34 (Delhi), it has been held by the Delhi High Court that there is no requirement of law that reasons recorded for initiating reassessment procedure should also accompany the notice issued under Section 148. Further, it was reiterated in *Sun Direct TV*

P. Ltd. [2018] 409 ITR 49 (Mad) and *South Asia FM Ltd. vs. ACIT* [2018] 413 ITR 205 (Mad) that it is not required to supply reasons recorded for reopening of assessment along with notice under Section 148.

There is no time-frame indicated for supply of reasons and disposal of objections in *GKN Driveshafts (supra)*. However, in the case of *Sahakari Khand Udyog Mandal Ltd. vs. ACIT* [2014] 370 ITR 107(Gujarat), Gujarat High Court issued the following directions in respect of time-frame to be followed for compliance of *GKN Driveshafts* for the state of Gujarat:

1. AO shall supply the reasons within 30 days of the filing of the return without waiting for the assessee to demand such reasons.
2. Assessee would be expected to raise his objections, if he so desires, within 60 days of receipt of such reasons.
3. AO would dispose off the objections, as far as possible, within four months of date of receipt of the objections filed by the assessee.
4. However, in those cases where the assessee does not adhere to the time limit, the above time-frame would not apply. This would not mean that the procedure provided in the case of *GKN Driveshafts* would not apply.

The SLP filed by the Revenue vide SLP(C) No. 008189/ 2016 registered on 21.01.2016 was dismissed by the Supreme Court on 18.03.2016. Though the said guidelines were for the State of Gujarat, the same may be taken note of by the Assessing Officers to avoid litigation.

NON-SUPPLY OF REASONS TO THE ASSESSEE

In respect of non-supply of reasons recorded for reopening to the assessee, the courts have unequivocally held the reopening of assessment as invalid. In the case of *Haryana Acrylic Manufacturing Co. vs. CIT* [2009] 308 ITR 38 (Delhi), reasons recorded were not supplied to the assessee inspite of being asked and *Delhi High Court* held the reopening as invalid. Again in the case of *PCIT vs. Jagat Talkies Distributors* [2017] 85 taxmann.com 189 (Delhi), assessee was not given a copy of reasons recorded for reopening and order passed under Section 148 was quashed. The same view was taken by the Bombay High Court in *CIT vs. Videsh Sanchar Nigam Ltd.* 340 ITR 66 and *CIT vs. Trend Electronics Ltd.* [2015] 61 taxmann.com 308 (Bom). In a recent decision of Karnataka High Court in the case of *PCIT vs. V. Ramaiah* [2019] 103 taxmann.com 201 (Karnataka), it has been held that recording of reasons before issue of notice under Section 148 and communication of the same to the assessee is sine qua non. The Supreme Court has dismissed the SLP against the said order in *PCIT vs. V. Ramaiah* [2019] 103 taxmann.com 202 (SC). There are plethora of decisions holding the same view.

NON-DISPOSAL OF OBJECTIONS FILED BY THE ASSESSEE

There are contrary decisions of the high courts and different benches of the ITAT in respect of non-disposal of objections filed by the assessee against reopening of assessment. Most of the high courts have held that non-compliance of *GKN Driveshafts* in respect of non-disposal of objections filed by the assessee against the reopening is only procedural/ administrative mistake and the matter was set aside to the AO

for disposal of objections by a speaking order in a reasonable time.

WHERE MATTER WAS SET ASIDE TO AO FOR DISPOSAL OF OBJECTIONS

In *Scan Holdings P. Ltd. vs. ACIT* [2018] 402 ITR 290 (Delhi), it was held that where AO rejected objections filed by the assessee without elucidating and dealing with contentions and issues raised in objection letter, order was set aside and matter was remanded back for disposal afresh.

In *Kamlesh Sharma vs. ITO* [2009] 287 ITR 337 (Delhi) also, where AO passed assessment order under Section 147 without first passing a speaking order on objections raised by assessee to notice under Section 148, assessment was set aside. The said decision was followed in *Keshav Shares & Stocks Ltd.* [2008] 326 ITR 553 (Delhi). In the case of *Areva T&D Ltd.* 294 ITR 233 (Madras) also, it was held that non-disposal of objection is procedural irregularity and matter was set aside to AO.

In *PCIT vs. Sagar Developers* [2016] 72 taxmann.com 321 (Guj), it was held by Gujarat High Court that requirement of supplying the reasons recorded by the AO and permitting the assessee to raise objections and to decide the same by the AO by a speaking order are not part of the statutory provisions, but are created under the judgement of Supreme Court in the case of *GKN Driveshafts*. Any default on the part of the AO is administrative in nature suffering from breach of principle of natural justice. In such cases, the decision-making process should be placed at a stage where the defect is detected rather than to permanently annul the action of the authority. In the above decision, order of Delhi High Court in the case of *Ferrous Infrastructure (P) Ltd. vs.*

DCIT [2015] 63 taxmann.com 201 was also considered in which a contrary view was taken.

In a recent decision of *Home Finders Housing Ltd. vs. ITO* [2018] 93 taxmann.com 371 (Mad), it has been held by Madras High Court that: 'The disposal of objections is in the value of a procedural requirement to appraise the assessee of the actual grounds which made the Assessing Officer to arrive at a prima facie satisfaction that there was escape of assessment warranting reopening the assessment proceedings. The disposal of such objection must be before the date of hearing and passing a fresh order of assessment.' The court, further held that: 'Such a violation in the matter of procedure is only an irregularity which could be cured by remitting the matter to the authority.'

SLP against the said order has been dismissed by Supreme Court in *Home Finders Housing Ltd. vs. ITO* [2018] 94 taxmann.com 84(SC).

WHERE ASSESSMENT ORDER WAS QUASHED DUE TO NON-DISPOSAL OF OBJECTIONS

In the case of *Ferrous Infrastructure (P) Ltd. vs. DCIT* [2015] 63 taxmann.com 201(Delhi) and *CIT vs. Tupperware India P. Ltd.* [2016] 284 CTR 68 (Delhi), the assessment order was quashed on the ground of non-disposal of objections of the assessee. In the recent decision of *Nimitaya Hotel & Resorts Ltd.* [2019] 109 taxmann.com 185 (Delhi-Trib.) also, the ratio of the abovementioned two decisions was followed.

NO ASSESSMENT ORDER WITHIN 4 WEEKS OF DISPOSAL OF OBJECTIONS

In the case of *Asian Paints Ltd. vs. DCIT* [2008] 296 ITR 90 (Bombay), a writ petition was filed with the plea that assessment order is passed

within a very short time whereby the assessee is left without any remedy to challenge such an order of rejection. It was held by the Bombay High Court that: 'Hence we make it clear that if the Assessing Officer does not accept the objections so filed, he shall not proceed further in the matter within a period of four weeks from the date of receipt of service of the said order on objections, on the assessee.' The said decision was relied upon by the ITAT, Mumbai Bench in the case of *Hirachand Kanuga vs. DCIT* [2015] 56 taxmann.com 199 (Mumbai) and assessment order was quashed on the ground that assessment order was passed in less than 4 weeks after order disposing of the objections was passed.

ACTION POINT

The AO should mandatorily provide a copy of the reasons recorded to the assessee immediately after issue of notice under Section 148. While sending the copy of the reasons recorded, it may be mentioned that objections to reopening may be filed by the assessee giving the reasonable time, as specified in the said letter, if the assessee so desires. The objections filed by the assessee should necessarily be disposed off immediately by a speaking order covering the issues raised by the assessee, in brief. The assessment order should be passed after a reasonable time of disposal of the objections so that the assessee gets adequate time for legal recourse against the rejection of objections filed by him against reopening of assessment.

JURISDICTIONAL ISSUES

SATISFACTION OF JURISDICTIONAL AO AND ISSUE OF NOTICE UNDER SECTION 148 BY THE SAME AO

Since the notice under Section 148 of the Act is a jurisdictional notice, any inherent defect therein cannot be cured under Section 292B of the Act.

A notice under Section 148(1) would be a valid notice if the jurisdictional AO records the reasons for reopening the assessment as contemplated under Section 148(2) and thereafter the same officer namely the jurisdictional Assessing Officer issues the notice under Section 148(1) of the Act. [*Pankajbhai Jaysukhlal Shah vs. ACIT* [2019] 110 taxmann.com 51(Gujarat).

AO recording reasons and the AO issuing notice under Section 148 must be the same. Successor AO cannot issue notice under Section 148 on the basis of reasons recorded by the predecessor AO. [*Hyoup Food Oil Ind. Ltd. vs. ACIT* (2008) 307 ITR 115 (Gujarat), *CIT & Anr. vs. Aslam Ullakhan* [2010] 321 ITR 150 (Kar.)]

Reason to believe for reopening of assessment can be formed only by Jurisdictional Assessing Officer and not any other Assessing Officer. The basic requirement of Section 147 is that the assessing officer must have a reason to believe that any income chargeable to tax has escaped assessment and such belief must be the belief of jurisdictional Assessing Officer and not of any other assessing officer or authority and in absence of the same entire proceedings taken by him would become void for want of jurisdiction [*ACIT vs. Resham Petrotech Ltd.* (2012) 136 ITD 185 (Ahm. Tribunal)].

TERRITORIAL JURISDICTION-APPLICABILITY OF SECTION 124(3)

In respect of territorial jurisdiction, there is a decision in favour of Revenue in the case of *Abhishek Jain vs. ITO* [2018] 94 taxmann.com 355/405 ITR1 (Delhi). In the said case, Delhi High Court held that in terms of Section 124(3) (b) jurisdiction of an Assessing Officer cannot be called in question by an assessee after expiry of one month from date on which he was served with a notice for reopening assessment under

Section 148. This decision refers to *Harshad Chiman Lal Modi vs. DLF Universal Ltd. & Anr.* (2005) 7 SCC 791, which classifies and draws jurisprudential difference amongst territorial or local jurisdiction; pecuniary jurisdiction; and jurisdiction over the subject matter. As far as territorial or pecuniary jurisdictions are concerned, objection should be taken at the earliest possible opportunity and/ or before the settlement of issues and not at the subsequent stage. Jurisdiction as to the subject-matter is distinct and stands on a different footing.

In *CIT vs. Shri Shyam Sunder Infrastructure (P) Ltd.* [IT Appeal No. 236 of 2014] Delhi High Court in the order dated 04.02.2015 referred to Section 124(3) and held that:

'Facially, Section 124(3) stipulates a bar to any contention about lack of jurisdiction of an AO. It is not as if the provisions of the Act disable an assessee from contending that in the given circumstances the AO lacks jurisdiction; rather Section 124(3) limits the availability of those options at the threshold. The assessee upon receipt of notice of the kind mentioned in Clause (a) and (b) of Sub-section 3 has the option to urge the question of jurisdiction; the expressed tenor and terms of the provisions clarify that such objections are to be articulated at the threshold or at the earlier points of time.'

Where Assessing Officer conducted survey upon assessee and thereafter issued a notice under Section 148 dated 27.03.2015 and assessee by letter dated 29.04.2015 raised objection to territorial jurisdiction of Assessing Officer, since objection was not raised within 30 days even from date of issuance of notice under Section 148, assessee had lost right to raise objection by efflux of time. [*Elite Pharmaceuticals vs. ITO* [2016] 73 taxmann.com 69 (Calcutta)]

ACTION POINT

The jurisdictional AO who has recorded the reason can only issue notice under Section 148. Successor AO cannot issue notice under Section 148 on the basis of reasons recorded by his predecessor. In case of change of incumbent, reasons should be recorded afresh. Jurisdictional mistake in issuing notice under Section 148 is not curable under Section 292B of the Act. Hence, the AO has to be very careful as regards jurisdiction while recording and issuing notice under Section 148.

ORDER UNDER SECTION 144 WHERE RETURN IS NOT FILED IN RESPONSE TO NOTICE UNDER SECTION 148

Whenever a return is not filed in response to notice under Section 148, then the best judgement assessment has to be completed under Section 144. In *R.B. Seth Shreeram Durgaprasad and Fatechand Nursingdas (Export Firm) vs. CIT* [1987] 170 ITR 23 (Bombay), it was held by Bombay High Court that where an assessee does not file return in response to notice under Section 148, the AO is obliged to frame best judgement assessment under Section 144 on the basis of material available with him. The Court held that:

‘Section 147 predicates the existence of some material. Where an assessee does not respond to a notice under Section 148, the taxing authority is obliged to determine the assessee’s income as best as he can based on that material. There is no real difference between the manner in which the taxing authority reaches its conclusions under the provisions of Section 144 and of Section 147. Both are assessments made to its best judgment. It is as open to the assessee to argue that the material does not support

the assessment made under Section 147 as under Section 144. There is, therefore, no merit in the submission that the words “so far as may be” in Section 148 exclude the applicability of the provisions of Section 144 to an assessment made under Section 147.’

In the case of *Ms. Meenakshi Agarwal vs. ITO* [ITA no 417/Del/2015] in order dated 16.10.2015, ITAT, SMC Bench, Delhi has analyzed the provisions in respect of assessment under Section 144 where return is not filed in response to notice under Section 148 as under:

‘Notice under Section 148 of the Act, issued to the assessee required it to file a return within 30 days from the date of service of such notice. There is no provision in the Act, which would allow on AO to treat the return which was already subject to a processing under Section 143(1) of the IT Act, as a return filed pursuant to a notice subsequently issued under Section 148 of the Act. However, once an assessee itself declares before the AO that his earlier return could be treated as filed pursuant to notice under Section 148 of the IT Act, three results can follow. Assessing Officer can either say no, this will not be accepted, you have to file a fresh return or he can say that 30 days’ time period being over I will not take cognizance of your request or he has to accept the request of the assessee and treat the earlier returns as one filed pursuant to the notice under Section 148 of the IT Act. In the former two scenarios, AO has to follow the procedure set out for a best of judgment assessment and cannot make an assessment under Section 143(3). On the other hand, if the AO chose to accept assessee’s request, he can indeed, make an assessment under Section 143(3).’

The above order of *Meenakshi Agarwal (supra)* has been followed by the ITAT, Kolkata Bench in the case of *Pinnacle Commodities Pvt. Ltd.* [ITA No. 1901/Kol/2018] in order dated 09.08.2019 and in *Pankaj Dutta vs. ITO* [ITA No 2206/Kol/2016] in order dated 17.11.2017.

NO NEW CLAIM IN RETURN FILED IN RESPONSE TO NOTICE UNDER SECTION 148

In the landmark decision of *CIT vs. Sun Engineering Works P. Ltd.* [1992] 198 ITR 297(SC), the Hon'ble Supreme Court observed that the words 'such income' in Section 147 clearly refer to the income which is chargeable to tax but has escaped assessment and the ITO's jurisdiction under the Section is confined only to such income which has escaped assessment. Since the proceedings under Section 147 are for the benefit of the revenue and not an assessee and are aimed at gathering the "escaped income" of an assessee, the same cannot be allowed to be converted as "revisional" or "review" proceedings at the instance of the assessee, thereby making the machinery unworkable. The Hon'ble Supreme Court further held that:

'Keeping in view the object and purpose of the proceedings under Section 147 which are for the benefit of the revenue and not an assessee, an assessee cannot be permitted to convert the reassessment proceedings on his appeal or revision, in disguise, and seek relief in respect of items earlier rejected or claim relief in respect of items not claimed in the original assessment proceedings, unless relatable to 'escaped income', and re-agitate the concluded matters. Even in cases where the claims of the assessee during the course of reassessment proceedings relating to the escaped assessment are accepted, still the

allowance of such claims has to be limited to the extent to which they reduce the income to that originally assessed. The income for purposes of 'reassessment' cannot be reduced beyond the income originally assessed.'

In the case of *Videocon Leasing & Finance Ltd vs. JCIT* [2006] 103 ITD 309 (Ahmedabad), ITAT, Ahmedabad Bench held that:

'Income for the purpose of assessment under Section 147 cannot be a negative figure. In a case, even if at any stage of these proceedings, the Assessing Officer finds that income chargeable to tax has not escaped assessment, he is free not to take further action and drop the proceedings. He is not bound to conclude the proceedings and make the assessment to the detriment of the revenue. If pursuant to notice under Section 148, the assessee submits a loss return and the Assessing Officer is satisfied with the return of income or it is really negative as claimed by the assessee in his return, he is entitled to close the proceedings.'

In the case of *CIT vs. State Agro Development Corporation* [2001] 248 ITR 484(J&K), J&K High Court held that:

'The assessee cannot claim that assessment should be completed and loss should be determined to enable him to claim the benefit of carry-forward and set-off against the income of subsequent years. In such a case, the proper course for the ITO would be to drop the proceedings under Section 147. In the instant case, by refusing to allow the assessee the benefit of carry-forward of loss, the ITO had, in effect, dropped the proceedings under Section 148 and he was right in doing so.'

Where income assessed in reassessment proceedings after giving effect to order of

Tribunal became less than income originally assessed, said order passed by Tribunal was not sustainable being contrary to decision of Apex Court in *CIT v. Sun Engg. Works (P.) Ltd.* [*CIT vs. Jai Hind Coop. Housing Society Ltd.* [2013] 349 ITR 537 (Bombay)]

ACTION POINT

The AO is not to allow any fresh claim of the assessee in the return filed in response to notice under Section 148. The income for purposes of “reassessment” cannot be reduced beyond the income originally assessed. Income for the purpose of assessment under Section 147 cannot be a negative figure. If at any stage of reassessment proceedings, the AO finds that income chargeable to tax has not escaped assessment, he is free to drop the proceedings.

ISSUES REGARDING EXPLANATION 3 TO SECTION 147 OF THE ACT

Section 147 of the Act itself provides that the Assessing Officer may assess or reassess— ‘also any other income chargeable to tax which has escaped assessment and which comes to his notice subsequently in the course of the assessment proceedings under this section.’ Revenue has consistently been of the view that once assessment is validly reopened, all income chargeable to tax which escaped assessment can be brought to tax in the reassessment order. In the reassessment proceedings, Revenue has been making addition in respect of other escaped income also which came to the notice of the AO during the assessment proceedings under Section 147 even though there was no mention of the aforesaid escaped income in the reasons to believe. However, certain courts held that the AO cannot make addition of such escaped income in respect of which there was no discussion in the satisfaction note. To deal

with the said dispute, a clarificatory provision by way of Explanation 3 to Section 147 of the Act was inserted by the Finance Act 2009 with retrospective effect from 01.04.1989 which is extracted as under:

‘For the purpose of assessment or reassessment under this section, the Assessing Officer may assess or reassess the income in respect of any issue, which has escaped assessment, and such issue comes to his notice subsequently in the course of the proceedings under this section, notwithstanding that the reasons for such issue have not been included in the reasons recorded under Sub-section (2) of Section 148.’

After insertion of the said Explanation, it was assumed that there will be no dispute in respect of addition made of such escaped income which was not included in the satisfaction note, once the reopening of assessment was valid per se. However, a dispute arose shortly after the said insertion of the said Explanation by the decision of Hon’ble Bombay High Court in the case of *CIT vs. Jet Airways (I) Ltd.* [2010] 195 Taxman 117 (Bombay). In the said decision, it was held that where no addition is made in respect of that income on the basis of which reason to believe to reopen the assessment was recorded, it is not open to the AO, even after invocation of Explanation 3 to Section 147, to bring to tax any other income. Subsequently, in the case of *Ranbaxy Laboratories Ltd vs. CIT* [2011] 336 ITR 136 (Delhi), the Hon’ble Delhi High Court followed the decision of *Jet Airways Ltd. (supra)*.

However, in *Pratibha Finvest (P.) Ltd.* [2013] 29 taxmann.com 420 (Delhi); [2013] 215 Taxman 470 (Delhi)/[2013] 263 CTR 206 (Delhi), Delhi High Court held that: ‘ In the opinion of this court, the law as it existed always was that if a valid notice under Section 147 was issued by the

AO, the scope of scrutiny and final assessment made in the reopening proceedings was not conditioned upon the material which impelled him to issue notice. To hold such a view would be to impinge on the concededly wide power conferred upon the Revenue in Section 147/148 and undermine its objective.'

In the aforesaid decision, the court relied on *V. Jaganmohan Rao vs. CIT Excess Profits Tax* [1970] 75 ITR 373 (SC) in which it was held that: 'It is, therefore, manifest that once assessment is reopened by issuing a notice under Sub-section (2) of Section 22 the previous under-assessment is set aside and the whole assessment proceedings start afresh.'

Further, in *Majinder Singh Kang vs. CIT* [2012] 344 ITR 358/25 taxmann.com 124 (Punj. & Har.), it was held that: 'The provision nowhere postulates or contemplates that it is only when there is some addition on the ground on which reassessment had been initiated, that the Assessing Officer can make additions on any other ground on the basis of which income may have escaped assessment.' SLP of the assessee against the said judgment was also dismissed by the Apex Court bearing Special Leave Petition (Civil) No. 13028 of 2011 on August 19, 2011. The said decision was followed in the case of *CIT vs. Mehak Finvest P. Ltd.* [2014] 52 taxmann.com 51(P&H).

Subsequently, in the case of *N. Govindraju vs. ITO* [2015] 377 ITR 243 (Karnataka), Karnataka High Court held that; 'There is no conflict between the main Section 147 and its Explanation 3. This Explanation has been inserted only to clarify the main section and not curtail its scope. Insertion of Explanation 3 is thus clarificatory and is for the benefit of the revenue and not the assessee.' The Court further held that:

'If notice under Section 148(2) is found to be valid, then addition can be made on all grounds or issues which may come to notice of Assessing Officer subsequently during course of proceedings under Section 147, even though reason for notice for 'such income' which may have escaped assessment, may not survive.'

The decisions in the case of *Jet Airways Ltd.* (*supra*) and *Ranbaxy Laboratories Ltd.* (*supra*) were considered and distinguished in the abovementioned decision.

However, in the subsequent decision of *CIT vs. Monarch Education Society* [2017] 387 ITR 416 (Delhi), decisions in the case of *Jet Airways Ltd* (*supra*) and *Ranbaxy Laboratories Ltd.* (*supra*) were followed by Delhi High Court.

Identical issue came before the Hon'ble Delhi High Court in the case of *PCIT vs. Jakhotia Plastics (P.) Ltd.* [2018] 94 taxmann.com 89 (Delhi). The Hon'ble Delhi High Court held that:

'This Court specifically is of the opinion that the Karnataka High Court's view in the case of N. Govindaraju (supra) is a more accurate one. In this court's view the emphasis placed in Jet Airways' case (supra) on "and also" undermines the essential objective of Section 147 of the Act and unduly restricts and narrows it. The circumstance clarifies existence of an additional power to bring to tax other sums. This per se would not mean that the sums or amounts sought to be brought to tax in a reassessment notice (which are ultimately not the subject of the final reassessment orders), act as a limitation.'

However, the court held that since there is some doubt as to the accuracy of the interpretation in the case of *Ranbaxy Laboratories (supra)* and *Monarch Educational Society (supra)*, the

issue was referred to the Full Bench. SLP filed by the assessee against the said order has been dismissed by the Supreme Court in *Jakhotia Plastics (P.) Ltd vs. PCIT* [2018] 94 taxmann.com 96(SC).

ACTION POINT

As there is no decision of Supreme Court on the above issue, once assessment is reopened, the AO should make addition of such escaped income which comes to the notice of the AO during reassessment proceedings even though it was not included in the reason to believe, irrespective of the fact that no addition is made in respect of that income on the basis of which assessment was reopened.

WHETHER AO COULD BE COMPELLED TO PURSUE REMEDY NECESSARILY UNDER SECTION 153C IN EXCLUSION TO REMEDY AVAILABLE UNDER SECTION 147

In the case of an assessee, where certain material belonging to or pertaining to him is found from the search at the premise of other person, provisions of Section 153C can be invoked. There can be a dispute as to whether the said material belongs to/ pertains to that person or not. The dispute can also be as to whether material seized is incriminating material or not. To obviate such disputes, the AO has the option to resort to reopening of assessment under Section 148, instead of invoking Section 153C, on the basis of the material received from the Investigation Wing, once he has reason to believe that income chargeable to tax has escaped assessment. The issue is whether the AO is compelled to invoke Section 153C in exclusion to reopening of assessment under Section 148 in such cases. In this context, it is pertinent to mention that Section 153C starts

with the non-obstante clause: 'Notwithstanding anything contained in Sections 139, 147, 148, 149, 151 and Section 153.' As against this, Section 158BD did not have such non-obstante clause. There are conflicting decisions on this issue, mostly in favour of the assessee.

After the decision of *CIT vs. Kabul Chawla* [2015] 380 ITR 573(Delhi) and *CIT vs. Sinhgad Technical Education Society* [2017]397 ITR 344(SC), addition can be made under Section 153A only on the basis of incriminating material unearthed during the course of search in respect of non-abated assessments. There is dispute regarding relevant assessment years also after the decision of *CIT vs. RRJ Securities Ltd.* [2016] 380 ITR 612 (Delhi). In view of the above, continuing with Section 153C may need thoughtful consideration and deliberation.

In the case of *Shailesh S. Patel vs. ITO* [2018] 97 taxmann.com 570 (Ahmedabad-Trib.), ITAT, Ahmedabad Bench has analyzed the above issue in detail in paras 14 to 14.4 of the order. The ITAT has held as under:

'Hence, S. 147 will be rendered inoperative and will give way to Section 153C once power under S. 153C are exercised validly. This, however, is not the same thing to say that there is any statutory compulsion to resort only to mode prescribed under Section 153A/ Section 153C in the event of search. The scheme of Act does not suggest that mere search action revealing incriminating material against the person other than searched person would automatically oust the power of the AO over the assessee concerned under Section 147 of the Act. The overriding provisions of Section 153C merely enables the AO to set aside the pending reassessment proceedings and grants primacy to Section 153C of the Act. As noted earlier, exercise of power under Section 153C

is governed without any stringent fetters of holding 'reason to believe' contemplated under Section 147. Therefore, while exercise of overriding power under Section 153C will render Section 147 otiose, the converse case of clipping the powers available under Section 147 in search cases per se is not found to be reconcilable to the scheme of the Act. In the light of scheme of the Act narrated above, we are of the view that the AO of the assessee (person other than searched person) cannot be compelled to pursue remedy necessarily under Section 153C of the Act in exclusion to remedy available to the AO under Section 147 of the Act.'

In the case of *Sushil Kumar S Nadkarni vs. ITO* [ITANo. 826/PN/2010, Order dated 29.11.2013], the ITAT, Pune Bench the issue was raised by the assessee that the AO was not competent to issue notice under Section 148 on the basis of the material before him because the material found in the course of search at Mumbai was passed on to the AO of the assessee and therefore, on that basis the Assessing Officer ought to have initiated proceedings of assessment by issuing notice under Section 153C and not under Section 148 of the Act. The ITAT held as under:

'The aforesaid plea is based on an argument to the effect that the correct jurisdiction for the Assessing Officer to make the re-assessment was under Section 153C of the Act and therefore, the issuance of notice under Section 148 of the Act to effectuate the re-assessment in the present case is not valid. In our considered opinion, the argument of the assessee is quite misplaced because in order to test the validity of initiation of proceedings by issuance of notice under Section 148 of the Act in the present case what is required

to be examined is as to whether or not the necessary ingredients prescribed in Section 148 of the Act are satisfied.'

DECISIONS IN FAVOUR OF ASSESSEE

There appears to be no decision of any high court in respect of the above issue of applicability of Section 148 instead of Section 153C. In the decisions which are in favour of the assessee, different benches of the ITAT have held that Section 153C begins with non-obstante clause and has an overriding effect on Section 147/148. It has been held that as per the scheme of Section 153C, AO has no discretion or choice to invoke the provisions of Section 148. In the case of *Arun Kumar Kapur* [2011] 140 TTJ 249 (Amritsar Trib.), the above view was taken and reopening under Section 148 was quashed. Subsequently, the said decision has been followed by different benches of ITAT *inter alia* in the following cases:

- *G. Koteswar Rao vs. DCIT* [2015] 64 taxmann.com 159 (Vishakhapatnam Trib.)
- *Rajat Shubhra Chatterjee vs. ACIT* [ITA 2403/Del/2015; order dated 20.05.2016], ITAT Delhi
- *Navrattan Kothari vs. ACIT* [ITA No. 425/JP/2017, order dated 13.12.2017], ITAT, Jaipur
- *Adarsh Agarwal vs. ITO* [ITA No 777/Del/2019; order dated 14.01.2020], ITAT, Delhi

ACTION POINT

AO may first examine as to whether the necessary conditions to proceed for assessment under Section 153C are met or not. He may record that the necessary ingredients of Section 153C

are not satisfied. If yes, then the AO is out of the clutches of provisions of Section 153C and then he can record the reason to believe as to how the case satisfies the necessary conditions for reopening of assessment under Section 147. To avoid litigation, the AO may complete the assessment under Section 153C immediately, particularly of those assessment years, reopening of which under Section 147 may get time-barred. In respect of such assessment years, where there is tangible material, which was not found during the course of search, AO may reopen the assessment under Section 147.

REOPENING OF ASSESSMENT ON THE BASIS OF TANGIBLE MATERIAL IN THE CASE OF SEARCH ASSESSMENTS

After the decision of *CIT(C)-III vs. Kabul Chawla* [2015] 380 ITR 573 (Delhi) and *PCIT vs. Meeta Gutgutia* [2017] 395 ITR 526 (Delhi), *Sinhgad Technical Education Society* [2017] 397 ITR 344 (SC) and plethora of decisions in which ratio of *Kabul Chawla (supra)* has been reiterated, addition made on the basis of incriminating material found from the search premise only is being sustained by ITAT and high courts in respect of non-abated assessments. Even the addition made on the basis of incriminating material found and impounded from the premise covered under simultaneous survey action under Section 133A pertaining to non-abated assessment years, addition is not being sustained by different Benches of the ITAT relying on the abovementioned decisions. In respect of abated pending assessments only, addition can be made on the basis of non-search material also. Therefore, in such cases where the AO is in the possession of tangible material, which is not found/ seized from the search premise and is pertaining to the non-abated assessment years, only recourse left

with the AO is to reopen assessment on the basis of that tangible material immediately after completion of assessment under Section 153A or Section 153C. Such tangible material may be in the nature of information received from the Investigation Wing regarding accommodation entry taken by the assessee from entry operators, documents found/impounded during the course of survey under Section 133A or any other material received by the AO during the course of assessment proceedings under Section 153A or Section 153C, or any pre-search material. However, such reopening would be possible only if time for reopening the non-abated assessment under Section 147 is available till completion of assessment under Section 153A. In this connection, it is pertinent to note that as per Section 153A, assessment order has to be passed for each of the six assessment years separately and therefore, the AO need not wait for completion of assessment for all six assessment years in the case of an assessee. Where there is no incriminating material found/ seized from the search premise in respect of a non-abated assessment year, such assessment may also be completed immediately so that reopening can be made within the time limit provided under Section 147 on the basis of tangible material available in the possession of the AO. Also, the AO may complete the assessment of those assessment years on priority, reopening of which under Section 147 may get time-barred. Similar approach may be adopted in respect of proceedings under Section 153C also.

KEY TAKEAWAYS

As recording of reason to believe is the cornerstone of reassessment, CBDT has issued an exhaustive 'Standard Procedure for Recording Satisfaction under Section 147' dated 10.01.2018 along with four separate 'Sample Templates' for the

guidance of the assessing officers. If the same is followed diligently, mistakes in recording satisfaction for reopening of assessment can be avoided (Refer Para 3).

The reason to believe must have live link or close nexus with the tangible material on the basis of which AO seeks to reopen the assessment. This is equally important even in those cases, where return was processed under Section 143(1) or where return was not filed. (Refer para 5, 6, 7.7)

Supreme Court in *Kelvinator India Ltd. (supra)* has added a further condition that reopening cannot be made merely on change of opinion. Question of change of opinion arises when an AO forms an opinion on a set of facts and decides not to make an addition and holds that the assessee is correct. When the original assessment order is totally silent on any aspect of the matter, it cannot be said that the reason to believe constitutes a 'change of opinion'. (Refer paras 7.1 to 7.5)

The AO cannot reopen an assessment merely on the ground that a wrong view was taken in the original assessment order. Recourse to correct that mistake is revision under Section 263 and not the reopening under Section 148 of the Act. Particularly in the case of audit objections, a very careful view has to be taken as regards remedial action to be taken under Section 148 or Section 263 (Refer para 7.17).

The AO is required to demonstrate in his satisfaction note that the material on the basis of which he is going to reopen the case was not considered in the original assessment order and also that no opinion was formed by the AO in respect of the said material (Refer para 7.17).

Where assessment has earlier been made under Section 143(3)/148 and 4 years have expired from the end of the relevant assessment year, three conditions are required to be met for

reopening: (i) 'reason to believe' is based on the tangible material, (ii) reopening is not based on 'mere change of opinion' and (iii) there is failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment. In this regard, the AO has to examine that not only all material facts were disclosed before the AO during the original assessment, but the same were disclosed 'fully' and 'truly' and reason to believe should be recorded in such a manner that failure on the part of the assessee to disclose fully and truly all material facts is prima facie established. Further, where assessment is reopened on the basis of information received from the investigation wing regarding accommodation entry etc. the AO must record this fact in the satisfaction note that the said information/ material received from the Investigation Wing was not available at the time of original assessment (Refer para 8).

Information/ material received from the Investigation Wing should be linked and correlated with the return of income/ assessment records and particularly specific transactions. Further, the reasons to believe should not be mere reproduction of findings of the DDIT (Inv.) i.e. it should not be 'borrowed satisfaction' but should demonstrate independent application of mind of the AO in respect of material/ information available with him. There are no fetters on the AO to make inquiry under Section 133(6), after taking necessary approval, before recording satisfaction for reopening of assessment (Refer para 9).

Valid issue and service of notice under Section 148 is mandatory for reopening of assessment. Service of notice under Section 143(2) is mandatory after return is filed in response to notice under Section 148. This is jurisdictional requirement and mistake is not curable under Section 292 BB. Issue of notice, not service of

notice, under Section 148 is mandatory before the limitation period. Further, notice under Section 148 must be handed over to postal authorities for dispatch before the limitation period. Valid service of notice under Section 148 is mandatory before the reassessment proceedings. During the assessment proceedings, it must be ascertained that notice under Section 148 has been received by the assessee. To avoid litigation, notice under Section 143(2) should be issued after few days of filing return of income in response to notice under Section 148. No notice under Section 143(2) is required to be issued where no return is filed in response to notice under Section 148. (Refer paras 10, 11 and 12).

Section 154 is not a substitute for Section 147/ Section 148. Therefore, notice under Section 154 may weaken the Revenue's case when the assessment is subsequently reopened on the same point. Further, if any pending rectification is there on the issue concerned, the same should necessarily be first closed/ dropped before issuing notice under Section 148 (refer para 13).

Approval by the authority other than as specified under Section 151 is fatal and will make the reopening invalid. The sanction granted for issue of notice under Section 148 should be self-speaking reflecting due application of mind and satisfaction of the sanctioning authority. (Refer para 14 and 15).

The AO should mandatorily provide a copy of the reasons recorded to the assessee immediately after issue of notice under Section 148. The objections filed by the assessee should necessarily be disposed of immediately by a speaking order covering the issues raised by the assessee in brief. It would be better if the assessment order is passed after a reasonable time of disposal of the objections, so that the assessee gets time for legal

recourse against rejection of objections raised (Refer para 16).

The jurisdictional AO who has recorded the reason can only issue notice under Section 148. In case of change of incumbent, reasons should be recorded afresh. Jurisdictional mistake in issuing notice under Section 148 is not curable under Section 292B of the Act (Refer para 17).

Whenever a return is not filed in response to notice under Section 148, then the best judgement assessment has to be completed under Section 144 (refer para 18).

In the landmark decision of *CIT vs. Sun Engineering Works P. Ltd.* (*supra*), the Hon'ble Supreme Court observed that the proceedings under Section 147 are for the benefit of the revenue and not an assessee. The AO shall not allow any fresh claim in the return filed in response to notice under Section 148 (refer para 19).

On the issue where no addition is made on the issue(s) involved in reason to believe, the addition can be made on grounds or issues which may come to the notice of AO subsequently during course of proceedings under Section 147, even though reason for notice for 'such income' which may have escaped assessment, may not survive. There are two different views on this issue based on judicial precedents. However, the AO should make addition of all such escaped income which comes to the notice of the AO during reassessment proceedings even though it was not included in the reason to believe (Refer para 20).

Where certain material belonging to or pertaining to an assessee is found from the search in the case of another person, the AO may examine as to

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whether the necessary conditions to proceed for assessment under Section 153C are met or not. If not, the AO is out of the clutches of provisions of Section 153C and then he can record the reason to believe as to how the case is best fit for reopening of assessment under Section 147 as against assessment under Section 153C of the Act (Refer para 21).

Where there is no incriminating material found/ seized from the search premises in respect of a non-abated assessment year, the assessment under Section 153A/ 153C may be completed immediately so that reopening can be made within the time limit provided under Section 147 on the basis of tangible material, if any, available in the possession of the AO (refer para 22).

Reckoning the Period of Six Assessment Years for Making Assessment under Section 153C(1) -Whether the Amendment w.e.f. 01.04.2017 IS Retroactive?



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Executive Summary

Legal forums at various levels have been annulling assessment orders framed u/s 153C(1) in case of 'other person' (the non-searched person) for some of the assessment years out of a total permissible period of six assessment years on the ground that they fall beyond the relevant period if reckoned from the year of recording satisfaction/handing over of seized material, as opposed to the statutory provisions, which require the reckoning of the aforesaid period from the year of initiation of search itself, in the same manner as provided u/s 153A. The former view, as upheld by Delhi High Court for the first time in 2015 in the case of *RRJ Securities*, is being followed by lower forums, which is not only resulting in annulment of assessment orders and consequential revenue leakages but also bearing absurd consequences. Though a series of amendments have been brought u/s 153A & 153C by the Finance Act, 2017 w.e.f. 1.4.2017, including the amendment specifically providing for the manner of reckoning the period of six assessment years from the date of search itself u/s 153C also, yet the assessments u/s 153C(1) in pursuance of the searches initiated before 1.4.2017 are being annulled by legal forums in observance of the Delhi High Court decision (Supra). This article attempts to explore the possible arguments, which revenue may seek to put forward in defending the assessment orders in such cases from being annulled or defending the revenue's appeals.

It is clearly provided under Section 153C(1) that the assessment can be made in respect of 'other person' (non-searched person) *for the relevant assessment year or years referred to in Sub-Section (1) of Section 153A*'. Sub-section (1)(b) of 153A *inter alia* provides reckon the period of six assessment years immediately preceding the assessment year relevant to the previous year

in which search is conducted. Thus, in order to make assessment in case of searched person as well as the 'other person' based on documents seized in the very same search, it was clear from the language of the Section that the period of relevant six assessment years for the purposes of Section 153C(1) would be in the similar manner as provided in Section 153A. Logically also,

there could not be two separate yardsticks for reckoning period of six assessment years under Sections 153A(1) and 153C(1) as the provisions of Sections 153A and 153C are in the nature of mirror provisions and wherever procedure of Section 153A has to be followed under Section 153C, it was clearly provided even prior to 01.04.2017 and there was no ambiguity.

However, in absence of the specific expression ‘...six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted...’ appearing under Section 153C(1), the expression ‘...for the relevant assessment year or years referred to in Sub-section (1) of Section 153A...’ has been interpreted by Delhi HC in *RRJ Securities 318 ITR 612 (Delhi)* in conjunction with First Proviso to Section 153C so as to conclude that the period of six assessment years in case of ‘other person’ would be reckoned from the assessment year preceding date of handing over of books/ documents/seized material/ recording satisfaction and not from the initiation of search. The High Court concluded as under:

....In terms of proviso to Section 153C, a reference to the date of the search under the second proviso to Section 153A has to be construed as the date of handing over of assets/ documents belonging to the assessee (being the person other than the one searched) to the Assessing Officer having jurisdiction to assess the said assessee. Further proceedings, by virtue of Section 153C(1) of the Act, would have to be in accordance with Section 153A of the Act and the reference to the date of search would have to be construed as the reference to the date of recording of satisfaction. It would follow that the six assessment years for which assessments/ reassessments could be made under Section 153C would also have to be construed with reference to the date of handing over of assets/ documents to the Assessing Officer of the assessee.....

It needs to be noted that substitution of date of handing over of seized material in place of date of initiation of search as mentioned in the First Proviso under Section 153C was only for a limited purpose to determine the years of abatement of assessment proceedings as provided in Second Proviso to Section 153A and not at all with reference to powers of AO to make assessment under Section 153C, which was separately provided under Section 153C(1) itself by using the phrase ‘for the relevant assessment year or years referred to in Sub-section (1) of Section 153A’. This view is further strengthened by the fact that even after amendment brought under Section 153C(1) w.e.f. 01.04.2017 by inserting the expression “...six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted...” the First Proviso has still not been amended. This fortifies the view that First Proviso to Section 153C never dealt with the period of reckoning six assessment years for purposes of making assessment under Section 153C(1). Under Second Proviso to Section 153A, only the abatement of proceedings in case of searched person was provided as on date of initiation of search without referring to which assessment years the assessment under Section 153A or Section 153C could be made due to initiation of search. The act of abatement and the act of assessment are two different functions, having different connotations and purpose and hence the two cannot be equated/ interchanged by any stretch of interpretation. The power to make assessment after initiation of search is separately provided in Section 153A(1) itself and not in Second Proviso to Section 153A. Therefore, First Proviso of Section 153C was entirely in different context and it clearly referred to Second Proviso of 153A only substituting the date of handing over in place of the date of initiation of search in case of ‘other person’ for the limited purposes of abatement only. The reliance on First Proviso of 153C for purpose of ascertaining the period of

assessment under Section 153C(1) was therefore misplaced.

Under the scheme of the Act and time permitted to complete the assessment under Section 153C(1), these assessments under Section 153C are likely to be completed only after assessment under Section 153A in case of searched person is completed. Therefore, the reference point for abatement of pending proceedings in case of non-searched person at the time of issue of notice under Section 153C was accordingly required to be advanced further to the date of handing over of seized material to enable the AO make assessment under Section 153C. It was in this context that the First Proviso allowed to treat the date of handing over as deemed date of search, so that the assessment already completed in case of non-searched person in the intervening period before seized material was handed over do not get abated. This proviso has not yet been amended implying thereby that this logic still holds the ground and that date of handing over of documents as referred in First Proviso to Section 153C never had any nexus to the reckoning of the period of six assessment years which could be assessed under Section 153C(1) in case of 'other person'.

If the period of six AYs for purposes of making assessment under Section 153C in case of 'other person' were to be reckoned from year of handing over of seized material and not the year of initiation of search, then it may lead to the following absurd consequences:

- i. There will be always a time lag between examination of the seized material and recording of satisfaction about 'other person' by the AO of the searched person within the time available under the Act and handing over of the seized material. Thereby, in no case the period of 6 AYs of searched person will coincide with period of

6 AYs in case of 'other person', even though in both cases the trigger for assessment is the material seized from the very same search and the number of years effectively available for making assessment under Section 153C based on seized material would be lesser than what it is under Section 153A in spite of seized materials of 'other person' available for such mis-match period.

- ii. The year of search for 'other person' shall also get advanced beyond the actual year of initiation of search to the year of handing over, which may be approximately 2-3 years after the actual year of search. As a result, there will be a situation where the period of six assessment years, if reckoned from handing over, would comprise of some assessment years in respect of which there can be no seized material because the period between year of search and year of actual handing over will fall beyond the actual year of search and there cannot be any chance of having any seized material for deemed year(s) post the actual year of search.
- iii. Further, if the year of search is advanced to year of handing over for purposes of making assessment under Section 153C(1), then some of the assessment years which are though within six years w.r.t to actual year of search but may fall out of ambit of assessment under Section 153C w.r.t year of handing over, even though there may be seized material available pertaining to such AY(s).

In short, if the date of handing over is deemed to be from the date of initiation of search instead

of the date of actual search for assessment under Section 153C(1), it would result into an anomalous situation wherein, on the one hand, in some AYs w.r.t year of handing over ('deemed search year') there would be no seized material, because such AYs may be beyond the year of actual search. This would thereby lead to redundancy as Section 153C can be invoked in cases of a non-searched person only when any document/ material relating to such person is found from the search initiated against any searched person. On the other hand, there may be a reverse situation in some of the assessment years, which may fall beyond 6AYs period if reckoned from subsequent date of handing over, even though some seized material pertaining to such AYs, albeit got excluded merely due to the substitution of the year of actual initiation of search with date of handing over, may actually exist. The intention of the Act could never have been to allow such AYs with available seized material pertaining to 'other person' to go beyond the scope for Section 153C by artificially replacing the year of search with the year of handing over. Under the holistic scheme of assessment under Sections 153A and 153C, which apply to procedure for assessments in case of search or requisition, it is the intention of the Act to place these provisions like mirror provisions for making assessment in case of searched and non-searched person, emanating out of the material seized in the same search. Hence, there cannot be two yardsticks for reckoning the relevant AYs for assessment in both sections with respect to the exact same search. The courts have invariably held that any interpretation, which is not as per express language of the Act, and as such, resulting in absurd consequences inconsistent with the intent of the statute, is to be ignored.

The appellate forums have also been relying upon the explanatory memorandum circulated

vide CBDT Circular No. 2/2018 explaining the amendments brought by the Finance Act 2017 to conclude that amendment to 153C(1) was only prospective in nature w.e.f. 01.04.2017 and that prior to 01.04.2017 the period of six assessment years under Section 153C(1) are still to be reckoned from the date of handing over of documents only in case of 'other person'.

The relevant part of the above circular is reproduced as under:

1. *80. Rationalisation of provisions of the Income Declaration Scheme 2016 and consequential amendment to Sections 153A and 153C.*
2. *80.1 The provisions of Clause (c) of the Section 197 of the Finance Act 2016 provide that where any income has accrued, arisen or been received or any asset has been acquired out of such income prior to commencement of the Income Declaration Scheme 2016 (the Scheme), and no declaration in respect of such income is made under the Scheme, then, such income shall be deemed to have accrued, arisen or received, as the case may be, in the year in which a notice under Sub-section (1) of Section 142 or Sub-section (2) of Section 143 or Section 148 or Section 153A or Section 153C of the Income-tax Act is issued by the Assessing Officer, and provisions of the said Act shall apply accordingly.*
3. *80.2 In view of the various representations received from stakeholders, Section 197 of the Finance Act 2016 has been amended so as to omit Clause (c) of the said Section.*
4. *80.3 Applicability: This amendment takes effect retrospectively from 1st June 2016.*

5. *80.4 However, in order to protect the interest of the revenue in cases where tangible evidence(s) are found during a search or seizure operation (including Section 132A cases) and the same is represented in the form of undisclosed investment in any asset, Section 153A of the Income-tax Act relating to search assessments has been amended to provide that notice under the said Section can be issued for an assessment year or years beyond the sixth assessment year already provided up to the tenth assessment year if— (i) the Assessing Officer has, in his possession, books of accounts or other documents or evidence which reveal that the income which has escaped assessment amounts to, or is likely to amount to, fifty lakh rupees or more in one year or in aggregate in the relevant four assessment years (falling beyond the sixth year); (ii) such income escaping assessment is represented in the form of asset; (iii) the income escaping assessment or part thereof relates to such year or years.*
6. *80.5 Applicability: The amended provisions of Section 153A of the Income-tax Act shall apply where search under Section 132 of the Income-tax Act is initiated or requisition under Section 132A of the Income-tax Act is made on or after the 1st day of April, 2017.*
7. *80.6 Section 153C of the Income-tax Act has also been amended to provide a reference to the relevant assessment year or years as referred to in Section 153A of the Income-tax Act.*
8. *80.7 Applicability: These amendments take effect from 1st April, 2017'*

The heading of the said portion of the circular 'Rationalization of provisions of IDS-2016 and consequential amendment to Sections 153A & 153C' itself sets the context of the amendment under Section 153A & 153C. Further, as evident from para 80.1 to 80.4 of the circular, the consequential amendment under Section 153A was made to provide an increase in the period of assessment from a period beyond 6 years to a period of up to 10 years, subject to certain conditions, which were necessitated due to the removal of Clause (c) of Section 197 of the Finance Act 2016. This was obviously done by inserting the expression "...and for the relevant assessment year or years..." w.e.f. 01.04.2017 after the words "...six assessment years..." already existing under Section 153A prior to 01.04.2017. Simultaneously, the meaning of expression "relevant assessment year or years" was also provided for the first time under Section 153A(1) only w.e.f. 1.4.2017 as per which the expression "relevant assessment year or years" would have reference to only the additional period of 7th year to 10th year to rationalize the provisions of search assessment with provisions of IDS-2016. Thus, it is very clear that the expression "relevant assessment year or years" with certain new conditions was brought under Section 153A only with a view to tax the additional assessment years also from 7th year to 10th year w.e.f. 01.04.2017 considering the deletion of Clause (c) of Section 197 of the Finance Act 2016, without, in any way, affecting/ amending the original power to make assessment of the "six assessment years" which was already existing under Section 153A. Therefore, it is clear that the two expressions "six assessment years" and "the relevant assessment year or years" have been brought under Section 153A.

Further, a similar expression "and for the relevant assessment year or years" was inserted in the

Second Proviso to 153C also w.e.f. 1.4.2017 with the intention to merely align & harmonize all the provisions of 153C with 153A in view of the holistic scheme of assessment under Section 153A and 153C. Further, no separate meaning of this expression was assigned under Section 153C, thereby implying that the meaning and implications of this expression appearing under Section 153C would remain the same as in the case of 153A. Hence, by implication, wherever the “*relevant assessment year or years*” appear under Section 153C, they refer to the period of 7th year to 10th year for the purposes of Section 153C in line with similar reference as provided for 153A and accordingly to this extent only applicable equally for searches initiated after 1.4.2017 as in case of 153A. Therefore, the reference in para 80.7 in CBDT circular no 2/2018 in connection with amendments becoming applicable from 1.4.2017 for purposes of 153C also can be inferred to be applicable only to the limited extent of the amendment of the expression “*the relevant assessment year or years*”.

Though the expression “*...six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted...*” was not specifically mentioned under Section 153C(1) but this expression was appearing already in Second Proviso to Section 153C. Further, it was already provided under Section 153C(1) that the assessment can be made under Section 153C in respect of such other person ‘*for the relevant asst year or years referred to in Sub-section (1) of Section 153A*’. 153A(1) (b) *inter alia* provided to make assessment for the period of “*...six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted...*”. Thus, it was clear that the period of 6 assessment years for the purposes of 153A(1) would also be the same period of 6 assessment years for the

purposes of 153C(1) also and there could not be two separate yardsticks for reckoning period of 6 assessment years under Section 153A(1) and 153C(1) in order to make the assessments in case of searched person and ‘other person’ on the basis of documents seized in the exact same search. It is quite apparent that the interpretation made by legal forums, by relying upon the First Proviso under Section 153C to arrive at the relevant 6 assessment years from date of handing over when the Second Proviso under the same Section 153C as well under Section 153A is referring to reckon the period of 6 assessment years from the year of search only, was not as per the scheme of the Act. Therefore, in order to prevent the unintended and inconsistent consequences pouring over from the provisions of the Act, a curative amendment was made by the Finance Act 2017 by inserting the words “*six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted...*” just before the extant expression “*...and for the relevant assessment year or years*” under Section 153C(1) also. Furthermore, it is not the case that the above expression was brought under Section 153C for the first time only w.e.f. 1.4.2017. This expression has been existing under Section 153C even prior to 1.4.2017, as may be noted from the Second Proviso to Section 153C(1) inserted w.e.f. 1/7/2012, which provides enabling powers to the Central Government to make rules to prevent the AO from issuing notices under Section 153C for the “*six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted*”. It is important to note here that the Second Proviso to 153C clearly provided to reckon such period of six assessment years from the year in which the search is conducted for the purpose of enabling the central govt to

make rules in this regard. Hence, the Second Proviso to 153C itself w.e.f. 01.07.2012 already provided for the manner of computing the period of 6 assessment years, i.e., from year immediately preceding the previous year in which search is conducted, which *inter alia* is similar to the extant provision under Section 153A also. Therefore, even if the expression “six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted...” was inserted under Section 153C(1) w.e.f. 01.04.2017 but as this very expression was already appearing in Second Proviso to same Section 153C w.e.f. 01.07.2012, the curative amendment to this extent has to be read *ibid* to cure the defect and align and harmonize the provisions of Section 153C(1) with Second Proviso of Section 153C and to make it consistent and in *pari materia* with similar provisions of Section 153A also, as evident from para 80.6 of the Circular.

Accordingly, the reference in para 80.7 of the CBDT Circular No. 2/2018 in connection with the amendment to Section 153C being effective from 01.04.2017 has to be inferred in the limited context only to the extent that it refers to the newly inserted expression “*relevant assessment year or years*” under Section 153C w.e.f. 01.04.2017 and cannot, in any way, be inferred to be applicable to the expression “six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted”. Otherwise, the conflict between the same expression appearing in Second Proviso to Section 153C and the main Section 153C(1) cannot be resolved for periods prior to 01.04.2017.

Further, in spite of inserting the expression “... six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted...” under Section

153C(1), no simultaneous amendment was made in First Proviso implying and reinforcing the intention of the statute that the reference to 6 assessment years in First Proviso to Section 153C from the date of handing over was only for limited purpose of *abatement* as provided in Second Proviso to Section 153A and not in context of reckoning the period of 6 assessment years for purpose of making *assessment* under Section 153C(1). Hence, it is again clear that the amendment under Section 153C(1) inserting the expression “six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted” was merely clarificatory and curative, without bringing any substantive changes or creating any new conditions and as such amendment under Section 153C(1) has to be read into from the date from which the power to make assessment for 6 assessment years was originally provided under Section 153A itself.

Notwithstanding the above arguments, as para 80.5 of CBDT circular refers to the extended period of relevant assessment years from 7th year to 10th year only, the condition of the date of initiation of search after 01.04.2017 would be applicable in that context alone and not in any other context which is not covered by CBDT circular para 80.5

As already explained in earlier paras, the amendment under Section 153C(1) inserting the expression “six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted” is not only curative but also in the nature of a machinery provision without imposing any new conditions, denying any accrued rights or imposing disabilities to this extent as the powers to assess for six assessment years under Section 153C already existed prior to amendment also. As held by the Apex Court in case of *CIT vs. M/s Calcutta Knitweaves* 362 ITR 673(SC), it is trite

that while interpreting a machinery provision, the courts would interpret the provision in such a way that it would give meaning to the charging provisions and that the machinery provisions are liberally construed. Therefore, without prejudice to the earlier arguments, the amendment brought in the statute on 01.04.2017 to the machinery provision to the extent of inserting the expression “six assessment years immediately preceding the assessment year relevant to the previous year in which search is conducted” under Section 153C(1) being only clarificatory/ curative in nature, has to be given a construction so as to give the charging provision of Section 153C a purposive meaning, thereby implying that the amendment to this extent would always be applicable to all pending cases where the issue of notices under Section 153C was on or after 01.04.2017 irrespective of AY, as in the present case. If this interpretation is followed, then there shall remain no conflict between provisions of the statute and the clarification issued by CBDT in Circular No. 2/2018, at least to the proceedings commenced after 01.04.2017.

The foregoing arguments discussed in this article have remained to be considered by the Delhi High Court in case of *RRJ Securities* 380 ITR 612 (Delhi) in the correct perspective. Further, the amendment w.e.f. 01.04.2017 for the

purposes of curing the defect together with the CBDT Circular No. 2/2018 seeking to clarify the full and proper context of the amendments were not available at the time when the decision in *RRJ Securities* was delivered in 2015. Hence, the decision of Delhi HC in *RRJ Securities* (supra) is distinguishable. In fact, the department did contest the decision by filing the SLP against the decision of HC in *RRJ Securities*, however, the same got dismissed due to an incorrect tagging with another case on a different question of law, and consequently, no review was filed by the department because the tax effect was below the monetary limits as prescribed by the CBDT for filling SLP as evident from the CBDT letter F. No. ADG(L&R)-II/SCC/FTS No. 200304/2015/2019-20/4638 dated 25.09.2019. Hence, the decision of the Delhi High Court in *RRJ Securities* has neither been ratified by SC nor has it considered all the aspects of the law as discussed in this paper and clarified by the notifications thereafter.

Therefore, there is a definite ground to contest any view which holds the date of handing over for purposes of reckoning 6 assessment years under Section 153C(1) instead of date of search as provided under the law, in respect of searches prior to 01.04.2017 also.

Validity of Statement on Oath



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Executive Summary

Statements on oath are recorded by officers u/s 131(1) and 132(4) of Income Tax Act. The article analyses with the help of judicial pronouncements how to record proper statements backed by credible evidence without any threat or coercion. These statements serve as a crucial piece of evidence necessary for making sustainable additions in assessment.

In income tax proceedings, statements on oath are often recorded u/s 131(1) and 132(4) of Income Tax Act. Various judicial pronouncements have given analysed the extent to which these statements on oath can be relied upon. During the course of search, statement on oath is recorded u/s 132(4) of Income Tax Act, which is reproduced below:

“(4) The authorised officer may, during the course of the search or seizure, examine on oath any person who is found to be in possession or control of any books of account, documents, money, bullion, jewellery or other valuable article or thing and any statement made by such person during such examination may thereafter be used in evidence in any proceeding under the Indian Income-tax Act, 1922 (11 of 1922), or under this Act.”

CBDT vide Instruction F. No. 286/2/2003-IT (Inv. II) dated 10-3-2003 issued instruction

with regard to general confession of additional income during the course of search and seizure and survey operation which is reproduced below:

“Instances have come to the notice of the Board where assesseees have claimed that they have been forced to confess the undisclosed income during the course of the search & seizure and survey operations. Such confessions, if not based upon credible evidence, are later retracted by the concerned assesseees while filing returns of income. In these circumstances, such confessions during the course of search & seizure and survey operations do not serve any useful purpose. It is, therefore, advised that there should be focus and concentration on collection of evidence of income which leads to information on what has not been disclosed or is not likely to be disclosed before the Income-tax Department. Similarly, while recording statement during

the course of search & seizure and survey operations no attempt should be made to obtain confession as to the undisclosed income. Any action on the contrary shall be viewed adversely.

Further, in respect of pending assessment proceedings also, Assessing Officers should rely upon the evidences/materials gathered during the course of search/survey operations or thereafter while framing the relevant assessment orders.”

Statement on oath recorded u/s 132(4) of Income Tax Act carries substantial evidentiary value due to the fact that it is always recorded in the presence of two panchas who are required to be present during the entire search proceedings at the premises. It carries evidentiary value to a great extent even upon subsequent retraction by the person whose statement is recorded.

Recording of a perfect statement on oath is an art which requires experience as well as clear understanding of facts and law. The following points need to be kept in mind while recording of a statement on oath:

1. The purpose of recording a statement on oath is to collect and confront evidence to the assessee. It should never be used as a tool to harass or compel him to make any statement against his or her wishes. The statement must be recorded without undue pressure or coercion and in the presence of witnesses.
2. Any incriminating evidence found during the course of search or survey in the form of undisclosed assets or documents not recorded in regular books of account must be confronted to the assessee in statement on oath. The reason is that if the incriminating evidence is not immediately

confronted to the assessee, in subsequent proceedings the assessee may come up with concocted explanations on the guidance of counsels advising the assessee.

3. In search cases, penalty is leviable u/s 271AAB of Income Tax Act. The provision requires the assessee to admit undisclosed income, specify the manner in which such income has been derived as well as substantiate the manner in which the undisclosed income was derived for penalty to be leviable at lower rate of 10% of undisclosed income. In view of the penalty provision, it is essential that where the assessee admits undisclosed income, the assessee must be asked specific questions to specify the manner in which such income has been derived and to substantiate the manner in which the undisclosed income was derived.
4. In view of CBDT Instruction dated 10.03.2003, confessions of undisclosed income must be based upon credible evidence as far as possible.
5. Various courts have held that addition u/s 153A & 153C of Income Tax Act cannot be made in the absence of incriminating material. The incriminating material primarily consists of statement on oath as well as seized papers. In most search cases, the authorized officer is given a brief note containing the primary reason why the search is being conducted. The authorized officer must question the assessee in statement on oath with regard to details mentioned in the note which is largely based upon satisfaction for carrying out the search. It is possible that that the assessee has taken

accommodation entries but no evidence is found with regard to the entries taken. In such circumstances, properly recorded statement could immensely help in sustaining that addition. Hon'ble Supreme Court in the case of *Video Master vs. JCIT* [2015] 378 ITR 374 (SC) held that where addition on account of undisclosed income was based on statement of partner of assessee-firm, it could not be said that addition was based on no evidence.

6. There is no specific provision for recording of statement during survey u/s 133A of Income Tax Act. However, various high courts have upheld validity of such statements where they are backed by credible evidence. Some of these judgments are discussed below
7. It is the right of assessee to get copy of his statement on oath recorded. A copy must be provided to him at the earliest whenever requested for by the assessee
8. It is mandatory for the Assessing Officer to allow cross examination where statement on oath of another person is being used against any assessee. Failure to allow cross examination substantially reduces the evidentiary value of the statement on oath and is a violation of basic rights of the assessee
9. It has been observed that assessee frequently retract from their statements on oath recorded during search and survey. A properly recorded statement coupled with credible evidence found & seized would definitely stand the test of appeal even if the assessee retracts from the statement on oath recorded.

To be able to better appreciate validity of statements on oath recorded, it is important to consider some important judicial pronouncements in this regard. Some judgments where additions have been upheld based upon statements on oath recorded u/s 132(4) of Income Tax Act are discussed below.

Hon'ble Madras High Court in the case of *B. Kishore Kumar vs. DCIT* [2014] 52 taxmann. com 449 (Madras) held that where assessee himself stated in sworn statement during search and seizure about his undisclosed income, same was to be levied tax on basis of admission without scrutinizing documents. Operative part of the judgment is reproduced below:

“6. With regard to the undisclosed income of Rs.52,73,920/- supported by printouts, in the sworn statement dated 29.8.2006, the assessee says that he had separate business income which was not included in his income tax returns. Therefore, admission of undisclosed income of Rs.52,73,920/- is categoric and undisputed. The assessee in the sworn statement made on 10.10.2006, stated that outstanding loans to the tune of Rs.25 Lakhs to 30 Lakhs are to be recovered with interest at the rate of 18%. This is a clear admission. This amount has also been calculated and added as undisclosed income. When there is a clear and categoric admission of the undisclosed income by the assessee himself, in our considered opinion, there is no necessity to scrutinize the documents. The document can be of some relevance, if the undisclosed income is determined higher than what is now determined by the department. Moreover, it is not the case of the assessee that the admission made by him was incorrect or there is mistake. In fact, when there is a clear admission, voluntarily made, by the

assessee, that would constitute a good piece of evidence for the Revenue.

7. The learned counsel for the assessee relied upon a decision of the Delhi High Court in *CIT v. Girish Chaudhary*, [2008] 296 ITR 619 to plead that loose sheets of papers should not be taken as a basis for determining undisclosed income. However, in the case on hand, loose sheets found during the search are not the sole basis for determining the tax liability. It is a piece of evidence to prove undisclosed income. The printout statements of undisclosed income is not disputed by the assessee and in his sworn statements it is accepted. In fact, he admitted that outstanding loans to be recovered are in the range of Rs.25 Lakhs to 30 Lakhs. We find no error in the procedure followed by the Assessing Officer on admitted facts. The entire exercise by the department to bring to tax undisclosed income, we find has been generous and simple. There appears to be no confusion in the quantification of the tax liability and we uphold the order of the Tribunal.”

SLP filed in the case of *B. Kishore Kumar vs. DCIT* was dismissed by Hon'ble Supreme Court in Special Leave To Appeal (C) Nos. 9153 TO 9159 of 2015 reported in [2015] 62 taxmann.com 215 (SC)

Hon'ble Delhi High Court in the case of *Bhagirath Aggarwal vs. CIT (351 ITR 143)(Delhi)* held that an addition in assessee's income relying on statements recorded during search operations cannot be deleted without proving statements to be incorrect. Operative part of the judgment is reproduced below:

“11. Before us the learned counsel for the appellant contended that the statement made by an assess could always be subsequently retracted. He further submitted that it was

open to the person who made an admission to show that the admission was incorrect. For this proposition he placed reliance on a Division Bench decision of this Court titled *Ester Industries Ltd. v. CIT* [2009] 316 ITR 260/185 Taxman 266 (Delhi). However, that case was not one of search and seizure u/s 132 of the said Act. Furthermore, in the present case no material has been produced by the appellant/assessee to show that the admission made by him was incorrect in any way. On the other hand, it is the assessee who is insisting that it is for the department to corroborate the statement of admission made by him and until and unless the department corroborates the same, the statement cannot be relied upon. We are afraid that is not the correct position of law. The admission once made can certainly be retracted, if the circumstances permit, and it can also be shown to have been made under some mistake or to be otherwise incorrect. But, the onus would be on the maker of that admission. In this case it is the appellant/assessee who has admitted and surrendered a sum of Rs. 1.75 crore as his undisclosed income. It was incumbent upon him to show that he had made a mistake in making that admission and that the said admission was incorrect. He had access to all the documents which has been seized inasmuch as the copies had been supplied to him. However, he did not produce anything to establish that the admission was incorrect in any way. That being the position, the appellant/assessee cannot resile from his earlier statement made on 10-11.11.2005 and 21.11.2005.”

Hon'ble Delhi High Court in the case of *CIT vs. M.S. Aggarwal* [2018] 93 taxmann.com 247 (Delhi) held that where in course of block assessment proceedings, AO made addition to assessee's undisclosed income in respect of gift,

in view of fact that assessee did not even know donor personally and, moreover, he himself in presence of his Chartered Accountant had made a statement under sec. 132(4) admitting that said gift was bogus, impugned addition was to be confirmed. Operative part of the judgment is reproduced below:

“32. Confessions are important for when voluntarily made there is a presumption that no person would make a statement against his interest unless it is true. Therefore, courts have to be cautious and careful that the confession recorded was voluntarily and not obtained under coercion and by force and wrongful inducement. Force and coercion are not synonymous and cannot be mixed and equated with mere anxiety and stress due to search and seizure operations, or inducement propelled by remorse and atonement to make an admission and confess a wrong. Motive of the person making the admission to gain indulgence, advantage or avoid evil of a temporal nature, cannot be treated as equivalent to inducement, coercion or fraud. Whether a confession is voluntary or induced by force, threat, coercion and wrongful inducement would primarily be one of fact, albeit any judicial verdict and decision on the issue must take all relevant facts and circumstances of the case into consideration and should not be guided by mere pre-ordained impressions. Factors like time of retraction, nature and manner of retraction etc. are relevant. Mere retraction does not make or proves that the admission was obtained by inducement, threat etc. Further, prudence requires that the court would examine the truthfulness and correctness of the admission when admissions are accepted and relied. Corroboration by attending circumstances may be justified. [See K.T.M.S.

Mohd. v. Union of India [1992] 65 Taxman 130/197 ITR 196 Telstar Travels (P.) Ltd. v. Enforcement Directorate [2013] 9 SCC 549, Adambhai Sulemanbhai Ajmeri v. State of Gujarat [2014] 7 SCC 716 and Seeni Nainar Mohammed v. State [2017] 13 SCC 685)].

“34. A gift is given out of natural love and affection to a person who is close to the donor or for the purposes of charity. Plea of charity has not been raised in this case. There is no evidence or even an indication as to how the respondent-assessee knew the donor, a well known businessman, who gave the gift to the respondent-assessee. In view of the aforesaid discussion, we have no hesitation in holding that the gift in question of Rs.50,00,000/- purportedly received by the respondent/ assessee from Mr. Rama Pati Singhania was a procured one and the admissions/confession made as recorded in the statements dated 25th November, 1999 and 6th January, 2000 are trustworthy, true and correct. Finding of the Tribunal on accepting the gift as genuine is contrary to law being perverse and contrary to facts and material on record.”

Hon'ble Delhi High Court in the case of Smt Dayawanti vs. CIT [2017] 390 ITR 496 (Delhi) held that where inferences drawn in respect of undeclared income of assessee were premised on materials found as well as statements recorded by assessee's son in course of search operations and assessee had not been able to show as to how estimation made by Assessing Officer was arbitrary or unreasonable, additions so made by Assessing Officer by rejecting books of account was justified. Operative part of the judgment is reproduced below:

“18. The nature of the books included katchaparchas, papers containing calculations and amounts routed to bank accounts of

various members of the family, sums receivable towards business, etc. They also included documents relating to purchase of property. The statements were made under oath on 18-04-2006 and 03-05-2006. No doubt, they were not during the course of search. Yet, they were made voluntarily. There was no allegation ever that the assessee or any of her family members, including Abhay and Varun Gupta, who made the main statements under oath, were pressurized to do so; there was in fact no contemporaneous retraction. Indeed, the assessee appears to have resiled from the statement, only through the returns, filed after receipt of notice under Section 153A. The probative value of these statements is to be seen not from only whether it was allowed to stand, or whether it was resiled from. The stage when such statement is resiled, whether the assessee was able to give any explanation for the statement, its connection with the material seized, all are relevant, in the opinion of the court, to judge if it is to be considered in an assessment. In other words, there cannot be a rule carved in stone, as it were, that statements that are resiled cannot be considered at all.

20. The lynchpin of the assessee's submissions on this aspect is also that the statements were not recorded during the search but later and that they cannot be considered of any value. This court is un-persuaded with the submission. The search was conducted on 22-03-2006. Various materials: documents, agreements, invoices and statements in the form of accounts and calculations were seized. On 18 April 2006 and 3 May 2006, the assessee's sons (including one of the appellants, Abhay Gupta) recorded statements under oath; the assessee too made her statement under oath, admitting that

though returns were filed ostensibly on her behalf, she was not in control of the business. She and all other family members made short statements and endorsed the statements under oath, of those who elaborated the trading and business operations relating to clandestine income. These statements under oath were part of the record and continued to be so. They were never explained in any reasonable manner. Their probative value is undeniable; the occasion for making them arose because of the search and seizure that occurred and the seizure of various documents, etc. that pointed to undeclared income. In these circumstances, the assessee's argument that they could not be acted upon or given any weight is insubstantial and meritless."

However, Hon'ble Supreme Court stayed the operation of above Hon'ble Delhi High Court order in the case of Smt Dayawanti vs. CIT in Special Leave to Appeal (C) No. 20559/2017 vide order dated 03.10.2017.

Statement on oath is often recorded in compliance of summons issued u/s 131(1) of Income Tax Act. The relevant provision is reproduced below:

“Power Regarding Discovery, Production of Evidence, etc.

131. (1) The [Assessing] Officer, [Deputy Commissioner (Appeals)], [Joint Commissioner] [, Commissioner (Appeals)] [, [Principal Chief Commissioner or] Chief Commissioner or [Principal Commissioner or] Commissioner and the Dispute Resolution Panel referred to in clause (a) of Sub-section (15) of Section 144C] shall, for the purposes of this Act, have the same powers as are vested in a court under the Code of Civil Procedure, 1908 (5 of 1908), when trying a suit in respect of the following matters, namely:—

- a. discovery and inspection;
- b. enforcing the attendance of any person, including any officer of a banking company and examining him on oath;
- c. compelling the production of books of account and other documents; and
- d. issuing commissions.”

There are no specific provisions for recording statement on oath during survey. However, summons are issued and statement on oath is recorded in compliance of the summons. Sometimes a simple statement is recorded during survey which has limited evidentiary value. Some judicial pronouncements in this regard are discussed below.

Hon'ble Bombay High Court in the case of *Pebble Investment and Finance Ltd vs. ITO* in Income Tax Appeal No.988 of 2014 held that statement made u/s 133A can be relied upon for purposes of assessment, in absence of any contrary evidence or explanation as to why such statement made is not credible. Operative part of the judgment is reproduced below:

“9. We note that a statement made under Section 133A of the Act is not bereft of any evidentiary value. The same may not be conclusive but in the absence of any contrary evidence or explanation as to why the statement made under Section 133A of the Act is not credible, it can be acted upon. The decision of Madras High Court in CIT v/s. S. Khader Khan Son reported in 300 ITR 157 as upheld by the Apex Court, is not of any assistance to the Appellant. In the facts before the Court in S. Khader Khan (supra), the person who made the statement under Section 133A of the Act had retracted it before the Assessment Order was passed. Moreover, in the absence of the the Appellant-Assessee offering any

explanation as to why the statement cannot be relied upon, no fault can be found on the reliance upon the statement of the Director of M/s. Omega. Further, so far as request for cross examination is concerned, we find that Appellant-Assessee, during the first round of proceedings before the Assessing Officer did not raise any such issue. At that point of time, the person who make the statement, could have been produced by the Assessing Officer. It was only in the second round of proceedings when the Appellant-Assessee was not able to contact the Director of M/s. Omega, that they came up with a request for his cross examination. Therefore, the submission on part of the Appellant that the delay has led to it being unable to produce evidence is of no avail as the delay was in seeking cross examination by it. Further, the documents which were produced were considered along with and/or the facts viz: nonproduction of vital documents. This coupled with the fact that the owner of the Furnace i.e. Appellant did not have any knowledge about its whereabouts at the time of adjudication.”

SLP filed in the above case of *Pebble Investment and Finance Ltd vs. ITO* was dismissed by Hon'ble Supreme Court in Petition(s) for Special Leave to Appeal (C) No(s).11784/2017 vide order dated 05.07.2017.

Hon'ble Delhi High Court in the case of *Raj Hans Towers (P.) Ltd. vs. CIT (373 ITR 9)(Delhi)* held that where assessee had not offered any satisfactory explanation regarding surrendered amount being not bona fide and it was also not borne out in any contentions raised before lower authorities, additions so made after adjusting expenditure were justified.

Operative part of the judgment is reproduced below:

“10. In the present case, the admitted facts are that during the survey, a Director of the assessee - who was duly authorized to make a statement about the materials and the undisclosed income, did so on 20.11.2007. The Company did not retract it immediately or any time before the show cause was issued to it. For the first time, in reply to the show cause notice it faintly urged that the statement was not voluntary and sought to retract it. The reply, a copy of which has been placed on record, undoubtedly makes reference to some previous letter retracting the statement. Learned counsel urged that that letter was written on 21.12.2007. However, the actual reply to the show cause notice is silent as to the date. This itself casts doubt as to whether the retraction was in fact made or was claimed as an afterthought.

11. Furthermore, this Court is of the opinion that in the circumstances of the case both the CIT (A) and ITAT were correct in adding back the amount of Rs. 63,33,260/- after adjusting the expenditure indicated. The explanation given by the assessee, in the course of the appellate proceedings, that the surrender was in respect of a certain portion of the receipt which had remained undisclosed or that some parts of it were supported by the books, is nowhere borne out as a matter of fact, in any of the contentions raised by it before the lower authorities. For these reasons, this Court is of the opinion that no substantial question of law arises. The appeal is accordingly dismissed.”

Hon'ble Delhi High Court in the case of *PCIT vs. Avinash Kumar Setia* [2017] 81 taxmann.com 476 (Delhi) held that where assessee surrendered certain income by way of declaration and withdraw same after two years without any satisfactory explanation, it could not be treated

as bona fide and, hence, addition would sustain. Operative part of the judgment is reproduced below:

11. There was no statement of the assessee recorded during the survey under Section 133A. The assessee voluntarily made a declaration two months after the survey. There was absolutely no compulsion on the assessee to make such a declaration. The assessee waited for two years to resile from the said declaration. The submission of the assessee that since he had filed a return on 26-9-2009 without disclosing the sum of Rs. 1.25 crores, he should be deemed to have resiled from the said declaration cannot be accepted. The retraction in writing happened only on 16-12-2010. It was much too delayed to be taken to be bona fide. The circumstances under which the retraction was made has also not been explained. It was found that the above retraction, without any explanation whatsoever, and without mentioning the offer of surrender of Rs.1.25 crores made earlier on 18-12-2008 is not a retraction at all in the eyes of law.

16. The Court is not satisfied that the retraction made by the assessee two years after the declaration was bonafide. There was no satisfactory explanation for not including the said amount in the return of income filed by the Assessee on 26-9-2009.

17. In the circumstances, there was no justification whatsoever for the Tribunal to have deleted the additions made by the Assessing Officer which were upheld by the Commissioner (Appeals). The question framed is answered in affirmative.

Assessing officers are frequently faced with cases where there is retraction of statements recorded

u/s 132(4) or 131(1) of Income Tax Act. In these situations, the most important factors which need to be considered are as follows:

- i. The documentary evidence seized or impounded in support of statement on oath recorded. Hence, there should be focus and concentration on collection of evidence of income during search and survey.
- ii. The delay in retraction i.e. the time period elapsed between recording of statement and retraction there from.
- iii. Whether there was any undue pressure applied during recording of statement and presence of evidence in this regard.

Some important judicial pronouncements with regard to retraction of statements on oath are discussed below.

Hon'ble Gauhati High Court in the case of *Greenview Restaurant vs. ACIT* [2003] 263 ITR 169 (Gauhati) upheld validity of statement on oath despite retraction since the assessee failed to prove that there was any threat, inducement or coercion. Operative part of the judgment is reproduced below:

9. The primary facts pertaining to the search of the premises of the appellant-firm and its other groups on September 22, 1993, and the recording of statements of Baban Singh, its partner, are admitted. The appellant's objection is that the statements were recorded by using force and coercion on its said partner.

This was on September 23, 1993, in the presence of two witnesses. The retraction of the statement came only on December 24, 1993, followed by a reiteration on the part of the appellant on February 20, 1995, in the course of the assessment proceeding. There is

evidently a delay on the part of the appellant and its partners in retracting the statements re-corded. The attention of this Court has not been drawn to any material on record to establish that any attempt was made on behalf of the appellant to prove the allegation of inducement threat or coercion through the witnesses. We have examined the impugned orders rendered by the learned Tribunal with the reasonings in support of its finding against the complain of threat, inducement or coercion and we find no good and sufficient reason to differ from it. In our view, in the facts and circum-stances of the case, having regard to the materials on record, the appellant has failed to establish that the statements of its partner, Baban Singh, had been recorded in the course of the search by using coercion, threat or inducement. We, therefore, dismiss the contentions advanced by the learned senior Counsel for the appellant in this regard and affirm the conclusion on the learned Tribunal on this count."

Hon'ble Chhattisgarh High Court in the case of *ACIT vs. Hukum Chand Jain* [2010] 191 Taxman 319 held that when assessee did not retract his statement immediately after search and seizure was over and in return also no explanation was offered for surrender of undisclosed income at time of search and seizure operations under Section 132(4), it could be said that assessee had failed to discharge onus of proving that confession made by him under Section 132(4) was as a result of intimidation, duress and coercion or that same was made as a result of mistaken belief of law or facts.

Hon'ble Delhi High Court in the case of *PCIT vs. Avinash Kumar Setia* [2017] 81 taxmann.com 476 (Delhi) held that where assessee surrendered certain income by way of declaration and withdraw same after two years without any

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satisfactory explanation, it could not be treated as bona fide and, hence, addition would sustain.

Hon'ble Delhi High Court in the case of *Raj Hans Towers (P.) Ltd. vs. CIT (373 ITR 9)(Delhi)* held that where assessee had not offered any satisfactory explanation regarding surrendered amount being not bona fide and it was also not borne out in any contentions raised before lower authorities, additions so made after adjusting expenditure were justified.

In view of the above discussion, it can be concluded that recording a statement on oath is an important part of search and survey operations. Due care must be taken to ensure that there is no threat or coercion to the assessee and seized material is duly confronted to the assessee. Proper recording of statements backed by credible evidence would go a long way in making sustainable additions that are able to stand the test of appeal !!!

Mohini Mills Limited: An Unforgettable Legacy



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Shri Chandra Prakash Bhatia, Additional Commissioner, is an IRS Officer of 2006 Batch. He has served in various

units of Income Tax Department. He has been posted mostly in Bihar and Jharkhand and West Bengal. Though a science graduate, he has special interest in studying the 'Medieval Financial History'. For last three years, he served in Gujarat and had a close view of the art, culture and history of this area. He is a member of the Editorial Board of Taxalogue. At present, he is posted as Additional Commissioner (Technical Unit), ReAC, Kolkata.

Executive Summary

Mohini Mills Limited was a commercial enterprise, established by Baboo Mohini Mohan Chakraborty after his retirement from Civil Service. It is a tale of entrepreneurship and out of box thinking of a bureaucrat. The enterprise boosted the Swadeshi movement in the country. It has set an example of development of indigenous industries in a very backward district. Baboo Mohini Mohan Chakraborty and his descendants made a notable contribution to the development of cotton textile industry and will be remembered as a milestone in financial history of India as well as Bangladesh. Apart from the financial history, Mohini Mills Limited, became immortal by signing its presence in art, literature and films. The article throws light on the glorious history of fabrics of Bengal as well history of Kushtia, which is now a district in Bangladesh. Kabuguru Rabindranath Tagore was once borne as a special nominee to the Board of this company. It is difficult to realize how the ordinary threads can weave a fantastic fabric called human life.

“A great brand is a story that is never completely told.”

—Scott Bedbury
Branding Consultant

In early 20th century Bengal, Mohini Mills Limited and its product became a household name in the erstwhile Bengal and held a place of pride in public psyche, breezed through the literature, films and traditions. Mohini Mills Limited was a commercial enterprise, in which poet-laureate Rabindranath Tagore was borne as a special nominee to the Board. Isn't it strange that the

name of the company found a mention in a great novel: *Sahib, Bibi and Golam* written by another great Bengali writer, Bimal Mitro.

Mohini Mohan Chakraborty, the founder of Mohini Mills Limited, was born in a pure Brahmin family at Elangi Para, Nadia (old) on 6 July 1838. His father, Krishnalal Chakraborty, was an employee of the Bengal Police Department. Mohini Mohan Chakraborty was the eldest of the five brothers and a sister. His performance at Government School in Burdwan from 1852 to 1857 was extraordinary. His first job was as a clerk in Kushtia sub-divisional office.

Sir Alexander McKenzie, Sub-Divisional Magistrate of Kushtia Sub-division, and Sir W. W. Hunter, a high ranking civil servant of Bengal, were impressed by Mohini Chakraborty's work. Inspired and guided by such mentors, wheels of Mohini Baboo's life began to run in fast lane. He appeared for the post of Deputy Magistrate and qualified. His first posting was as the Deputy Magistrate and judge of Noakhali. He was judicious and never convicted any accused unless full evidences required it. Once he had to face the wrath of superior, when despite Collector's recommendation, he acquitted an employee, charged for embezzlement. As a District Magistrate, he was famous for his equitable and analytical presentation. He also served in Faridpur, Ara, Bhabhua and retired as District Magistrate of Bhagalpur.

On retirement, he was entitled to a handsome pension. Still beaming with energy, he ventured into the unchartered area of cotton industry. He pooled his lifelong savings and pension for the purpose of the cotton textile project in 1905-06. A wave of Swadeshi movement was sweeping India, resulting in development of indigenous industries. Baboo Mohini Mohan Chakraborty and later his descendants made a notable contribution to the cotton textile industry in Eastern India.

It may be pointed out that first modern cotton textile mill in Ahmedabad was set up by Ranchhodlal Chhotalal, a Gujarati, in 1858. Ranchhodlal Chhotalal had similarities to Baboo Mohini Mohan. Both were Brahmins and retired civil servants. Bengal entered in the cotton growing and processing quite late as compared to the Western India. Eastern India was quite competitive in some other industries as tea, jute, mining and metallurgy.

In 1905-06, Baboo Mohini Mohan Chakraborty started with eight looms in his home at Kushtia,

in Nadia. The looms were driven with oil engines. In those days, especially in Eastern India, it was a bold venture for a first generation entrepreneur. He sent two of his sons to Ahmedabad and Bombay to learn techniques of the cotton textile industry. Kushtia had twin advantage of river travel as well as improved rail connectivity. A rail line from Calcutta to Kushtia was operative as early as in September 1862. Soon, in 1908, mill expanded over 100 acres of land in Milpara area. He imported 200 brass handloom machines and looms from England.

Three of his four sons were completely engaged in cotton industry as Managing Agents. One son was a lawyer in Bhagalpur Judges' Court. The name of the sole proprietorship mill was CHAKRABORTY BROTHERS. Soon it was converted to a company, named Mohini Mills Limited. During the initial stage, two Gujaratis helped the company in managerial and marketing procedures. One was Keshavlalji Mehta and the other was Wadilalji Shah. The later was also a partner in Chakraborty Brothers for some time.

Mohini Mill Ltd. was registered as a public limited company with a nominal capital of Rs. 1,50,000 divided into 600 shares of Rs. 25 each. Within six months of the registration, three-fourth of the share capital was purchased by the investors of Barisal, Sylhete, Dacca, Chittagaon (now all in Bangladesh), Patna and Rangoon. Investors of Kushtia, where the registered office was situated, were proud of it. In the first ordinary general meeting on the 18th August 1908, a Board of Directors was constituted, consisting of following 14 gentlemen, some were well known across the country.

These Were: Baboo Mohini Mohan Chakraborty, Madhab Chandra Roy, Behari Lal Sen, Kalidas Nandi, Chandramoy Sanyal, Chandicharan Chattopadhyaya, Satyendra Nath Roy, Tara Pada

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Mazumdar, Gokul Chandra Mandal, Purna Chandra Roy (brother of Prafulla Chandra Roy) and Mahammed Rowson Khan Chowdhury. Three extraordinary members graced the board, namely, Raja Pramatha Bhushan Deb Roy Bahadur (a royal of Naldanga who had a large estate in Kushtia), Jagat Kishore Acharya (a zamindar of Mymensingh district) and *Rabindra Nath Tagore*¹, who had a family estate there.

The mill produced 500 pairs of dhotis and sarees per day. The authorized capital was increased from Rs. 1,50,000 to Rs. 2,00,000 in 1910 and then to Rs. 6,00,000 in 1918. The company declared dividends continuously during 1912 to 1918, except for the year 1914–15. Mohini Mills produced fancy cotton goods, dhoties, sarees, bed-sheets, markins, twills, and hospital requisites such as bandages, and gauge cloths, as also grey and coloured yarns, many of which had a large demand in Bengal and outside. An efficient management and diversified products helped it achieve remarkable progress. The thick cloth made a niche product. The other competitors were Bang Laksmi Cotton Mills Ltd. and Dakeshwari Cotton Mills Limited.

In 1920, allowing advantage to the British goods, the government imposed the excise duty on Indian goods in a discriminatory manner. Such a tax was also detrimental to the growth of Swadeshi cotton industries. One of the worst victims was the hosiery industry where the government imposed a levy of excise duty on its products, despite the fact that hosiery factories had to pay import duty for yarns. Moreover, Mohini Mills had to pay a 5% customs duty on the ad valorem rate of yarn imported from Manchester including the weight of tubes also being included. As a result, the effective import duty was more than 5%. Despite this, it survived due to its goodwill and sound consumer support.

¹Swadesi Enterprises in Bengal, 1900–1920 by Amit Bhattacharya, 1986



Fig. 1: Baboo Mohini Mohon Chakraborty



Fig. 2: A Certificate of Mohini Mills Ltd

Within his mill complex, Mohini Baboo built a theatre called ‘Sandhya Samiti’ to entertain the employees. A library was established, keeping in line with the Bengali inclination for literature. A football team was also formed and at that time, the football team of Mohini Mill was skilled enough to compete with the Calcutta team.

Apart from Mohini Mills Limited, Kushtia has been famous for the Shrine of King of Bauls, Lalon Fakir (1774–1890) and Tagore’s ancestral house, named the ‘Kuthibari’. Poet-laureate Tagore lived here and wrote many unforgettable poems/stories like *Sonar Tori*, *Katha o Kahini*, *Chitra*, *Chaitali*, etc. while managing his zamindari. The ‘Kuthibari’ is now a museum.

In one of his famous poems, *Bansi*, Kabiguru has described how a male character is thinking of his dream girl, “In the yard, one who is waiting, she is wearing her ‘Dhakai Sari’, with vermilion on her forehead.”



Fig. 3: Kabiguru Rabindranath Tagore



Fig. 4: Kuthibari Ancestral Tagore House in Shilaidaha, Kushtia

Kushtia has a history of Indigo Resistance Movement. In 1835, Lord Macaulay had mentioned about it in a report to the Indian government. The cultivators narrated how

oppressions were going on against them. J. Morris of Indian Civil Service came to investigate, since paying taxes was stopped. Lt. Governor Sir J.P. Grant recorded in his diary in 1860. Numerous cultivators in 1860 cultivated indigo. It spread in Bengal in 1860 and Shalghar Madhua organized the largest movement around Kushtia. The peasants of Jessore-Kushtia region revolted. Their leaders were Pari Sundari (a lady zamindar), Titu Mir and Haji Shariatullah. A folk-song of the nineteenth century depicts the mighty roles of these peasant leaders. Subsequently, with the publication of the Indigo Commission Report, an Act was passed prohibiting coercion of cultivators for indigo cultivation.

Before machine-made cotton arrived, the area was famous for jute and indigo. Surrounding places were well known for world-class luxury fabrics like 'Muslin' and 'Jamdani sarees'. Henry Glassie, a famous researcher on folklore arts described Bengal's weaving and embroidery, Jamdani is also popularly known as the Dhakai Saree. Description of such wonderful cloth is found in Chanakya's *Arthshashtra* (3rd century BC) and the Greek book of a traveller's account named *Periplus of the Erythraean Sea*. (Compiled between 1–3rd centuries).

Baboo Mohini Mohan Chakraborty died at the age of 84 in 1922. The mill marched ahead with increased capital and innovative products. It produced 1000 pairs of dhotis and sarees of different colours and varieties. The company set up modern machineries consisting of 10,000 spindles and 300 looms. A unit was established in the suburbs of Calcutta also, which produced items like dhotis, long cloth, sarees, mosquito nets, bed-sheets and shirting. All such products were immensely popular due to high quality and competitive pricing. Though Belgharia unit was larger, yet it was controlled from Kushtia Bazar, Nadia, its head office.

The annual statement of Mohini Mill for the year 1942 revealed that new modern machineries and equipments were installed in its factories No. 1 and No. 2. Despite Second World War, the company made profit worth Rs. 35.62 lakhs and paid dividend @ 25%. Its average rate of profit during the year 1938–55 was more than 13%. After the partition of Indian Dominion, its No. 1 Mill bearing the same name existed in Pakistan (Kushtia, now in Bangladesh) and No. 2 in Belgharia, Calcutta continued its work. Chakraborty Sons and Company was the managing agent with registered Office at 22, Canning Street (Biplabi Rash Behari Bose St.) Calcutta and exported goods to various countries like Pakistan, Nepal, Myanmar and Shri Lanka. After Independence, most of the units came under Eastern Pakistan.

At the peak of its journey, the authorized capital was Rs. 60 lakhs and subscribed capital was Rs. 59,98,818 and it had 48,460 total spindles and 975 looms and produced the different varieties of clothes for the common needs. Upto 1963, the company operated in profit, and paid dividend and income-tax regularly. Mohini Mills Limited faced bad days in 1965, as a war broke out between India and Pakistan. It was declared an enemy (vested) property by Pakistan and owners were forced out of country. It was taken over along all its assets consisting of land, machinery, school, temple, playground, pond, market and hospital by Eastern Pakistan Industrial Development Corporation.

After creation of Bangladesh, Mohini Mills was nationalized and taken over by Bangladesh Textiles Mill Corporation and operated in loss. Bangladesh Government auctioned off the mill and it was renamed as Shah Makhdum Mill in 1985. In 1990 Government again took it over but

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the mill has failed to regain its past glory. People of Kushtia still take pride on its golden days.

Calcutta High Court records show details of a case, *Mohini Mills Ltd. vs. Susama Debi and Ors.* on 22 December 1924. Its citation is (1925) ILR 52 Cal 586. This case was preferred under Section 12 of the Companies Act 1913. It was presided over by the Bench having Justice J. Suhrawardy and Justice Cuming. The case was dismissed due to lack of jurisdiction. Justice J. Suhrawardy was the father of H.S. Suhrawardy, who became the fifth prime minister of Pakistan in 1956 and held office for about one year.

Every Bengali of that era had used the fabrics of Mohini Mills. During its golden period, it produced not only fabrics but also various items like 'Sindoor', used by Hindu women as a symbol of being happily married. The mill found a mention in the great novel named *Shaheb, Bibi, Golam* written by Bimal Mitro in 1953. Gurudutt produced a film on this novel, which was released in 1962. The story centres on Bhoothnath (Gurudutt) and Choti Bahu (Meena Kumari). Bhoothnath (Gurudutt) is an accountant in Mohini Sindoor factory. In the film, Meena Kumari asks Gurudutt for 'Mohini Sindoor', which is believed to have the power to bring drifting men back to their wives. The role of Choti Bahu's husband was played by Rahman. The film won many national awards.



Saheb, Bibi Golam by
Bimal Mitro



Sahib, Bibi aur Ghulam
film poster- (courtesy
Guru Dutt Films Pvt Ltd)

**Fig. 5: Book Cover Courtesy-Mitra & Ghosh
Publishers Pvt. Ltd**

At present Mohini Mills in Bangladesh is inoperative and has huge outstanding liabilities. The bricks of Mill No. 2 at Belghoria, Kolkata are being stolen and sold at a premium on which word 'Mohini' in Bangla can be seen. The ghostly building seems to be weeping on its fate and people passing by appear oblivious of its past glory.

The film *Sahib, Bibi aur Ghulam* had melodious songs composed by Shakeel Badayuni. Songs were musically decorated by Hemant Kumar and sung by Asha Bhosle. In one of the dance song (आज मुझे नींद नहीं आएगी), lines in third stanza seem to be describing the Mill's present fate, "Kiski duniya yahan tabah nahi, Kaun hai jiske lab per aah nahi".

Traditional Transaction Methods in Transfer Pricing: An Appraisal



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-tax (Appeals) at Raipur in the state of Chhattisgarh. He is an MBA and has recently done a LLM in international tax laws from Kings College, London. The officer has worked at various levels in assessment, corporate, investigation, and in the appellate charges in the department. He delivered lectures as guest faculty on various provisions of the Income-tax Act to the LLB students at Hidayatullah National Law University, Raipur.

Executive Summary

Transfer Pricing provisions in Chapter X of the I-T Act 1961 entitled Special Provisions Relating to Avoidance of Tax enables the Transfer Pricing Officer in determining the Arm's Length Price (ALP) in relation to an international transaction between Associated Enterprises commonly referred as controlled transaction, by using the Most Appropriate Method (MAM) from the prescribed methods under Section 92C (1) of the Act. This article examines the traditional methods such as Comparable Uncontrolled Price Method (CUP), Cost Plus Method (CPM) and Re-sale Price Method (RPM) known as direct methods, their relative strengths and weaknesses, conditions and circumstances in which they are applied in determining the ALP. The importance of Functions, Assets and Risks (FAR) have been underlined in the selection of comparables and their impact on comparability analysis. Importantly, the influences of the OECD and UN transfer pricing guidelines have been discussed along with the areas of differences in approach with the provisions of the I-T Act 1961. Analysis undertaken are supported by judicial pronouncements of various courts including that of other countries. The article suggests that accuracy of comparability analysis in determining the ALP is enhanced by a clear understanding of the controlled transactions, right selection of comparable cases, and by adopting the most suitable or appropriate method.

In this article, we examine the traditional transaction methods in Transfer pricing such as Comparable Uncontrolled Price Method (CUP), Re-sale Price Method (RPM) and Cost Plus Method (CPM), their utility, strengths and constraining factors in their application. For making a comparability analysis, which is the core for arriving and applying the Arm's length Principle, we have touched upon the importance

of products, functions, assets and risks in similar circumstances of the comparable entity selected for the analysis. The impact of the OECD and UN transfer pricing guidelines on the TP provisions in India have been discussed along with the differences in approach. Observations and analysis made are supported by case laws on specific issues, which have helped in fine-tuning the clarity and application of the

traditional methods. The article is illustrative and by no means exhaustive on the subject and will be followed by the second part dealing with transactional profit methods.

Transfer pricing was introduced by the Finance Act 2001 and came into force from April 2002. It appears in Chapter X of the Income Tax Act 1961 (the Act) entitled 'Special Provisions Relating to Avoidance of Tax'. Though the title of the chapter relates to avoidance of tax, the Assessing Officer is required to examine the international transactions between the associated enterprises (AEs) and not avoidance of tax as was held by the Bangalore Special Bench in the case of *Aztec Software & Technology Services* (107 ITD 141) for referring the case to the Transfer Pricing Officer (TPO) for determining the Arm's Length Price (ALP) of the transaction under Section 92CA (1) of the Act. Transfer pricing provisions enables the assessing authorities to examine the price paid for goods and service between related enterprises in a controlled transaction (in their commercial or financial relations) by using the prescribed methods for determining the Arm's Length Price of the controlled transactions. The ALP refers to the price which is applied or proposed when unrelated or independent enterprises enter into similar transactions under market conditions or uncontrolled conditions. The Arm's Length Principle follows the approach of treating the members of a MNE group as operating as separate entities, as if they were independent entities rather than constituents of a single unified business and focusing on the nature of transactions between them and whether the conditions differ from the conditions that would be seen in comparable uncontrolled transactions. A comparability analysis remains the key for determining and applying the ALP and must take into account Functions, Assets and Risks (FAR) which must be the same under

similar circumstances of the comparable entity selected for making the comparability analysis. In some methods, the product similarity assumes significance in addition to the FAR, as we shall see below. There are two broad categories of methods, Traditional transaction methods and Transactional profit methods for determining the Arm's Length Price between associated enterprises in a controlled transaction. We examine the traditional transaction methods in this study.

The Comparable Uncontrolled Price method (CUP), Resale Price Method (RPM) and the Cost Plus Method (CPM) are regarded as the traditional transaction methods. The OECD regards them as the most direct means of establishing whether the conditions in the commercial and financial relations between associated enterprises are at Arm's length¹. The 1995 OECD Transfer Pricing Guidelines preferred the traditional transaction methods over the transactional profit methods² such as the Transactional Net Margin Method and Transactional Profit Split Method and treated them as methods of the last resort but in 2010 this hierarchy was eliminated and replaced by the principle of Most Appropriate Method (MAM) to the circumstances of the case.³ However, the OECD prefers the CUP method over the others if applicable in an equally reliable manner.⁴

On the other hand, the *UN Manual on Transfer Pricing* does not accord preference for particular methods,⁵ it lays down that the most suitable method should be chosen taking into considerations facts and circumstances, type of

¹OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*, OECD 2017, [2.3]

²Ibid [2.49]

³Kofler G, "Article 9' Associated enterprise" in Reimer and others (eds) *Klaus Vogel on Double Tax Conventions* (Wolters Kluwer 2015) p 653.

⁴Ibid.

⁵United Nations, *Practical Manual on Transfer Pricing for Developing Countries* (2017), [B.3.1.3.2]

transaction, functional analysis, comparability factors and possibility of making adjustments to the data to enhance comparability.⁶ In the Transfer Pricing provisions in India, the ALP must be determined by the MAM as prescribed under Section 92C of the Act read with rules 10B of the Income-tax Rules and CBDT Circular No. 6/2013 of 29 June 2013. Similar to the UN Transfer Pricing guidelines, the Transfer Pricing Provisions in India do not emphasize the use of any particular method over the other, no hierarchy of methods is prescribed but place the burden on the taxpayer to select the MAM,⁷ by furnishing comparable transactions and relevant material and documents,⁸ the selection of the method must be justified on some sound reasoning and must demonstrate that the method so selected is the most appropriate.⁹ There is no need to demonstrate why other methods are eliminated because once a method is selected as the MAM, some methods will be easily eliminated as not being the MAM based on simply a high level analysis of the comparability factors¹⁰ on a transaction basis and not on aggregate basis and comparing the margins of associated enterprises with that of unrelated enterprises.¹¹ Recently, in most of the Transfer Pricing study reports the taxpayers are enumerating their reasons for preferring a specific method and also explain why other methods are unsuited. However, when the taxpayer has chosen a MAM and has substantiated the choice in its TP study, the onus is on the TPO to record and substantiate reasons as to why the taxpayer's MAM is incorrect and some other method needs

⁶Ibid.

⁷*Aztec Software & Technology Services Ltd vs. Assistant Commissioner of Income-tax* [2007] 107 ITD 141 (Bang SB).

⁸Ibid.

⁹*Serdia Pharmaceuticals (India) (P) Ltd v Asst CIT* [2011] 44 SOT 391 (Mum Trib.).

¹⁰Kofler, op.cit. note n*3, p. 654.

¹¹*Development Consultants (P) Ltd vs. Dy. CIT* [2008] 23 SOT 455 (Kol. Trib.).

to be the MAM.¹² In various tribunal decisions, which are quoted herein, preference have been accorded to the traditional methods as they are considered to give the most reliable results over the transactional profit methods.

COMPARABLE UNCONTROLLED PRICE METHOD (CUP)

The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.¹³ The price difference or variation may be an indication that transactions amongst the AE's are not at the Arm's Length and may require adjustments to adopt the price in the uncontrolled transaction replacing that in the controlled transaction. In making the comparisons under this method, it is not only the nature of product which has an impact on the quoted price but also broader business functions, markets, economic conditions as these factors affect the prices of products and services. In the Income-tax Rules 1962, CUP is explained in rules 10B read with Section 92C of the Act and is identical to the OECD Guidelines in taking the price of a comparable uncontrolled transaction (with adjustments, if necessary) to account for price difference. The selection of comparables and making adjustments at both product and functional level under CUP requires precision which is the main reason for higher accuracy and reliable results in this method.

The analysis can be further strengthened by carrying out an internal CUP comparability and external CUP both are of equal importance.¹⁴ In the Canadian case of *Alberta Printed Circuits*, the court examined the external CUP to test

¹²*ITO vs. Alumeco Indian Extrusion Ltd* [2013] 38 taxmann.com 382 (Hyd. Trib.).

¹³OECD, op.cit. note n*1 [2.14].

¹⁴Kofler, op.cit note n* 3, 644

Internal CUP in arriving at the benefits test for the services rendered.¹⁵ In the case of *Mattel Toys (I) (P) Ltd vs. Dy. CIT*, the Mumbai tribunal held that where internal comparables are available they are preferred over external comparables.¹⁶ The reason is that under internal CUP the controlled and uncontrolled transaction of the same taxpayer is taken which provides reliable data for price comparability. If the price charged in the controlled transaction is less than that being charged in the uncontrolled transaction, no adjustment may be necessary in making analysis in CUP. Significantly, the CUP method dispenses with the requirement of a tested party¹⁷ irrespective of legal and economic ownership of valuable intangibles, which can be comparables themselves for the ALP analysis.¹⁸ Internal comparability which is common to the traditional methods is preferable over the tested party, which is an important aspect of Transactional Profit methods such as Transactional Net Margin Method, as the latter method will require further analysis in identifying the least complex party, free from ownership of valuable intangibles and other factors of comparison. This is the reason for the recommendation of traditional methods over the transactional methods by the OECD guidelines and the courts in India.

LIMITATIONS AND IMPACT ON ANALYSIS

In a study of cases in which CUP method has been employed in India, it is seen that the selection of comparables have been held to be not satisfactory whereby the tribunals have remitted the assessment back to the TPO for filtering the

¹⁵*Alberta Printed Circuits Ltd and Her Majesty The Queen* 2011 TCC 232 [201]-[212]

¹⁶[2013] 34 taxmann.com 203 (Mum Trib) [53]

¹⁷UN, op.cit note n*5, [B.3.2.3.1]

¹⁸*Maruti Suzuki India Ltd v Additional Commissioner of Income-tax transfer pricing W.P. (C) 6876/2008*

comparables and undertaking a comprehensive functional analysis. This highlights one of the weaknesses of the CUP that adequate and relevant data in the public domain may not be available for a comparability analysis and if available the genuineness, reliability of data itself may have to be tested. As CUP is price sensitive, even a minor product/ functional difference of the comparable may give unreliable results which have been highlighted by the courts and tribunals in the decisions on TP adjustments. It was held that CUP method cannot be applied where there were different geographical, volume, market conditions,¹⁹ separate timing of order,²⁰ and unsuited if there are material product differences or where substantial adjustments were required,²¹ where there are separate comparable days of contract of sale,²² even if same products are sold to resident AEs it cannot be taken as benchmark for ascertaining ALP of its similar sale transaction with non-resident AEs.²³ In the Canadian case of *Glaxo-SmithKline*,²⁴ failure to consider the license agreement which required purchase of Ranitidine from Glaxo approved sources rendered the assessment using the CUP method disapproved by the Supreme Court and was remanded to the tax court for redetermination. Here, the contractual agreement alone was the cornerstone of the whole transaction which impacted the price.

Often, the data required for undertaking a comparability analysis is complex that may require filtering which along with related

¹⁹*Amphenol Interconnect India (P) Ltd v Dy. CIT* [2015] 53 taxmann.com 83 (Pune trib) [5] - [7].

²⁰*Ibid* [2015] 64 taxmann.com 424 (Pune Trib) [14]

²¹*Qual Core Logic Ltd v Dy. CIT* [2012] 22 taxmann.com 4 (Hyd. Trib) [39]

²²*Liberty Agri Products (P) Ltd v ITO* [2011] 16 taxmann.com 174 (Chennai Trib) [8]

²³*Gemstone Glass (P) Ltd v Jt. CIT* [2016] 156 ITD 176 (AhdTrib) [8]

²⁴*Canada v GlaxoSmithKline Inc.*, 2012 SSC 12 [51]

documentation may be burdensome for the taxpayer. It is often time consuming and difficult, expensive, and a laborious exercise both from the perspective of the taxpayer and tax administration. The OECD guidelines and UN Manual do not recommend abandoning CUP merely because comparable data is not available, but as solution suggest broadening the search criteria including the possibility of using hybrid or external sources or taking a deductive or additive approach. However, taking such approach in the Indian context would require a higher comparability analysis by increasing the filtering process of unrelated external ratios which impact price and as a consequence will increase the compliance burden.

Since the primary purpose of Transfer Pricing in India is influenced by Article 9 of OECD and UN Model Convention to prevent tax avoidance, some TP adjustments have been made by using secret comparables which, even if not in the public domain, can be thrust upon the taxpayer in the CUP method as was held by the Ahmedabad Tribunal in *Dy. CIT vs. Hazira LNG (P) Ltd.*²⁵ However, highlighting the importance of transparency from the perspective of the taxpayer and tax administration, the OECD guidelines note that the use of secret comparables not in public domain by the tax administration will be unfair.²⁶ Against the use of secret comparables, the UN Transfer Pricing Manual states that taxpayers contend that the use of such secret information is against the basic principle of equity and it would be unfair if they face the consequences of adjustments made on this basis, such as additions to income typically coupled with interest, penalties etc.²⁷ Because of the lack of data in making a comparability analysis in the CUP method, inclination for

²⁵[2017] 77 taxmann.com 61 [18]

²⁶Kofler op.cit. note n*3, 645

²⁷UN, op.cit. note n* 5 [B.2.4.8.3]

selecting other methods which are not so product sensitive and do not require many comparables are commonly seen in the orders of the TPO.

RESALE PRICE METHOD (RPM)

The Resale Price Method appears in Rule 10B(1)(b) of the Income-tax Rules, and to put it simply, is the price at which the property purchased or services obtained by an entity from an AE is resold, or provided to an independent enterprise. The resale price is reduced by the gross profit margin from the purchase and resale of the same or similar property or services in a comparable uncontrolled transaction, the price so arrived is further reduced by the expenses incurred by the entity for the purchase of property or obtaining services. The price arrived at is adjusted to account for functional differences if any, including accounting practice, if any, between the international transaction and the comparable uncontrolled transaction which impact the gross profit margin in open market conditions. The adjusted price arrived at is the ALP for the purchase of property or services, as the case may be. It can be observed that a step-wise reduction of expenses at different stages is crucial in arriving at the ALP.

SIMILARITIES AND DIFFERENCE IN METHODOLOGY

The methodology prescribed in the Act is similar to that outlined by OECD guidelines. However, this method differs from the CUP as minor product difference is less likely to have an impact on the profit margins, although in making a comparability analysis it is the product or property transferred which must be compared. The RPM thus focuses on functional comparability and its strength lies in being a demand driven method in a B2B business segment because the resale price is the market

price with less scope of artificial profits and losses by distributors other than an arm's length gross profit margin. Another difference with the CUP method is that in the RPM method, the resale price margin can be determined by an internal comparable which is different from the internal CUP (reseller purchasing and selling in a comparable uncontrolled transaction) and external comparable (resale price margin of an independent enterprise). It is the same or identical product or services from the point of purchase to resale requiring fewer adjustments to account for product differences; the method renders better results when the purchase and resale are within a short span of time because with the lapse of time the changes in market conditions and economic factors will impact comparisons.

Even if the resale of products and services take place in accordance with the global price list, a comparability analysis, which remains the core of TP analysis, is indispensable while adopting the RPM. The Mumbai tribunal in the case of *Kodak Polychrome Graphics (I) (P) Ltd v Addl. CIT* held that where the taxpayer made no comparability analysis while adopting resale price method, purchase transactions could not be held to be at ALP simply because AE supplied products at global price list.²⁸ Lack of comparables and relevant data in the public domain on gross margins can affect the RPM method, importantly accounting consistency is a vital consideration for the accuracy of this method as the transactions involve purchase and resale of products and services, any unrealistic bench marking of the gross profit margin can lead to skewed result between the supplier and distributor, the former would be shown in a loss but the latter in profit. Since functional comparability is the core of RPM, the reliability of RPM may be affected if the

independent enterprise chosen for comparability has different business synergies and there are functional differences. This is because the RPM takes into account gross margins and any material or functional difference in the business of the comparable entity will impact the margin and render the comparison erroneous. In *Abott Medical Optics (P) Ltd vs. DCIT*, the Bangalore tribunal upheld the action of the TPO in rejecting the RPM on the ground that the business model of the taxpayer was not comparable with that of comparable companies as they were not incurring such expenditure on selling, distribution, and sales promotion.²⁹ Delay in resale or value addition to the product by the reseller may render the RPM unsuitable and may require choosing another method for comparability and reliable results as each method requires different comparability ratios of controlled transactions. Though adjustments can be made, but at the cost of time, documentation, and broadening the search. For applying a method the starting and ending points of a transaction assumes significance and where the transaction halts at a transit point, such as value addition, the transaction becomes unfit for applying the RPM.

COST PLUS METHOD (CPM)

The Cost Plus Method (CPM) begins with the costs incurred by the supplier of property or services in a controlled transaction for the property transferred or services provided to an AE.³⁰ An appropriate cost plus mark-up is added to this cost to arrive at an appropriate gross profit in the light of the Functions Assets and Risks and market conditions. In this method the same principles of RPM apply in determining whether a transaction is a comparable uncontrolled transaction, fewer adjustments may be necessary

²⁸[2013] 36 taxmann.com 42 (Mum Trib) [48]

²⁹[2016] 71 taxmann.com 338 (Bang. Trib) [8]

³⁰OECD, op. cit note n* 1 [2.45]

on account of product differences, more weight is given to material and functional comparability as this method is benchmarked on gross profit margins. The CPM is a useful method in cases of contract manufacturing or contract services, toll manufacturer, inter-company sale of intangible property and with the right choice of comparables reliable results can be obtained. This method is outlined in Rule 10B (1)(c) of the Income-tax Rules 1962 and as can be noticed, resembles the description provided in the OECD guidelines.

UNIQUE FACTORS OF COMPARABILITY

The emphasis in the Income-tax Rules 1962 for both RPM and CPM is on functional analysis taking into account both direct and indirect production costs. But there are constraining factors in proper application of this method. The Income-tax Rules and the OECD guidelines lay down that same accounting practice of the entity selected as a comparable is important as any difference in the accounting practice with different reporting standards can affect the gross profit comparable margins. In *Essilor Manufacturing India (P) Ltd vs. Dy. CIT*, the tribunal rejected the CPM as the taxpayer sought adjustment on account of variation of depreciation method applied by it in comparison to comparables which itself showed that the cost components of the taxpayer were in variations with that of the comparables.³¹ The same situation applies where the assets are owned and if comparisons are made with an entity which has leased assets the result will be erroneous as the items charged to the profit and loss account will be different under the head 'lease rentals' for the latter and 'depreciation' in the former. Sometimes, the costs incurred may not impact the profit in a specific

year and can be incubatory, that is affecting the profits in subsequent years and may require adjustments if not abandoning the comparable. While allocating costs, only those items both direct and indirect which have a link with the gross margins and the market price can be taken for comparability, but this exercise may require deeper scrutiny where the prices have been scaled down in relation to cost of production to compete in the market.

Neither the Income-tax Rules nor the OECD guidelines specify the methodology for applying the normal gross profit mark-up. This is dependent on the gross margins and the calculations made by the accounting standards which forms the basis of applying percentage on the gross margins. The OECD guidelines suggest that when applying the CPM, care should be taken to apply a comparable mark-up to a comparable cost basis.³² In this regard, although support can be taken from a functional analysis but similar to the CUP method and as held by the *Pune Tribunal in Alfa Laval (I) Ltd vs. Dy. CIT*, the segmental differences such as market functions, geographic difference, volume difference, credit risk, types of customers, product liability risk are crucial and may affect the FAR and create problems for the CPM and make it inapplicable.³³

Under the traditional transaction methods, the functional analysis in comparable circumstances is the key though it is only in the CUP method that product similarity also is important. The strength of the traditional methods lies in making a comparable analysis at the product and functional level and these factors bring out the demand and supply of specific products and services and their price in open market conditions.

³²OECD, op.cit. note n*1 [2.49]

³³[2014] 46 taxmann.com 394 (Pune Trib.) [6.3]

³¹[2016] 67taxmann. Com 377 (Bang. Trib) [4.4]

Before making the choice of methods the vital condition is to understand the nature of business transaction for example if the business is contract manufacturing of garments a CPM is useful, for purchase and resale of items such as SIM cards or mobile phones in which no value is added by the reseller the RPM is handy but where commodity transactions take place such as manufacturing and sale of coffee or raw material purchases the CUP method can be applied. Besides understanding the transaction it is necessary to examine the facts not so visible and if necessary subjecting a part of the transactions on the basis of those facts to a separate method. A case in this regard is the Delhi High Court judgment in *Denso India Ltd vs. CIT*³⁴ in which although the payment of royalty by the taxpayer was subjected to the Transactional Net Margin Method the

assessing officer subsequently noticed that the taxpayer imported 85% of raw material not from the manufacturer but from an intermediary who was connected both with taxpayer and the manufacturer. The ALP was determined by taking the CUP method for the transaction pertaining to raw material procurement and was upheld by the court. This decision in which two methods have been approved on the facts of the case is a departure from the MAM approach.

Thus, the choice of methods for determining the ALP will depend on the nature of transactions considering the product and undertaking a FAR analysis. The selection of comparables is a vital step in making the analysis which requires judgment and understanding of comparable transactions and comparable circumstances.

³⁴[2016] 68 taxmann.com 55 (Delhi)

Applicability of Section 2(47)(vi) in Offshore Indirect Transfer of Immovable Property



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Executive Summary

This article introduces a fresh perspective to the taxation of offshore indirect transfer of immovable property. It argues that such offshore indirect transfer can be taxed under the specific anti-abuse provisions of Section 2(47)(vi) of the Income-tax Act 1961 as they stood prior to the retrospective amendments brought into the Act through the Finance Act 2012. The article further discusses the possible need to amend the Act to cover similar indirect transfer of movable property under Section 2(47) as well as the need to bring amendments to Article 13 of the Double Taxation Avoidance Agreements to cover indirect transfer of certain movable properties.

INTRODUCTION

The applicability of Capital Gains on Indirect Transfer arrangements made headlines in 2012 after the landmark ruling of the Hon'ble Supreme Court in the Vodafone case¹ and the consequent clarificatory retrospective amendments brought out in the Income-tax Act 1961 ('Act') through the Finance Act 2012. The Indirect Transfer provisions have since been discussed and deliberated upon extensively both domestically and internationally.

However, there is a particular provision in the Income-tax Act which deals with indirect transfer

of immovable property which, in the opinion of the author, has not been studied adequately in the tax literature. Clause (47) of Section 2 of the Act deals with the definition of 'transfer' in relation to a capital asset. As per Sub-clause (vi) of Section 2(47), any transaction which has the effect of transferring, or enabling the enjoyment of, any immovable property is covered in the definition of 'transfer'. This paper aims to discuss the applicability of this provision in case of indirect transfer of immovable property, especially in case of non-residents; the possible need for expansion of the existing provisions in the Act; and the corresponding provisions on indirect transfer of immovable and movable properties in the tax treaties.

¹Vodafone International Holdings B.V. vs. Union of India (341 ITR 1) (SC)

SECTION 2(47)(VI)

The relevant extracts of Section 2 are produced below for ready reference:

DEFINITIONS

2. In this Act, unless the context otherwise requires,-

(47) 'transfer', in relation to a capital asset, includes, -

(vi) any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

Explanation 1.—For the purposes of Sub-clauses (v) and (vi), 'immovable property' shall have the same meaning as in Clause (d) of Section 269UA.'

Sub-clause (vi) was inserted in Section 2(47) vide Finance Act 1987 with effect from AY 1988-89. This provision specifically brings into the ambit of the term 'transfer' any transaction by way of any agreement, or arrangement, or in any other manner which has the effect of transferring, or enabling the enjoyment of, any immovable property. The term 'immovable property' has been defined in Clause (d) of Section 269UA as under:

'(d) 'immovable property' means -

(i) any land or any building or part of a building, and includes, where any land or any building or part of a building is to be transferred together with any machinery, plant, furniture, fittings or other things, such machinery, plant, furniture, fittings or other things also.

Explanation — For the purposes of this sub-clause, 'land, building, part of a building, machinery, plant, furniture, fittings and other things' include any rights therein;

(ii) any rights in or with respect to any land or any building or a part of a building (whether or not including any machinery, plant, furniture, fittings or other things therein) which has been constructed or which is to be constructed, accruing or arising from any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement of whatever nature), not being a transaction by way of sale, exchange or lease of such land, building or part of a building;'

[Emphasis supplied]

Therefore, the term 'immovable property' is defined in a very wide manner and is harmonious to the definition of 'transfer' given in Section 2(47).

SCOPE OF TAXATION IN CASE OF NON-RESIDENTS

The scope of taxation in case of Non-Residents is provided for by Section 5 of the Act. The relevant portion of Section 5 is produced below:

SCOPE OF TOTAL INCOME

5. (1)

(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which—

(a) is received or is deemed to be received in India in such year by or on behalf of such person; or

(b) accrues or arises or is deemed to accrue or arise to him in India during such year.’

In other words, any income which is received or is deemed to be received in India or which accrues or arises or is deemed to accrue or arise in India to a non-resident is taxable in his hands in India during the relevant previous year. What constitutes income that is deemed to accrue or arise in India is provided for in Section 9 of the Act. The portion of Section 9 that is relevant for the topic under discussion is given below:

‘Income deemed to accrue or arise in India.

9. (1) The following incomes shall be deemed to accrue or arise in India:

(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.’

[Emphasis supplied]

Section 9(1)(i) provides that any income accruing or arising, whether directly or indirectly, through the transfer of a capital asset situated in India shall be deemed to accrue in India. Therefore, the provision provides for source based taxation of capital gains arising from the transfer of capital assets situated in India.

INDIRECT TRANSFER OF IMMOVABLE PROPERTY SITUATED IN INDIA

The indirect transfer of immovable property has always been a contentious issue in taxation, internationally. There are divergent provisions to tax indirect transfers of immovable property in the domestic laws of different countries. Even in the tax treaties, the provision for taxation of

transfer of immovable property through offshore indirect transfers is found only in around 35% of all Double Taxation Avoidance Agreements (‘DTAA’) globally.²

Before proceeding further, we need to understand the meaning of the term ‘indirect transfer of immovable property’. Suppose, a person (X Inc.), resident of Country A holds certain immovable property in India which it desires to sell to another non-resident company in Country B (Y B.V.). If X Inc. directly sells its immovable property in India, the capital gains arising on such transfer shall be deemed to accrue or arise in India by virtue of applicability of Section 9(1)(i) quoted above.

In order to avoid the above tax liability in India, X Inc. may opt to hold the immovable property in India through a subsidiary entity and sell the shares or interest in that entity to Y B.V. Two cases may arise in such indirect transfers which are discussed below.

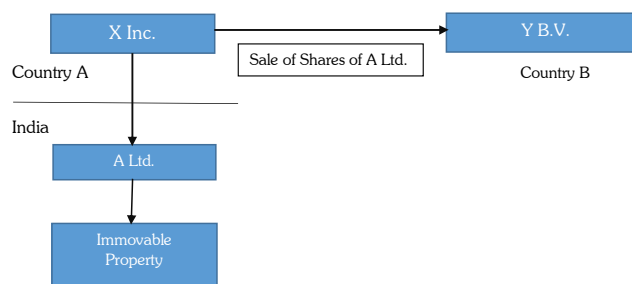


Fig. 1

In the case described above, X Inc. sells the shares of its subsidiary in India, A Ltd., which in turn holds the immovable property in India. The immovable property is sold to Y B.V. indirectly through the shares of A Ltd. However, this arrangement may not succeed in avoiding tax liability as the shares of A Ltd. constitute a capital asset situated in India and the capital gains arising to X Inc. on sale of such shares is

²Draft Version 2 of The Taxation of Offshore Indirect Transfers—A Toolkit by the Platform for Collaboration on Tax.

deemed to accrue or arise in India under the domestic provisions. Such a transaction will also be taxed in India under Article 13(5) of most of the Indian DTAA's.

A different tax planning would be to hold the rights in the immovable property in India through a subsidiary entity located in a low or no tax jurisdiction. The scenario is described below.

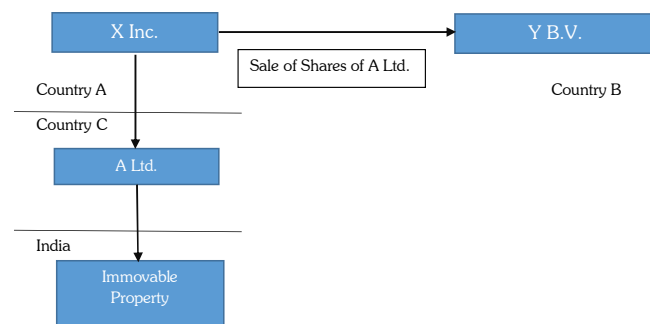


Fig. 2

In the above case, X Inc. sells shares of A Ltd. to Y B.V. which, in effect, transfers the immovable property in India to Y B.V. This is a classic example of an offshore indirect transfer of immovable property in India. This case will be examined in extensive detail in the paragraphs below.

TAXATION OF OFFSHORE INDIRECT TRANSFERS OF IMMOVABLE PROPERTY UNDER THE INCOME-TAX ACT 1961

Sometimes, it is alleged that the provisions to tax offshore indirect transfers were brought into the Act for the first time only in 2012, vide the retrospective amendments brought in by the Finance Act 2012, through the insertion of Explanation 5 to Section 9(1)(i) and other corresponding amendments.³ However, the indirect transfer of immovable property as described in the aforesaid cases has always been covered under the ambit of the Income-tax Act, 1961 since AY 1988-89. This is where Section 9(1)(i) read with Section 2(47)(vi) comes into play.

³The scope of Explanation 5 is discussed later in this paper.

As discussed above, Section 9(1)(i) deems any income accruing or arising, directly or indirectly, through the transfer of a capital asset situated in India as income accruing or arising in India. Therefore, for income to be deemed to accrue or arise in India, the following conditions need to be satisfied:

1. There should be a 'transfer'.
2. The transfer should be of a capital asset.
3. The capital asset should be situated in India.

All the above conditions are satisfied in the offshore indirect transfer case described above. The term 'capital asset' is defined under Section 2(14) in a very wide manner and the immovable property in India that has been transferred in the aforesaid case qualifies as a capital asset under Section 2(14)⁴. Since the immovable property is located in India, it qualifies the third condition of capital asset being situated in India.

With regards to transfer of the capital asset in question through the shares of company located in Country C (A Ltd.), it qualifies as 'transfer' by virtue of Section 2(47)(vi) which includes in the definition of 'transfer' any transaction by way of acquiring shares in a company or by way of any agreement or any arrangement or in any other manner whatsoever, which has the effect of transferring or enabling the enjoyment of, any immovable property. Since the immovable property in India gets transferred to the company in Country B (Y B.V.) by virtue of acquiring shares of A Ltd., the said arrangement qualifies the definition of transfer as given in Section 2(47)(vi).

In view of the above, India has the authority to tax such offshore indirect transfers of immovable

⁴However, the immovable property in question should not be a rural agricultural land.

property by virtue of Section 9(1)(i) read with Section 2(47)(vi).

The various arguments that can be raised against the above taxability of the offshore indirect transfer of immovable property have been discussed and dealt with in the subsequent paragraphs.

1. The Capital Asset being transferred in the above transaction are the shares of A Ltd. and such shares are not situated in India

It may be argued by the taxpayers that what is being transferred in the given transaction are the shares of A Ltd. and not the immovable property located in India. Therefore, the capital asset in question is not situated in India and the transaction does not qualify the third condition specified above for applicability of Section 9(1)(i).

However, it seems that this argument will not stand the test of judicial scrutiny. Section 2(47)(vi) is a specific anti-abuse rule against such very transactions that involve the transfer or enjoyment of immovable property by way of acquiring shares in a company or becoming a member of a cooperative society or any other agreement or arrangement. Section 2(47)(vi) specifically provides for a 'look through' approach and allows for taxation of transfer of an immovable property done by means of arrangements mentioned above. Section 2(47)(vi) has been worded in a very wide manner. This can be seen from the use of the expressions 'any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.' In other words,

any agreement or an arrangement which has the effect of transferring an immovable property in India qualifies the definition of 'transfer' and therefore qualifies as income deemed to accrue or arise in India in the hands of the non-resident under Section 9(1)(i).

2. The Intention of Introducing Sub-clause (vi) to Section 2(47) was Very Narrow

It may be argued by the taxpayers that the application of Section 2(47)(vi) to indirect transfer of immovable property may be not be permissible within the scope of the provisions of the section and that the intention of the provision was never to bring indirect transfers into the tax net. The scope and intention of Sub-clause (vi) can be understood from the CBDT Circular No. 495 dated September 22, 1987. The relevant portion of the Circular is produced below:

'Definition of "transfer" widened to include certain transactions

11.1 The existing definition of the word 'transfer' in Section 2(47) does not include transfer of certain rights accruing to a purchaser, by way of becoming a member of or acquiring shares in a co-operative society, company, or association of persons or by way of any agreement or any arrangement whereby such person acquires any right in any building which is either being constructed or which is to be constructed. Transactions of the nature referred to above are not required to be registered under the Registration Act, 1908. Such arrangements confer the privileges of ownership without transfer of title in the building and are a common mode of acquiring flats particularly in multistoreyed constructions in big cities. The definition also does not cover cases where possession is allowed to be taken or retained in part performance of a contract, of the nature

referred to in Section 53A of the Transfer of Property Act 1882. New Sub-clauses (v) and (vi) have been inserted in Section 2(47) to prevent avoidance of capital gains liability by recourse to transfer of rights in the manner referred to above.

11.2 The newly inserted Sub-clause (vi) of Section 2(47) has brought into the ambit of 'transfer', the practice of enjoyment of property rights through what is commonly known as Power of Attorney arrangements. The practice in such cases is adopted normally where transfer of ownership is legally not permitted. A person holding the power of attorney is authorised the powers of owner, including that of making construction. The legal ownership in such cases continues to be with the transferor.

11.3 These amendments shall come into force with effect from 01.04.1988 and will accordingly apply to the assessment year 1988-89 and subsequent years.

[Section 3(g) of the Finance Act]"

[Emphasis supplied]

It may be argued that the intention of introducing Sub-clause (vi) is clearly provided in the above Circular which aims at covering transactions (like flats in building by co-operative societies or enjoyment of property through power of attorney arrangements) which were otherwise not covered in the ambit of the term 'transfer'. The Memorandum explaining the Finance Bill, 1987 also uses similar language. The situation of an indirect transfer of immovable property through shares of a foreign company was not envisaged while introducing Sub-clause (vi) in the Act.

Even if it is accepted that the intention of introducing Sub-clause (vi) to Section 2(47) was only to deal with situations mentioned in the

Circular above, that does not restrict the quasi-judicial powers of the tax authorities to deal with transfer of immovable property through arrangements that are covered by the express language of the provisions of Section 2(47)(vi). Recourse to the Memorandum explaining the Finance Bill and the departmental circular needs to be taken only when there is any ambiguity regarding the interpretation of any statutory provision. Where a particular transaction is clearly covered by the wordings of a provision, the intention behind introducing the particular provision need not be ascertained.

Reliance in this regard can be placed on the cardinal rule of interpretation of statute, i.e. the literal rule of interpretation. It is a settled principle that it is when the language is vague that the Legislature's intention is to be taken into consideration. The Hon'ble Supreme Court in the case of Pandian Chemicals Ltd.⁵ while interpreting the provisions of Section 80HH of the Act, observed as under:

'8. The learned counsel for the appellant then contended that having regard to the object with which Section 80HH was introduced in the statute book, this Court should give a liberal interpretation to the words in a manner so as to allow such object to be fulfilled. The rules of interpretation would come into play only if there is any doubt with regard to the express language used. Where the words are unequivocal, there is no scope for importing any rule of interpretation as submitted by the appellant.'

[Emphasis supplied]

Further reliance can be placed on the decision of the Hon'ble Apex Court in the case of *Bhaji vs. Sub-Divisional Officer, Thandla*⁶ where the

⁵*Pandian Chemicals Ltd. vs. CIT* [2003] 129 Taxman 539 (SC)

⁶*Bhaji vs. Sub-Divisional Officer, Thandla* 2003(1) SCC 692

Court was dealing with the amendments brought out in the M.P. Land Revenue Code 1959. The Court observed as under:

'Reference to the Statement of Objects and Reasons is permissible for understanding the background, the antecedent state of affairs, the surrounding circumstances in relation to the statute, and the evil which the statute sought to remedy. The weight of judicial authority leans in favour of the view that Statement of Objects and Reasons cannot be utilized for the purpose of restricting and controlling the plain meaning of the language employed by the Legislature in drafting statute and excluding from its operation such transactions which it plainly covers. (See Principles of Statutory Interpretation by Justice G.P. Singh, Eighth Edition 2001, pp.206-209).'

[Emphasis supplied]

Thus, it can be said that the Memorandum and the Circular only describe the loopholes at that point of time which were being fixed by introducing this provision. Nowhere does it stop the tax authorities from applying the provision to other situations where it can be applied. The Legislature cannot be expected to foresee all possible situations where there may be transfer of immovable property indirectly and mention them in the Memorandum. By wording the provision in the widest manner possible, the Legislature has expressed its intent to tax all agreements or arrangements which have the effect of transfer of immovable property in India.

3. Application of Section 2(47)(vi) to indirect transfer of immovable property is akin to lifting of corporate veil in all cases

It may be argued on behalf of the taxpayers that the use of Section 2(47)(vi) read with Section 9(1)(i) to tax indirect transfer of immovable

property in India would mean that the corporate veil of the intermediary company is being lifted in all cases. The corporate veil of an entity should be lifted only when it is specifically provided for by the Statute itself or where, due to glaring facts established on record, it is found that a complex web has been created only with a view to defraud the revenue interest of the State. Further, there are no safeguards that have been provided in Section 2(47)(vi) as have been provided in Explanation 6 to Section 9(1)(i) in case of transfer of shares or interest in a company or entity registered or incorporated outside India. Explanation 6 provides that value of the assets located in India should exceed the amount of ten crore rupees and they should represent at least 50 per cent of the value of all the assets owned by the company or entity.

At the cost of repetition, it is imperative to mention that Section 2(47)(vi) is a specific anti-abuse rule that aims to tax capital gains arising from transfer of immovable property situated in India. The provision clearly enables the tax authorities to lift the corporate veil of the intermediary companies to tax the gains arising from transfer of immovable property located in India. The provision is similar to Article 13(4) of the Model Tax Conventions issued by OECD and UN which provide that gains derived by a resident of one Contracting State from the alienation of shares or comparable interests may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, situated in the other State.⁷

While the Model Conventions provide for a 50 per cent condition in determining the taxability

⁷Article 13(4) of the Model Conventions is discussed in greater detail later in this paper

of the transfer of the shares or interests in the country where the immovable property is located, the domestic law of India provides for such taxation in India in all cases, irrespective of the proportion the value of the immovable property bears to the total value of the shares being transferred. India believes that there should be no difference in the taxation on transfer of immovable property if it is done directly (taxed fully in India) or if it is done indirectly, even if such property accounts for say just 30% of the value of the shares of the foreign company. The proportionate gain arising from such transfer should be taxed in India by virtue of the source (to the extent of the immovable property) being situated in India. What is being taxed is the transfer of the immovable property situated in India by whatever agreement or arrangement.

This can be explained with the help of an illustration. Suppose the entire shares of F Co. are sold outside India for a value of Rs. 300 Crores, of which a proportion in value (say 30%) is derived from the immovable property located in India, then the gain arising on the transfer value (Rs. 90 Crores) of the immovable property located in India shall be taxable in India under the provisions of Section 9(1)(i) read with Section 2(47)(vi).

Therefore, in view of the above discussion it can be said that Section 2(47)(vi) is a very relevant provision in the taxation of non-residents and an offshore indirect transfer of immovable property in India can be brought to tax in India by virtue of Section 9(1)(i) read with Section 2(47)(vi).

APPLICABILITY OF SECTION 2(47)(VI) TO THE CAIRN TAX DISPUTE

At this juncture, it may be relevant to refer to the case of *Cairn UK Holdings Ltd.*⁸ wherein a UK

⁸*Cairn UK Holdings Ltd. vs. DCIT* [2017] 185 TTJ 593 (Delhi – Trib.)

company (CUHL) sold the entire shareholding of its subsidiary company in Jersey (CIHL) to an Indian Company (CIL). The shares of the Jersey Company (CIHL) derived their value from India since CIHL was the holding company of 9 subsidiary companies in India which were engaged in the business of oil and gas sector in India. The Ld. Assessing Officer taxed such transfer in the hands of CUHL in India after applying Section 9(1)(i) read with Explanation 5. The Hon'ble Delhi ITAT decided the case in favour of the Department^{9,10}.

From the provisions and the facts of the case, it appears that the provisions of Section 2(47)(vi) also seem to be applicable in the instant case. CUHL indirectly held various oil and gas blocks in India through its Indian subsidiaries and these subsidiaries were indirectly transferred to CIL through the transfer of the entire shareholding of CIHL. The essence of the arrangement was to transfer the immovable property in India (oil and gas blocks) to CIL through the transfer of shares of CIHL. It is a classic case of indirect transfer of immovable property in India and should be covered by the provisions of Section 2(47)(vi).¹¹

The assessee in the *Cairn* case had also challenged legal validity of the retrospective application of Explanation 5 to Section 9(1)(i) before the

⁹The Court however ruled against the Department on the issue of levy of interest under Sections 234A and 234B

¹⁰The case was challenged for international arbitration by Cairn under the UK-India Bilateral Investment Treaty. While the main court hearings were completed in the case in August 2018, the arbitral award is expected to be issued not before mid-2020 as per the latest updates. However, the arbitral award will have no bearing on the sovereign right of India to tax income sourced in India. The arbitration has been undertaken under the Bilateral Investment Treaty and not under any tax treaty.

¹¹The issue regarding whether oil and gas blocks constitute 'immovable property' in India has not been dealt with in this paper and for the sake of brevity, it has been assumed that extraction in the oil and gas blocks will be covered by the term 'any rights therein' used in the definition of 'immovable property' in Section 269UA.

Hon'ble ITAT. The ITAT has held that it is not the appropriate forum to rule on the constitutional validity of the retrospective application of the indirect tax provisions. However, the Hon'ble ITAT, by holding that the assessee cannot be burdened with the levy of interest where it could not have visualized its tax liability at the time of the transaction, has tacitly lent credence to the view that the indirect transfer provisions were a new levy which had not existed previously. It seems that this contention could not have been raised by the assessee against the applicability of Section 2(47)(vi) to tax the indirect transfer of immovable property in the case. The indirect transfer of immovable property in India is taxable in India since the introduction of Section 2(47)(vi) thereby making Cairn liable to tax in India with applicable interest.

NEED FOR EXPANSION OF THE PROVISIONS OF SECTION 2(47)(VI)

While the indirect transfer of immovable property in India is taxable under the provisions of Section 9(1)(i) read with Section 2(47)(vi) as discussed above, there seems to be no parallel provision in the Act for the taxation of indirect transfer of movable property situated in India. The only provision that attempts to tax such indirect transfers is given in Explanation 5 to Section 9(1)(i), which was introduced through the Finance Act 2012. The Explanation is produced below for ready reference:

“Explanation 5 - For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India:”

In simple words, the Explanation provides that the shares of a foreign company shall be deemed to be a capital asset situated in India if they derive their value substantially from the assets located in India. The income from the transfer of such a capital asset in India shall be deemed to accrue or arise in India under the provisions of Section 9(1)(i). Thus, the Explanation explicitly taxes the indirect transfer of assets located in India through the transfer of shares of a foreign company. The procedural aspects for the taxation of such indirect transfers are provided in Explanation 6, Explanation 7 and the provisos to Explanation 5 to Section 9(1)(i).

We know that the taxability of a non-resident is governed by the provisions of the domestic law as well as the provisions of the applicable Double Taxation Avoidance Agreement ('DTAA'). By virtue of Section 90(2), the provisions of the Act or the DTAA, whichever are more beneficial to the assessee are applicable to a non-resident in India. The provisions of the DTAA which are relevant to the discussion in this paper are given in paras 4 and 5 of Article 13 (Capital Gains) of the UN Model Convention. The provisions are produced below for ready reference:

‘4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

5. Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation

of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least—per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.’

Since Article 13(4) deals with the indirect transfer of immovable property, it seems to be more or less similar to the domestic law provisions given in Section 9(1)(i) read with Section 2(47)(vi) discussed in the preceding paragraphs. On the other hand, Article 13(5) only deals with a situation where the shares of a company located in a Contracting State (say, India) are transferred by a person from another Contracting State (say, UK). It does not deal with a situation where the UK resident sells the assets located in India indirectly through the shares of a foreign company (say, a company located in France which derives its value substantially from the assets located in India). Therefore, it can be seen that there is no parallel provision to Explanation 5 of Section 9(1)(i) in the DTAA to tax indirect transfer of property in India (except to the extent of immovable property covered by Article 13(4)). Such a situation makes the provisions of Explanation 5 otiose in many cases as the taxpayer is governed by the beneficial provisions under the applicable DTAA.

Further, Section 9(1)(i) read with Explanation 5 deems the shares of the foreign company to be a capital asset situated in India and requires the gains from the transfer of such shares to be taxed in proportion to the value attributable to the assets located in India. As the high number of litigations and the frequent amendments to

the provisions show, the application of these provisions has proved to be cumbersome and contentious.

From the above discussion, it appears that the complexities involved in the taxation of indirect transfers may be avoided if, instead of deeming the shares of the foreign company to be a capital asset situated in India (as has been done by Explanation 5 to Section 9(1)(i)), there is a provision which directly considers such indirect transfers of the assets located in India to be a ‘transfer’ of a capital asset situated in India. This objective can be achieved by either expanding the existing provisions of Section 2(47)(vi) to cover transfer of movable property as well or by inserting a new Sub-clause (vii) to Section 2(47) for indirect transfer of movable property and is worded on the same lines as Sub-clause (vi) on immovable property.

Such a combined applicability of Sub-clauses (vi) and (vii) to Section 2(47) would lead to the taxation of the indirect transfer of any capital asset located in India (movable or immovable) through the transfer of shares or interests in a company or entity registered or incorporated outside India or through any agreement or arrangement or in any other manner whatsoever.

In this regard, it is also imperative to mention that there will be a need to prescribe clarity on the computation mechanism for the capital gain computation for such indirect transfer and also bring clarity on the interplay of the amended provisions with the existing indirect transfer provisions in Explanation 5, 6 and 7 to Section 9(1)(i). However, in the opinion of the author, such an introduction of Sub-clause (vii) to Section 2(47) would make the taxation of indirect transfer of capital assets situated in India simpler and less litigative.

NEED FOR AMENDMENTS IN THE TREATY PROVISIONS

As has been stated above, the taxation of a non-resident is determined by the domestic law provisions as well as the provisions of the applicable DTAA. Article 13(4) (identical in the 2017 updates of the UN and the OECD Model Conventions) deals with the indirect transfer of immovable property and grants the Source State the right to tax such capital gains in case the shares of the foreign company derive more than 50 per cent of their value from immovable property located in the Source State.

On the other hand, Article 13(5) of the UN Model Convention taxes the gains from the alienation of the shares of a company or comparable interests (say, located in India) in the Source State (India) if the alienator (say, in UK) holds directly or indirectly a specified percentage of the capital of the company. Such a provision is absent in the OECD Model Convention.

Article 13(6) of the UN Model Convention (and Article 13(5) of the OECD Model Convention) provide for a residuary clause which states that gains derived from alienation of property not covered by any of the preceding paragraphs of Article 13 are taxable in the State where the alienator is resident. Therefore, residence based taxation is applied under this paragraph.

From the combined reading of all the above provisions, it can be seen that in the case of immovable property located in the Source State, while the direct transfer is taxed in the Source State under Article 13(1), the indirect transfer is taxed in the Source State under Article 13(4), provided the prescribed conditions are met. However, there are no such similar provisions to tax the indirect transfer of movable properties referred to in Article 13(5) of the UN Model

(i.e. shares or comparable interests in an entity located in the Source State) where the direct transfer of the same properties is taxable in the Source State under paragraph 5 of Article 13. The indirect transfers of such shares or comparable interests are covered by the residuary clause under Article 13(6) giving the entire taxing rights to the Residence State.

To elucidate this point in detail, let us take the following example. A Ltd. (resident in Belgium) holds 30% shares in B Ltd. (resident in India). As per Article 13(5) of the India-Belgium treaty, the gains from the sale of shares of B Ltd. by A Ltd. shall be taxable in the Source State (India) since A Ltd. holds at least 10% in the capital stock of B Ltd. Therefore, Article 13(5) provides for source based taxation in case of such direct transfers of movable property in the nature of shares. However, in case A Ltd. resorts to indirect transfer of such shares through an intermediary (say, a subsidiary C Ltd. in Mauritius which holds these 30% shares in B Ltd.), such transfer would be outside the ambit of Article 13(5) preventing India to tax such gains.

It is a widely accepted fact that income should be taxed in the jurisdiction where the economic value is created. When the impact of a direct as well as an indirect transfer is the same, there should be no difference in the taxing rights of such transfers. There needs to be tax neutrality between direct and indirect transfer of assets. Keeping this in mind, there may be a need to introduce adequate provisions in the Model Conventions to provide the taxing rights over such indirect transfers of movable property (in the nature of shares or comparable interests) to the Source State bringing them in line with the taxing rights over the direct transfer of these assets. This will prevent any abusive transactions that may be undertaken to avoid

tax under Article 13(5). Such a provision can be introduced by appropriately amending the provisions of Article 13(5) or by expanding the provisions of Article 13(4) to cover the movable properties mentioned in Article 13(5).

CONCLUSION

In conclusion, it can be said that Section 2(47)(vi) is a very wide and powerful section that can be effectively applied to tax the indirect transfer of immovable properties situated in India. It effectively provides for the 'look through' approach in such indirect transfers and can be applied without taking assistance of any of the

retrospective amendments brought in by the Finance Act 2012.

As discussed in the preceding paragraphs, there may be a need to expand the provisions of Section 2(47)(vi) to cover such indirect transfers of movable properties as well, to enable the taxman to prevent abuse of indirect transfer arrangements in a simple and unambiguous manner. Further, India needs to continue to strive to amend the provisions of Article 13 (Capital Gains) in the Model Conventions to provide for taxing rights to the Source State in the case of indirect transfers of movable properties that are in the nature of shares or comparable interests.

Retrospective Law: Global and Indian Instances



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Executive Summary

From the ancient time, retrospective law or ex post facto law has been a part of standard jurisprudence. It is neither an Indian creation, nor it is being used exclusively in India. Instances of its application to the International law as well as to the domestic laws of many countries have been cited in the article. In principle, retrospective criminal laws are highly disapproved and discouraged. Retrospective amendments have been frequently used in Revenue laws, sometimes to annul its interpretation by Courts and sometime to prevent its misuse. In India, it is within the power of Hon’ Supreme Court to examine the validity of laws enacted by the Union Government. Several examples of retrospective amendments and the need for such an amendment to the Income Tax Act have been discussed in the article. The most interesting examples are the amendments, which had to be made in the phased out laws so as to make its current and modified forms of enactments stand the test of legality. Report of the Twelfth Law Commission on Income Tax Reforms, submitted to the Government in 1958 has also been discussed in detail. Our present Income Tax Act 1961 has been based on most of such recommendations.

Keywords for the Article on Restropective Amendments

Advance tax, Australia, Company tax, Constitution, Harbour, Income Tax Act, India, IPC, ITO, Law Commission, Leviathan, Lord Macaulay, Lord Mansfield, Non resident, Nuremberg Trials, Previous year, Relief, Recovery, Retrospective, Supreme Court, Supreme Court, Tax demand, Thomas Hobbs, Validation, William Blackstone

Important Sections

9, 115JB, 234b, 220, 222, 250, Article 19 of Constitution

“That, on great emergencies, the State may justifiably pass a retrospective act against an offender, we have no doubt whatever. . . .”

—Lord Thomas Babington Macaulay
Hallam, Sept. 1828

Thomas Babington Macaulay, later known as Lord Macaulay, is best known for his introduction

of English and western concepts to *education in India*. He was appointed as the first Law Member of the *Governor-General’s Council* and served between 1834 and 1838. His final years in India were devoted to the creation of a Penal Code as the leading member of the Law Commission. This code, known as IPC, is still in force, despite several changes.

Retrospective law or an *ex post facto* law is one that retroactively changes the legal consequences of actions that were committed, or relationships that existed, before the enactment of the law. In criminal law, its effect may criminalize action that was legal when committed. Further, it may aggravate a crime by bringing it into a more severe category than it was in at the time it was committed. This may result into change of punishment prescribed for a crime by adding newer penalties or extending sentences; or it may alter the rules of evidence in order to make the probability of conviction for a crime higher. In Jurisprudence, retrospective criminal laws are highly disapproved and discouraged.

In *Leviathan*, Thomas Hobbes wrote in 1651 that ‘Harm inflicted for a fact done before there was a law that forbade it, is not punishment, but an act of hostility: for before the law, there is no transgression of the law’.

William Blackstone wrote in his *Commentaries on the Laws of England* (in 1765–69)- “[h]ere it is impossible that the party could foresee that an action, innocent when it was done, should be afterwards converted to guilt by a subsequent law; he had therefore no cause to abstain from it; and all punishment for not abstaining must of consequence be cruel and unjust.

All laws should be therefore made to commence *in future*, and be notified before their commencement. On the global perspective, use of retrospective in law-making is not new. Some important cases, outside India, are being discussed below:

THE NUREMBERG TRIALS

After conclusion of the World War II, thirteen separate trials of war criminals were held in Nuremberg between 1945 and 1947. These trials were presided over by judges from all

four major victorious allied powers: America, Britain, France and the Soviet Union. A total of 177 Germans and Austrians were indicted. All but 35 were found guilty: 25 were executed, 20 were sentenced to life imprisonment and 97 were sentenced to shorter prison terms. These trials represented a large-scale prosecution of Nazis, who pleaded the defence of superior orders. In previous war trials, after previous wars, this defence was generally held to be available to subordinate soldiers. Before World War II, prosecutions for war crimes were limited to heads of State, and to high-ranking military commanders only. The defence of being duty bound to follow orders from above was an accepted norm recognized by the international community. In convicting lower-ranking soldiers the Nuremberg trials were, in a sense, was applying international law retrospectively.

At the trials they were told that their actions were crimes against humanity. Such actions were criminal even though they were not in breach of settled international law. Despite their objections, most jurists justified the behaviour of the Nuremberg court by holding that the actions of the Nazis were immoral.

SHAW VS. DIRECTOR OF PUBLIC PROSECUTIONS

In 1961, the House of Lords handed down a decision in *Shaw vs. Director of Public Prosecutions* which caused heated discussion amongst lawyers and lawmakers. Shaw had published a booklet called the *Ladies’ Directory*, which advertised the names and addresses of prostitutes. Shaw was successfully prosecuted under a number of provisions of the *Sexual Offences Act 1956* and the *Obscene Publications Act 1959*. He was also convicted on a charge of ‘conspiracy to corrupt public morals’ on the basis that by published the booklet, Shaw was

conspiring with the prostitutes ‘... to debauch and corrupt the morals of youth and other subjects of the Queen.’”

Shaw petitioned to the House of Lords, claiming that the crime of conspiracy to corrupt public morals was hitherto unknown. The majority built their argument upon the notion; put forward by Lord Mansfield almost two hundred years earlier, that the courts are ‘guardians of public morals’ and that they ought to restrain and punish ‘... whatever is *contra bonos mores et decorum*.

BOTTOM OF THE HARBOUR

In Australia around 1970, a complex method of avoiding company tax was increasingly being adopted. The method involved transferring of assets before tax became payable. Sometimes another company not having sufficient assets was floated purposefully which was legally liable for such tax. These schemes were known ‘bottom of the harbour’. In the late 1970s the legality of these activities was not clear under the existing law. However, such schemes became popular to avoid or minimize tax liabilities. It was perceived illegal by enforcement agencies.

In 1980, the *Crimes (Taxation Offences) Act 1980* made it a criminal offence for a natural person to be a party to, or aid and abet, arrangements to make a company or trustee incapable of paying its taxation debts. Penalties for a breach of the Act were originally five years’ imprisonment or a \$50,000 fine, and in 1986 both penalties were doubled. This Act drew much criticism. Some argued that tax evasion was not ‘criminal’ in the generally accepted sense; that tax evaders were ‘white-collar’ offenders, and that the harsh penalties under the Act were unjustified. It is true that tax evasion had been, during the eighteenth and nineteenth centuries, seen as something less than criminal. As the obligation to pay tax was

seen as a civil obligation, any legislation which recovered unpaid tax could hardly be seen as criminal legislation.

Soon, the Commonwealth Parliament (Australian Federal Parliament) passed a series of related Acts; the most important of it was the *Taxation (Unpaid Company Tax) Assessment Act 1982*. This Act aimed to recover tax evaded under the *Crimes (Taxation Offences) Act 1980*. It was significant as it was explicitly retroactive: tax could now be recovered from ‘bottom of the harbour’ schemes which were entered into before the 1980 Act was passed. But, despite the criticism, there is no doubt that the 1980 legislation made certain tax evasion schemes criminal.

In the above cases, it is interesting to note that the principle of ‘equity and fairness’ was employed to justify a retroactive law against the defaulters.

INDIAN CONTEXT

In India, the first important challenge to retrospective changes being made was by way of challenge to amendment in 1951 imposing a duty on a manufactured tobacco which was brought into force retrospectively i.e. from the date of the introduction of the Bill and not from the date in which the law came into force. This legislation was challenged in the Court on two counts. The first was that the State legislature lacked the legislative competence to enact a sales tax law with retrospective effect. The argument was that sales tax was primarily an indirect tax, the essential feature of which was that its burden could be passed on to the consumer. Where it was imposed retrospectively, the burden of the past could not be so passed on to the consumer and therefore it ceased to be an indirect tax and for that reason was unconstitutional. The Supreme Court accepted that tax laws

were subject to the discipline of Part III of the Constitution (Fundamental Rights). However the Indian Supreme Court held that mere retrospectiveness would not render a tax law arbitrary and capricious. [*Chhotabhai Jethabhai Patel and Co vs The Union of India and Another*, decided on 11 December 1961, 1962 SCR Supl. (2) 1]

In the case of *CST vs Billion Plastics (P.) Ltd.* (S.T. Reference No. 10 of 1991, 22 February 1995), Hon'ble Bombay High Court held that if a dealer makes purchase of taxable goods from a person who is not a dealer in those goods at all (i.e., neither a registered nor an unregistered dealer), then levy of purchase tax in terms of Section 13 of the Bombay Sales Tax Act will not be attracted.

An example for retrospective law in India is the Karnataka Schedule Caste and Scheduled Tribes (Prohibition of Transfer of Certain Lands) Act 1978. It is an Act to provide for the prohibition of transfer of certain lands granted by the government, to persons belonging to the scheduled castes and scheduled tribes in the state, which means any land granted to the landless agricultural labourers belonging to scheduled castes and scheduled tribes, cannot be purchased. Provisions of this Act override any other Act. Anyone who purchases such a property will not get clear and marketable title; such property will be eventually acquired by Government and returned to the original owner without any compensation to the purchaser. This law which was introduced in 1978 is retrospective in nature and is considered an *ex-post facto law*. Even law of limitation does not apply to it. Hon'ble Supreme Court has recently declared that land allotted to nomadic tribes or members of the Scheduled Castes and Scheduled Tribes in Karnataka cannot be transferred or sold without prior permission from the government.

Such cases in huge numbers are pending across the State of Karnataka. International Real Estate Companies have expressed concern about investing in Bangaluru, as this law does not have a limitation or expiry time period.

APPLICATION OF RETROSPECTIVITY TO INDIAN INCOME-TAX ACT

The first much debated retrospective amendment was in 1983. The Income-tax Act conferred a tax exemption upon new industrial undertakings as percentage of capital employed in such undertakings. Since the inception of the exemption, a rule had been in place for computation of the capital employed (assessee was not entitled to relief under Section 80J in respect of borrowed capital as the same cannot be included in self-employed capital). This rule was struck down by various high courts as being inconsistent with the parent Act insofar as it provided for excluding long-term liabilities from the computation of capital employed. Parliament retrospectively amended the parent statute itself and engrafted the rule in the parent statute. This retrospective amendment was challenged on the ground that business undertakings had altered their position acting on the face and belief that the parent law would prevail and that the rules that were plainly inconsistent would be ignored, and therefore if the law was now retrospectively altered to ratify as it were rules that were illegal, it would seriously upset settled affairs and thus be harsh and burdensome.

The majority judgment held the rules were valid even as they were framed, and therefore the retrospective amendment was really clarificatory in nature. The issue of such a challenge to retrospectively was not decided by the majority. The dissenting judgment which accepted the proposition that the original rules were ultra-vires, struck down the retrospective amendment

to the statute is being an unreasonable restriction on of the right to carry on business. [*Lohia Machines Ltd and Anr vs. Union of India* (1985) 152 ITR 308 (SC)]

A case involving partition of Hindu Undivided Family, Hon'ble Supreme Court in *Govinddas vs. Income-tax Officer* [1976] 103 ITR 123 (SC) was decided by Justice P.N. Bhagwati, Justice A.C. Gupta and Justice S. Murtaza Fazal Ali in December 1975. The question of law put up was, "Whether Sub-section (6) of Section 171 of the 1961 Act applies only to situation where assessment of HUF is under Section 143 or Section 144 of I-T Act 1961, and not to situation where assessment of HUF is completed under corresponding provisions of the 1922 Act - Held, yes. Whether, therefore, where assessments of HUF for assessment years in question were completed in accordance with provisions 1922 Act which included Section 25A, ITO was not entitled to avail of provision enacted in Sub-section (6), read with Sub-section (7), of Section 171 of 1961 Act for purposes of recovering tax or any part thereof personally from any members of joint family - Held, yes.

The government amended Section 115JB of the Income-tax Act to ensure that MAT provisions are not applicable to a foreign company that does not have a permanent establishment in the country and was a resident of a nation having a double taxation avoidance agreement (DTAA) with India. Explanation under Section 115JB was inserted by the Finance Act 2008, retrospectively w.e.f. 01 April 2001.

Vodafone Case: The proposal was to allow the country to retrospectively tax cross-border transactions in which the underlying assets are located in India. Under the proposed amendment, all persons, whether resident or non-residents, having business connection in

India, will be required to deduct tax at source and pay it to the government even if the transaction is executed on a foreign soil. The Finance Act 2012 amended the Income-tax Act, 1961 by adding Explanation 4 under Section 9(1) with retrospective effect from 01 April 1962. The amendments had implications for British telecom giant Vodafone, which won the Rs 11,000 crore tax case in the Supreme Court. In view of the implications of the proposed amendments on overseas deals, it attracted very high attention in media.

Also, with a retrospective amendment by the Finance Act 2001, the Government disallowed expenses incurred in earning exempt income (Section 14A) retrospectively from 01 April 1961. However, reopening of past cases was prohibited.

Section 234B (charging of interest on regular assessment was also amended by the Finance Act 1995, retrospectively w.e.f. 01 April 1989.

The retrospective amendments to substantive income-tax provisions, which made the greatest impact was perhaps, brought in by the Finance (No. 2) Act 1980. This Act amended Sections 35, 80J (omitted w.e.f. 01 April 1989) and 80M (omitted w.e.f. 01 April 2004) with retrospective effect from 01 April 1961, 01 April 1972 and 01 April 1968, respectively. Section 80M was amended by inserting Section 80AA into the Act (omitted w.e.f. 01 April 1998). It seems that the amendment to Section 80M was sought to overturn the effect of a Supreme Court decision in *ITO vs. Segu Buchiah Setty* [(1964)52 ITR 538]. The issue related to Section 222, read with Sections 250 and 220, of the Income-tax Act 1961 [Corresponding to Section 46(2), read with Sections 31 and 45, of the Indian Income-tax Act 1922] on the issue of Recovery and Collection of Tax and Certificate Proceedings.

The question referred to Hon'ble Supreme Court in relation to Assessment Years 1953-54 and 1954-55 was-Whether on ITO's order being revised in appeal, default based on it and all consequential proceedings must be taken to have been superseded and fresh proceedings have to be started to realize dues as found by revised order-Held, yes.

CONSTITUTIONAL PROVISIONS IN INDIA

As for India, it is within the right of the courts to evaluate the reasonableness of the retrospective amendment of law in light of the above mentioned principle to ascertain whether it violates the provisions of Article 19(1)(g) of the Constitution (to practice any profession, or to carry on any occupation, trade or business) so as to declare it as unconstitutional. If a retrospective amendment of law is a direct interference with the principle laid down by the Hon'ble Supreme Court, then it would be struck down as unconstitutional and invalid. Thus, the might of the State must stand behind court orders for the survival of the rule of the court in the country.

NOVA CONSTITUTIO FUTURIS FORMAM IMPONERE DEBET NON PRAETERITIS

In the words of Lord Blanesburgh, the provisions which touch a right in existence at the passing of the statute are not to be applied retrospectively in the absence of express intendment or necessary intendment.

In order to qualify as a 'retrospective law' the words used must expressly provide or necessarily connote retrospective operation, otherwise, it will be deemed prospective.

TWELFTH REPORT OF THE LAW COMMISSION ON THE INCOME-TAX ACT

The Twelfth Report of the Law Commission on the Income-Tax Act was forwarded to the Union Minister of Law and Justice, Ministry of Law and Justice, Government of India by M.C. Setalvad, Chairman, Law Commission of India, on 26 September 1958. Para 5 of the forwarding letter mentioned that, "*The Commission wishes to acknowledge the services rendered by Shri S.A.L. Narayana Row, Commissioner of Income-tax, Shri N. Srinivasan, Deputy Secretary in the Ministry of Finance, and Shri K.N. Srivastava, Income-Tax Officer in connection with the preparation of this Report.*"

Retrospective amendments are not a new feature arising only after the enactment of the Income-tax Act 1961 ('the 1961 Act'). Even before that Act, retrospective amendments did happen, albeit largely for procedural issues. However, before enactment of the Income-tax Act 1961, two interesting amendments were carried out with effect from 01 April 1922.

TWO VERY INTERESTING RESTROPECTIVE AMENDMENTS

INTRODUCTION OF SECTION 60B IN THE INDIAN INCOME-TAX ACT 1922

Section 60B of the Indian Income-tax Act 1922 says, "*Tax may be levied for period other than previous year or deducted at source or paid in advance, wherever so provided.*" [Inserted by the Act 28 of 1960, Section 10 (with retrospective effect).]

The Commission had conducted a full review of the 1922 Act. Its Report documented included a draft Bill which, in due course, became

the 1961 Act. Such amendment had also become necessary in view of the decision of Hon'ble Madras High Court in *CIT vs. V.E.K.R. Savumiamurthy* (1946) 14 ITR 185 (Madras). [Ratio of this case was later approved by Hon'ble Supreme Court in (1970) 77 ITR 123 (SC)]. The Commission has discussed its proposal in detail on page 326 of its report.

In short, the Commission proposed the introduction of:

(a) the proviso to Sub-section (1) of Section 4 of the 1961 Act (Section 3 in the draft Bill); and, (b) a new Sub-section (2) in that Section. Important point for consideration was the difficulty noticed in sustaining the legality of the recovery of the tax on the current income under Section 18 and 18A [Sections 18 and 18A of the 1922 Act dealt with tax deduction at source, and advance tax].

Further, as regards item (b) above: Sub-clause (2) was intended to make it clear that there is some kind of liability to pay tax in cases where tax is deductible at source or payable in advance. It seems desirable to make a reference to this obligation to pay tax in advance etc. in the charging section itself, so as to bring out more directly a position which is implied in existing Sections 18 and 18A.

In effect, the Commission said that the procedural sections could not apply in a case where there was no substantive levy of tax. The tax could be recovered, in advance or by deduction, only if, and to the extent that, it was levied or leviable. And it was found difficult to sustain the legality of any recovery in excess of the tax leviable.

The doubt about the legality was found to be so serious that not only did Parliament enact the recommended provisions in the 1961 Act in due course, but it also enacted them retrospectively in the 1922 Act.

Section 10 of the Taxation Laws (Amendment) Act 1960, introduced both the proposed provisions as Section 60B in the 1922 Act, stating that the section 'shall be inserted, and shall be deemed always to have been inserted.' In effect, the amendment, made in 1960, applied from 01 April 1922.

The doubts expressed by the Law Commission as to the validity of tax recovery provisions were serious and valid, as is shown by the fact that a retrospective amendment was considered necessary by the Parliament.

The clear proposition which emerges from the introduction of this provision is that all the provisions relating to the collection and recovery of tax, whether by way of advance tax, the deduction of tax at the source, or otherwise, need to be tested for their validity with reference to the tax actually chargeable in each case. The wider proposition on which it is based is that procedural provisions cannot go beyond the substantive charging provisions.

VALIDATION OF RECOVERY PROCEEDINGS

A similar procedural infirmity came to light in the case of *ITO v. Seghu Buchiah Setty* decision of the Hon'ble Mysore High Court in case of *Seghu Buchiah Setty* 1960) 38 ITR 204 (Mys) later confirmed by Hon'ble Supreme Court in [(1964) 52 ITR 538 (SC)], Hon'ble Supreme Court in its order invalidated demand notices in certain circumstances.

The problem faced was so serious that the Parliament had to enact the Taxation Laws (Continuation and Validation of Recovery Proceedings) Act 1964. Section 5 of the Act states, "The provisions of this Act shall apply and shall be deemed always to have applied, in relation to every notice of demand served upon an assessee by any Taxing Authority under

any scheduled Act whether such notice was or is served before or after the commencement of this Act.” It means that the provisions would not only be retrospective, as regards the 1961 Act, but also as regards the 1922 Act. In effect, this amendment has application from 01 April 1922, though it has been enacted after the Indian Income-tax Act 1922 was repealed.

CONCLUSION

In fact the problems arising due to frequent amendments of the Income-tax Act has been pointed out on the very first page of the ‘Twelfth Report of the Law Commission on the Income-tax Act’ submitted to the Government on 26 September 1958 (Introduction part) as follows, “The amendments to the Income-tax Act have been so short-sighted and so short-lived as to rob the law of that modicum of stability which is essential to its healthy growth. Before the

provisions of the Act can be sufficiently clarified by the judicial process, new provisions are substituted in their place. In legislation as in other fields of human activity, it is well to bear in mind the dictum of Bacon, “Tarry a little, so, that we may make an end the sooner.” Stability is most essential to the proper administration of a taxing statute, and if the tax structure of this country is to be put on a sound footing, it is essential that a halt should be called to the, making of ill-digested amendments in a frenzy of hurry which has characterized the history of income-tax law of the last few years.”

Some retrospective amendments are always required either to prevent the misuse of law or to harmonize various decisions of honourable courts with the statutes. One can now realize as to how far-looking our lawmakers were in the past and how much attention was paid to the legal drafting, as compared to present time.

OECD's Unified Approach on Pillar One to Address the Tax Challenges Arising from the Digitalization of the Economy: A Critical Analysis



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Executive Summary

This article provides a comprehensive summary of the efforts undertaken by OECD in addressing the issues relating to the Tax Challenges Arising from the Digitalisation of the Economy. The article then discusses the intricacies of the proposed Unified Approach issued by OECD Secretariat and endorsed by the OECD Inclusive Framework on Base Erosion and Profit Shifting Project. A sample illustration has been presented to show how the proposal would apply to multi-national groups. It then goes on to highlight the probable economic impact of Unified Approach on all tax jurisdictions. It also deals with the basic shortfalls in conceptualisation of the Unified Approach.

BACKGROUND

BEPS ACTION PLAN

The tax challenges of digital economy were identified as one of the main areas of focus of the OECD/ G20 Base Erosion and Profit Shifting (BEPS) Project, leading to the 2015 Action 1 Report¹. The Action 1 Report observed that process of value creation have significantly evolved, especially for digital enterprises. It highlighted three key features of digitalized businesses:

- Ability to conduct business activities without any (significant) physical presence, called cross-jurisdictional scale without mass.
- The heavy reliance on intangible assets, especially intellectual property (IP); and
- The importance of data, user participation and their synergies with IP.

The OECD Action 1 report argues that these specific characteristics enable value creation by activities closely linked with a jurisdiction without needing to establish a physical presence there. Based on that understanding, it is commonly argued that the concept of permanent establishment (PE) in the era of digitalization appears less relevant,

¹OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241046-en>

or even obsolete², and that a new threshold is therefore needed to source taxation³. Also, the Arm's Length Principle fails to capture this value creation as businesses conducted through a website involves little, if any, functions, assets, or risks in market jurisdiction. And under the Transfer Pricing Rules, the focus is too much on the location of functions performed (i.e. the supply side) and too little on the location of markets and customers (i.e. the demand side),⁴ particularly where enterprises, such as Internet companies, serve markets in which they have no or only a very modest presence⁵.

OECD's interim report released in 2018 highlights that a number of companies dealing in digital products and services, have altered their structures in respect of their cross-border sales (e.g. Amazon, E-bay, Facebook, Google) in response to measures developed under Action 7 (prevent the artificial avoidance of PE status)⁶. These entities, which operated on a remote basis through centralized structures, have created local re-sellers as limited risk distributors

²Vishesh Dhuldhoya, "The Future of the Permanent Establishment Concept," 72(4a) Bull. Int'l Tax'n 12 (2018)

³Peter Hongler and Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy," Working Paper, at 14 (2015); and Michael P. Devereux and John Vella, "Implications of Digitalization for International Corporate Tax Reform," WP 17/07, at 25 (July 2017).

⁴P.B. Musgrave, *Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union*, in *Taxing Capital Income in the European Union: Issues and Options for Reform* pp. 46-77 (S. Cnossen ed., Oxford University Press 2000); P.B. Musgrave, *Principles for Dividing the State Corporate Tax Base*, in *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* pp. 228-246 (C.E. McLure, Jr. ed., Hoover Institution Press 1984).

⁵Maarten de Wilde and Ciska Wisman, "OECD Consultations on the Digital Economy: "Tax Base Reallocation" and "I'll Tax If You Don't"?", IBFD

⁶OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264293083-en>

(LRDs). However, these local affiliates are commonly structured to have no ownership interest in intangible assets, not to perform any development, enhancement, maintenance, protection, exploitation (DEMPE) functions, and not to assume any risks related to such assets. Accordingly, the transfer pricing policy typically leaves the LRD with a modest profit margin for its local sales and marketing activities. Another popular structure involves recording third-party sales from local customers remotely in a foreign principal entity and structuring the local affiliate as a routine market support service provider. Under this model, the local affiliate often receives a cost-plus service fee from the principal entity. The concern that often arises here is whether these LRD and service fee models (and associated transfer pricing) adequately compensate local affiliates for their local marketing intangibles development efforts for digital and non-digital companies alike⁷. Thus, without effective changes to profit allocation rules, an MNE group may seek to sidestep the nexus issue by establishing local affiliates that are not entitled to an appropriate share of the group's profit⁸.

Therefore, the primary issue here is that an MNE can 'reach into' a jurisdiction, either remotely or through an LRD/ services provider, to develop user and customer base and other marketing intangibles with limited exposure to taxation in the market jurisdiction. This kind of remote participation or at very best, modest participation in a domestic economy is the key issue in the digital tax debate, despite different views on the scale and nature of those challenges, as well as whether and to what extent the international tax

⁷News.bloombergtax.com, *INSIGHT: Cost-Plus Transfer Pricing for Marketing Support Services Between BEPS 1.0 and BEPS 2.0*, Aug. 13, 2019.

⁸OECD, *Addressing the Tax Challenges of the Digitalization of the Economy—Public Consultation Document* (Feb. 13, 2019–Mar. 6, 2019), 2019.

rules should be changed⁹. Basis this, it is a widely held view that digitalization tends to exacerbate BEPS issues, with a study highlighting that the effective tax rate for digitalised businesses is only 9.5 per cent compared to 23.2 per cent of traditional business models. The OECD Action 1 Report described this tax challenge from digitalization as primarily relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among jurisdictions.

In January 2019, OECD/G20 Inclusive Framework on BEPS (Inclusive Framework), agreed a Policy Note that grouped the proposals to resolve these challenges into two pillars¹⁰

Pillar One: Focuses on the taxing rights, undertake coherent and concurrent review of the profit allocation and nexus rules.

Pillar Two: Focuses on rest of the BEPS issues and deals with new rules that would establish a global minimum tax regime for multinational corporations.

CONSULTATION DOCUMENT

Following the January Policy Note, the Inclusive Framework in March 2019 sought input from external stakeholders through a public consultation process on three proposals to define how taxing rights on income should be allocated between jurisdictions¹¹:

The User Participation Proposal: It is intended to apply to highly digitalized businesses where users play a significant role in value creation such as social media, search engines etc. It involves

calculating non-routine profits and attributing a portion of the same to the value created by the activities of the users. Subsequently, these profits would be allocated in the jurisdiction in which the business has users based on revenue or any other allocation metrics.

Marketing Intangible Proposal: The scope of the Marketing Intangible Proposal is broader than the User Participation Proposal. It addresses a situation in which a multinational enterprise group can essentially “reach into” a jurisdiction, either remotely or through a limited local presence, to develop a user or customer base and other marketing intangibles.¹² It proposes allowing market jurisdictions to tax some or all of the non-routine income associated with marketing intangible and their attendant risk, while all other income would be allocated among members of the group based on existing Transfer Pricing principles. This special allocation would bypass the legal ownership or the DEMPE criteria enshrined in the Transfer Pricing Rules for assigning income arising from intangibles. The proposal puts forward different conceptual and mathematical approaches to attributing the marketing intangible, the most prominent of which is the revised profit split.

Significant Economic Presence Proposal: It brings in a factor presence test to broaden the scope of the current nexus rules. It is similar to the provisions introduced by Finance Act 2019 which amended Section 9 of the Income-tax Act, 1961 to expand the meaning of the term ‘Business Connection’ to include ‘Significant Economic Presence’. The Indian provision uses Revenue and User base as two distinct tests for establishing taxable presence. Similarly, the European Commission issued a proposal

⁹Jakob Bundgaard and Louise Fjord Kjærsgaard, Taxable Presence and Highly Digitalized Business Models, Tax Notes Int'l, Mar. 2, 2020, p. 977.

¹⁰OECD, Addressing the Tax Challenges of the Digitalization of the Economy – Policy Note, 23 January 2019.

¹¹Supra note 7.

¹²Tatiana Falcão, The OECD's Digital Economy Taxing Rights Allocation Mash-Up, Tax Notes International, August 5, 2019

Ideation

laying down rules relating to the corporate taxation of a significant digital presence based on criteria of turnover, number of users and number of business contracts concluded in a year. The OECD Proposal envisages Revenue as an essential criteria coupled with any of the following factors to establish nexus:

- The existence of a user-base and the associated data input.
- The volume of digital content derived from the jurisdiction.
- Billing and collection in local currency or with a local form of payment.
- Maintenance of a website in a local language.

- Responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance.
- Sustained marketing and sales promotion activities, either online or otherwise, to attract customers.

The proposal then contemplates using Fractional Apportionment method to allocate profits by taking into account factors such sales, assets and employees to apportion the tax base.

A comparative analysis of the three proposals is presented below:¹³

	User Participation Proposal	Marketing Intangible Proposal	Significant Economic Presence Proposal
<i>Policy rationale</i>	Taxing power to the jurisdiction where active users are located	Taxing powers to the jurisdiction where marketing intangibles are 'used'	Taxing powers to the jurisdiction where the company has a virtual presence, through a minimum number of users, sales or contracts etc.
<i>Scope</i>	Very narrow in scope as applied to businesses where user play a critical role in value creation	Applies to a wider range of businesses in comparison with the user participation Proposal.	Applies to a very wide number of remotely operated businesses
<i>Profit allocation</i>	Residual profit split method	Residual profit split method	Fractional Apportionment method
<i>Complexity</i>	Fairly complicated due to issues like diverging interpretations on what constitutes routine and non-routine profits and application of different methods for allocation of profits – arm's length and profit split.	Complexity may arise due to issues similar to the User Participation proposal as well as the need to differentiate between marketing and trade intangible. Also, a portion of profits arising from marketing intangibles may be reflected in normal returns. Similarly, evaluation of the value of marketing intangibles can prove difficult in practice.	No ring-fencing of digitalized businesses. No differentiation between routine and non-routine profits or marketing and trade intangible profits is needed.

The three alternatives discussed above have a number of significant commonalities¹⁴:

¹³IBFD, Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy, 6 March 2019

¹⁴OECD Secretariat, Public consultation document-Secretariat Proposal for a "Unified Approach" under Pillar One (October 2019–12 November 2019)

- All proposals would reallocate taxing rights in favour of the user/ market jurisdiction;
- All the proposals envisage a new nexus rule that would not depend on physical presence in the user/ market jurisdiction;
- They all go beyond the arm's length principle and depart from the separate entity approach;
- They all search for simplicity, stabilization of the tax system, and increased tax certainty in implementation; and
- Their methodology involves apportionment of global profits.

PROGRAM OF WORK

In May, the OECD presented the G-20 a new program of work on developing a consensus solution to tax challenges arising from the digitalization of the economy¹⁵. The program of work addresses that more and more jurisdictions are unhappy with the existing framework of international taxation and if inclusive framework does not give a comprehensive consensus-based solution within the agreed time-frame, the countries will adopt uncoordinated unilateral tax measures. The second chapter of the paper deals with technical issues that need to be resolved to take a coherent review of profit allocation and nexus rules.

Under the Pillar One, OECD discussed three methods for profit allocation amongst jurisdictions:

Modified Residual Profit Split ('MRPS'): Allocating a portion of non-routine profits of the group to markets jurisdictions creating value.

¹⁵OECD, Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy, May 2019.

The 4 steps for profit allocation involves:

- a. identifying the group profits, (b) excluding routine returns, (c) determine the portion of non-routine profit to be allocated to market, and (d) allocating the profit using an allocation key.

The technical challenges for using this method can be deciding the accounting standards to arrive at the group profits to be allocated, determination of portion of non-routine profits using simplified convention as it can be highly subjective and subject to litigation. Further, identifying the accurate allocation key is also challenging. Apart from the technical issues, a political and economic concern here is picking the markets generating value and justifying the value being created to the tax authorities as each jurisdiction would want a share of non-routine profits.

Fractional Apportionment Method: This method allocates the total profits to market jurisdictions creating value using an allocation key, eradicates the need for identifying routine and non-routine profits separately. This method involves three steps:

- b. Identifying the profits, b) identifying the allocation key, c) allocation of profits.

The technical and political challenges would be similar to MRPS.

Simplified Distribution Approach: This contemplates using fixed baseline payment approach for marketing and distribution jurisdictions and adjusting the profitability based on group's overall profitability and other relevant factors.

This is a highly subjective method, as the basis for deciding the baseline payment for each jurisdiction would require a consensus among all the jurisdictions will be questioned by the revenue authorities leading to more litigation.

UNIFIED APPROACH

In October 2019, the OECD secretariat issued a document proposing the Unified Approach to facilitate progress towards consensus on Pillar One which built on the commonalities identified in the Program of Work and taking into account the views expressed during the March public consultation¹⁶. This was a non-consensus document but provided the modalities of a solution that could be acceptable to all the members of the Inclusive Framework and was subsequently released to the public for comments.

In a statement issued in January 2020¹⁷, the Inclusive Framework endorsed the Unified Approach as the basis for the negotiation of a consensus-based solution to be agreed in 2020. This document is complemented by a separate revised Programme of Work for Pillar One that defines the remaining work that needs to be undertaken by the end of 2020 to address all the open ended questions and produce a consensus-based agreement.

SCOPE AND NEXUS

For the applicability of Amount A, the twin criteria of Scope and Nexus must be met in the market jurisdiction. There are two categories of businesses that are in scope: (1) automated digital services, and (2) consumer-facing businesses.

Automated digital services have been described as, ‘services that are provided on a standardized basis to a large population of customers or users across multiple jurisdictions’. They include

¹⁶OECD Secretariat, Public Consultation Document-Secretariat Proposal for a “Unified Approach” under Pillar One (October 2019–12 November 2019).

¹⁷OECD (2020), Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy – January 2020, OECD/G20 Inclusive Framework on BEPS, OECD, Paris.

online search engines, social media platforms, online intermediation platforms, digital content streaming online gaming, cloud computing services; and online advertising services. The second category includes businesses that generate revenue from the sale of goods and services of a type commonly sold to consumers, i.e. individuals that are purchasing items for personal use and not for commercial or professional purposes. This would also include businesses that generate revenue from licensing rights over trademarked consumer products and businesses that generate revenue through licensing a consumer brand (and commercial know-how) such as under a franchise model.

Specific carve-outs have also been mentioned in this document. Extractive industries and other producers and sellers of raw materials and commodities would not come within the scope of consumer-facing definition. Similarly, most of the activities of the financial services sector (which includes insurance activities) take place with commercial customers and will therefore be out of scope.

The Unified Approach will be limited to MNE groups that meet a certain gross revenue threshold. Second, even for those MNE groups that meet the gross revenue threshold, a further carve-out will be considered where the total aggregated in-scope revenue is less than a certain threshold. Third, consideration will be given to a carve-out for situations where the total profit to be allocated under the new taxing right would not meet a certain *de minimis* amount. Once this *de minimis* threshold of profitability is met, country-wise nexus criteria based on revenue (for automated digital services) or revenue plus based parameters (for consumer facing businesses) would have to be met.

ALLOCATION MECHANISM

The document uses a three tier profit allocation mechanism which allows a greater share of taxing rights to market jurisdictions. They are as follows:

Amount A: This is a result of pure reallocation and has nothing to do with Arm's Length Principle. It has been introduced as a possible solution to the problem created by the fact that digitalized enterprises can be heavily involved in the economic life of a country without having any physical presence in its territory and therefore market jurisdictions need greater taxing rights to capture this value creation. This greater taxing right has been granted by way of formulaic reallocation of an MNE's group deemed residual profit on a business line basis. The deemed residual profits of an MNE group would be calculated by excluding the MNE's deemed routine profits as represented by profitability thresholds determined on the basis of fixed percentages. Once that amount of the group's residual profit is determined, a share again, based on a pre-specified fixed percentage that could vary by industry will be deemed allocable in total to the market jurisdictions meeting the new nexus rules. Finally, the total residual profit as determined under the preceding steps will be allocated among the relevant market jurisdictions via a formula based on the sales in each jurisdiction (and possibly other factors that serve as indicia of consumer or user involvement with the relevant MNE)¹⁸.

Amount B: A prescribed set of remuneration based on fixed/ formulaic method for defined baseline distribution and marketing functions that take place in the market jurisdiction. Amount

¹⁸Kartikeya Singh, W. Joe Murphy, and Gregory J. Ossi, "The OECD's Unified Approach—An Analysis of the Revised Regime for Taxing Rights and Income Allocation", Tax Notes Int'l, Feb. 3, 2020, p. 549.

B is expected to approximate the Arm's Length price but is fixed with the goal of reducing complexity associated with the Arm's Length standard which requires a deep understanding of the taxpayer's activities, identification of comparables, an analysis of pricing factors, and a comparison of pricing¹⁹.

Amount C: Again Amount C is expected to approximate to Transfer Pricing based allocation of business profit and is calculated as an excess to 'Amount B' in cases where an activity in a specific market jurisdiction extends beyond baseline or routine marketing and distribution activities or is unrelated to marketing and distribution activities²⁰. Specifically, it could refer to additional profit that should be assigned in the local jurisdiction that results from (a) a higher rate of profit than the fixed rate of profit on marketing and distribution expenses (or on sales) used to compute amount B; or (b) a larger amount of marketing and distribution expenses than used to compute amount B; or (c) returns from functions other than marketing and distribution (such as manufacturing and research) that might be performed in the local jurisdiction²¹.

An illustration to explain the workings is presented below:

The following example illustrates with simplified figures how the proposal would be applied to a hypothetical multinational group 'Group X', which sells streaming and financial services worldwide. Assume the following facts regarding Group X's operations:

¹⁹Johnson & Johnson, Comments submitted to OECD, November 11, 2019.

²⁰Vasiliki Agianni, Associate - IBFD, Proposal for "Unified Approach" under Pillar One – details, 10 October 2019.

²¹Martin A. Sullivan, Economic Analysis: Spreadsheets for the OECD's Unified Approach and Two Alternatives, Tax Notes Int'l, Dec. 9, 2019, p. 877.

Ideation

- Group X has two business lines - streaming services and financial services. It has no other business line. The group is highly profitable, earning non-routine profits, significantly above both the market average and those of its competitors.
- P Co (resident in Country A) is the parent company of Group X. P Co owns all the intangible assets exploited in the group's streaming services business. Hence, P Co is entitled to all the non-routine profit earned by Group X.
- Q Co, a subsidiary of P Co, resident in Country B, is responsible for marketing and distributing Group X's streaming services and therefore performs only these baseline activities. It is structured as a limited risk distributor, owns no intangibles and purchases content from P Co for sale to third party customers with no further value addition. The transaction between P Co. and Q Co. is at arm's length.
- Q Co sells streaming services directly to customers in Country C and Country D, where it does not have any form of taxable presence under current rules.
- Q Co sells financial services to customers in Country E, where it does not have any form of taxable presence under current rules.

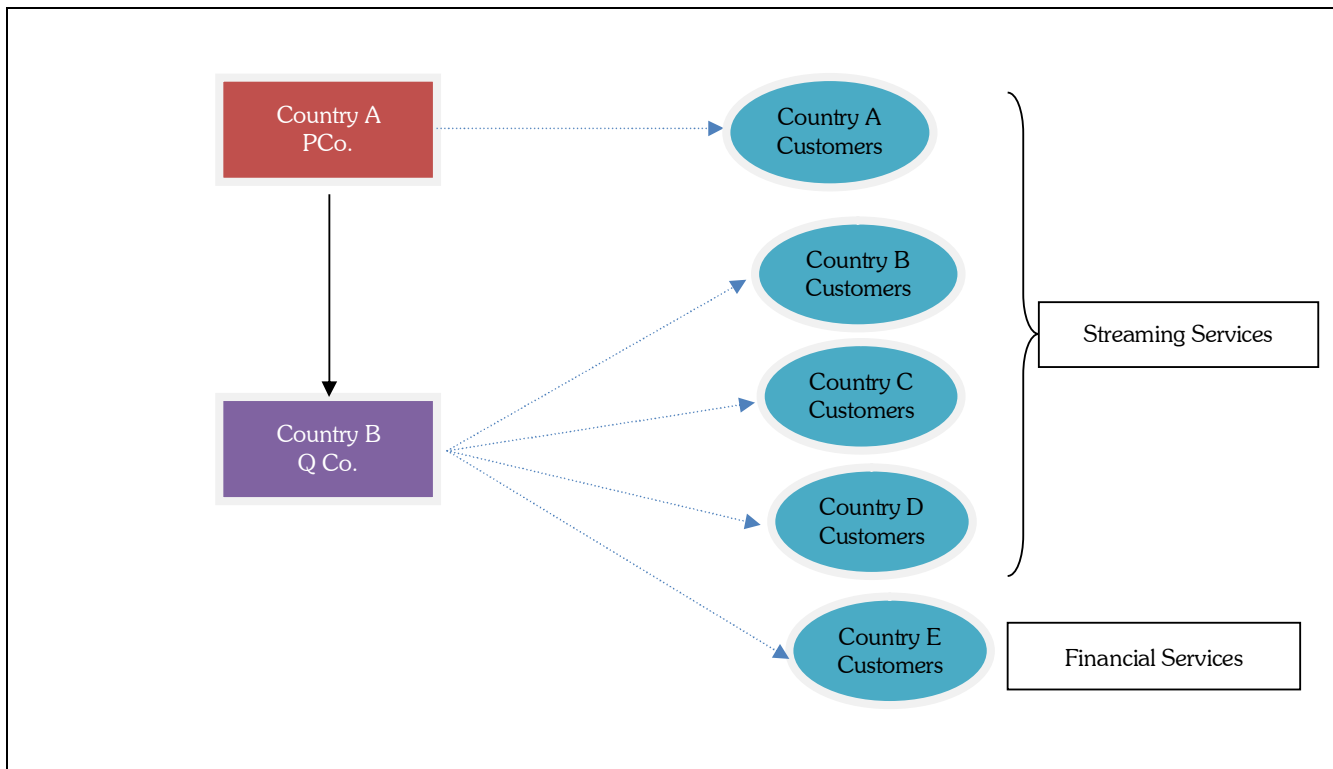


Fig. 1: Group X's Worldwide Operations

See Table 1 for Group X's consolidated income statement:

Table 1: Group X's Factual Data

In Million USD						
Particulars	P Co-Streaming Service		Q Co		Eliminations	Consolidated - Streaming Service
	Related Party Sale	Third Party Sales	Streaming Service	Financial Services		
Country A sales		1200				1200
Country B sales			500			500
Country C sales			300			300
Country D sales			50			50
Country E sales				600		-
Related party sales	550					-
Total Income (A)	550	1200	850	600	-550	2050
Employee cost	206	450	120	330		776
Marketing and distribution expense	-	-	100	100		100
Related party purchase	-	-	550	-		-
Other Expenses	160	350	54	100		564
Total Expense (B)	367	800	824	530	-550	1441
Profit before Tax (A-B)	183	400	26	70		609
PBT/TC	50.00%	50.00%	3.16%			42.30%

CALCULATING AMOUNT B

The Unified Approach calls for calculating Amount B and Amount C before Amount A. Amount C workings have not been shown in this illustration because given the guidance available at this point of time, it is really difficult to pin it down in a definite manner. Therefore only Amount B workings have been presented.

Amount B is a simple fixed return on marketing and distribution functions. It can either be a fixed markup on the marketing and distribution expense or it could be expressed as a percentage

return on sales. Here we assume the fixed mark-up on cost to be 10 percent and the fixed return on sale to be 3 percent for the baseline marketing and distribution functions performed by Q Co. The OECD proposal lays out the future path in terms of technical aspects that needs to be agreed for Amount B. This includes defining the baseline activities, choosing the right profit level indicator as well as determining the extent of differentiation required in the mark-up for different industries and regions in line with the arm's length principle.

The calculation of Amount B is presented below:

Table 2: Calculation of Amount B - Simplified Method to Compute Profits From Baseline Marketing and Distribution Functions

Fixed percentage of mark-up on cost (assumed) (1a)	10%
Local marketing and distribution expenses (1b)	100
Fixed return as percentage of sales (assumed) (2a)	3%
Total sales of Q Co in Country B, Country C and Country D (2b)	850
Taking amount B as higher of (1a*1b) & (2a*2b)	26

CALCULATING AMOUNT A

Step 1: The first step involves determining the total profit to be split. For this only the streaming service segment has been considered since financial services have been explicitly carved out from the scope of Unified Approach. The proposal suggests using the group's audited financial statement to arrive at the consolidated worldwide group operating profit using Profit before tax as the preferred profit measure. For illustrating the mechanics of this proposal, the example uses only a single line of business. However, the proposal recommends that where a MNE group has multiple business line or operates in different regions, segmentation may be needed to account for variability in profit margin across segment or regions. Reliance on financial statement data is intended to ensure that the operating profit figures are from a verifiable source with safeguards to ensure that the data are reliable and not tax-motivated²².

²²Francois Chadwick, International Tax Rules for the Digital Era, Tax Notes International, Sep 4, 2019.

Step 2: This involves calculating the routine profit earned by the Group. OECD in its proposal acknowledges the need to arrive at a level of profitability above which Amount A would apply. This relates to deeming a portion of return to be routine and is intended to act as an approximation of the amount that would result under a principle-based profit split, while dramatically reducing complexity and the potential for disputes over what constitutes a routine return in a particular case²³. We assume a routine profit margin of 10 percent on worldwide sales. OECD, in its Economic Analysis and Impact Assessment presentation (discussed later), has taken routine profit margin figures of 10 percent and 20 percent on sales, yielding a remainder of either 90% or 80% as non-routine profit or Deemed residual profit. So in addition to being in scope, businesses must have profit margin above the routine level for the proposal to work with regards to Amount A (Amount B allocation in any case would apply since the same is in nature of routine profits).

Step 3: A portion of the deemed residual profit, corresponding with the share of total profit from intangibles attributable to marketing intangibles has to be re-allocated to market jurisdiction. OECD, in its Economic Analysis and Impact Assessment presentation, has taken this at 20 percent of the Deemed residual profit (there seems to be no reasoned justification for the choice of that specific percentage). The same figure has been considered in this illustration. OECD

²³Supra note 17.

in its proposal has considered the need to determine whether the relative portion of the profit allocated to the market under Amount A should be the same across all in-scope businesses or whether, to reflect the different degrees of relevance of the policy rationale, there should be different percentages applied for different businesses²⁴.

Step 4: This portion of deemed residual profit is then allocated to market jurisdictions that meet the nexus criteria. This is determined on the basis of the revenue arising from a jurisdiction. In this illustration, no profit is allocated to Country D precisely because of this reason i.e. since its revenue fails to meet our presumed revenue threshold. OECD in its proposal talks about using revenue threshold as the only criteria for creating nexus in case of in-scope automated digital services. But for other consumer facing activities which are in-scope, there would be a plus requirement. Merely sale into a jurisdiction would not create taxable nexus. Revenue threshold plus certain other test (to be determined) would be required to create nexus. The next step involves allocating this portion of residual profits to eligible market jurisdiction, based on an agreed allocation key. The illustration uses Sales as the allocation key. However sales of a type that generate nexus for different in-scope businesses would be used as the allocation key as per the OECD proposal. The document also calls for designing specific revenue

sourcing rules to support its application by reference to different business models. Such rules are needed because monetization strategies of digital business models are unique. They are also needed because the customer base of digital businesses is mobile. Therefore there is a need to bring clarity to as to how the location of users would be determined in few cases like subscription based business models etc.

Table 3: Calculation of Amount A—Portion of Residual Profits Attributable to Marketing Intangibles Allocated to Sales Jurisdiction

Routine Profit Margin(assumed) (1)	10%
Total Sales (2)	2050
Total Profits (3)	609
Routine Profits (4 = 1*2)	205
Deemed residual profit (5 = 3 - 4)	404
Fraction attributable to marketing jurisdictions (assumed)(6)	20%
Amount A (5*6)	81

Table 4: Calculation of Amount A Allocation for Each Country

Country	Sales	Proportion of Total Sales	Share in Amount A
Country A	1200	0.6	49
Country B	500	0.25	20
Country C	300	0.15	12
Total Sales	2000		81

Note: Country D has not been allocated Amount A as it fails to meet the nexus threshold

Table 5: Change in Tax Base after Applying Unified Approach

Country	Before Unified Approach	After Unified Approach	Difference
Country A	583	551	-32
Country B	26	46	20
Country C	0	12	12

²⁴Supra note 12.

ECONOMIC ANALYSIS AND IMPACT ASSESSMENT

OECD held a webcast in February 2020 highlighting the projected impact of the OECD's proposed reforms, which estimated global net revenue gains of up to 4 percent of global corporate tax revenues, or \$100 billion annually. The OECD said those gains are broadly similar across high-, middle-, and low-income economies, however most of the tax revenue is expected from Pillar Two (a minimum tax plus anti-base-erosion tax). It projected only small global revenue gains from Pillar One (a residual profit allocation proposal), including small revenue increases for most countries with some losses by investment hubs²⁵. On average, middle and low income countries would gain relatively more in revenues than advanced economies. It also showed that more than half of the profit reallocated comes from 100 MNE groups.

One possible explanation for the low impact of Pillar One is that profitability margin of the tech industry varies significantly. Many tech companies may have low profit margins, or are not profitable at all, because of how much they invest in the growth of their business in order to gain increased consumer attention. For instance, take the case of Amazon which does not have any amount A reallocations because it has no residual profits. In 2017 Amazon profits before tax were 2 percent of sales. In 2019 it was still below threshold, with profits before tax equal to 5 percent of sales. Most or all of Amazon's businesses would seem to fit comfortably under the OECD's conception of business in scope of amount A because they provide digital content, an online marketplace, and cloud computing web services.

²⁵Mindy Herzfeld, *An Off-Ramp for the OECD's Digital Tax Project*, Tax Notes Int'l, May 18, 2020, p. 750.

An IMF working paper shows that while in the aggregate there may be large residual profits, many large multinationals appear to have negative residual profits. The IMF work also shows that consolidating corporate earnings (as proposed for computing the tax base under OECD pillars One and Two) requires consolidating losses as well. IMF concludes that under a formulary apportionment system, the global tax base could be reduced by up to 10 percent because of cross-border loss consolidation. The IMF projects that cross-border loss consolidation would reduce multinationals' overall tax bases. They're not reflected in the proposals' projections, because the proposals seem to account only for profits and not losses.

For India, Pillar One does not bring much cheer as was expected. An analysis by Martin Sullivan based on 2017 statistics of Country-by-Country data of top 25 companies released by US IRS showed that India was a net loser when it comes to amount A with a net outflow of 48 billion USD in terms of tax base²⁶. This is because the data showed that the country's share of profit as a percentage of global profit is higher than the country's share of sales as a percentage of global sales. However this paper acknowledges that the foreign revenue changes are speculative because they are based on aggregate data, not taking into account company-by-company differences in the composition of foreign profits and sales. Nevertheless, it serves as a clear warning signal and gives a preliminary idea as to where India is headed in terms of revenue gains from Pillar One. Therefore there is an urgent need to get a clearer understanding of this based on access to confidential, company-specific data sources that government has.

²⁶Martin Sullivan, *Economic Analysis: OECD Pillar 1 'Amount A' Shakes Up Worldwide Profit*, 97 Tax Notes Int'l 849 (Feb. 24, 2020).

TECHNICAL ISSUES²⁷

CONCEPTUALLY CANARD: THE VALUE CREATION FALLACY

The underlying narrative of the OECD with regards to the BEPS project has been to align taxation with value creation. This involves the assignment of the primary right to tax to an economically correct jurisdiction which further implies that a correct jurisdiction to tax can in fact be ascertained as an empirical matter. However this is loaded with faulty assumption. First, the assumption that multinational profit can be fragmented and that fragmentation is a neutral, even scientific task; and second, that accordingly, all countries should agree to the agreed fragmentation, and not some other fragmentation. The basic bedrock of this assertion is based on widely held view that assigning origin to income is scientifically impossible. Many types of income would have several places of origin, and the whole would be fundamentally indivisible into parts. There were too many variables, and too much interdependence among them, to extract a precise origin for the income earned in a global economy²⁸. Therefore division of global income tax base has always been a political question and not an economic one. The question here arises is why is the OECD alluding so tightly to the concept of value creation as the base for division of taxing rights. Some would say the entire point of focusing on value creation is to find a way to leave minimum for low-income countries as this emerging concept of value creation may be

²⁷The scope of this article is limited to highlighting the basic shortfalls in conceptualisation of the Unified Approach. It does not attempt to analyse and make recommendations on various design issues and other technicalities which are still under consideration and have not been agreed. Therefore the article focuses on only those aspects which have been accepted by the Inclusive Framework as fixed.

²⁸Allison Christians, *Taxing According To Value Creation*, Tax Notes International, June 18, 2018

substantially biased towards ‘brains’ as opposed to ‘hands’.

The Unified Approach acknowledges the fact that mere cross-border sale of tangible goods into a market jurisdiction does not in itself amount to a significant and sustained engagement in that jurisdiction and therefore does not create any new taxing rights for it. What is needed is value creation in the market jurisdiction through either a physical presence or targeted advertising or an active user base contributing in the form of either data or subscription.

It has been demonstrated that user engagement on online platforms create value through their usage of the product and thereby pay for their use of the platform many times ‘in kind’ in the form of data instead of, for example, by means of a paid subscription. The relevant tech companies capture and collect these data units and then process them into commercially tradable market knowledge. This user value, so it is claimed, would not be created if the digital (or other) service were to be paid for in money. Otherwise the market would, in itself, constitute a source of income, and that would not seem to be what the OECD envisages. This immediately pinpoints the weakness in the user value idea – i.e. the idea that if you pay for digital (or other) services in kind, you create value, but if you pay for these services in money, you do not create value. That sounds completely arbitrary, as if the method of payment makes the difference in terms of creating value²⁹.

Allocation of tax base to marketing jurisdiction is also based on the idea that engagement in market jurisdiction creates favourable attitude in the mind of the taxpayer and so leads to generation of marketing intangible by way of better brand value and trade name. However it is improper

²⁹Supra note 5

to think that only marketing intangibles create favorable attitudes in the minds of customers. Customer value of this nature is also created by other components of business capital that contributed to developing and producing the goods and services supplied and this includes - product quality, underlying research and development (R&D) and the logistics process (i.e. the supply chain) etc. This segregation between marketing intangibles from other business assets give rise to all sorts of delineation issues and legal uncertainties, to double taxation resulting from income allocation mismatches, to different treatment being afforded to cases that are economically equal and to distortions in the economy³⁰.

CACOPHONY AND CONFUSION: SCOPE AND NEXUS ENTANGLEMENT

The proposal is intended to be applicable to consumer facing businesses. However defining what would constitute consumer facing business is very difficult and would create numerous boundary issues and would lead to likely disputes between tax authorities and taxpayers. There are products that are used as both final consumer products as well as intermediate product. Also with evolving business models, any attempt at defining what constitutes consumer facing business would quickly become outdated.

The proposal talks about different approaches for digital and non-digital businesses. However the dividing line between digital and non-digital products is increasingly getting blurred. Take for instance a new kind of diapers in the market. These digital diapers come with a tiny RFID sensor that can detect diaper moisture, signal a nearby receiver, and send caregivers an alert. They say that the sensor can be manufactured for less than 2 cents, making it suitable for disposable diapers

³⁰Supra note 5.

without adding bulk³¹. Now the differentiation of whether it is a consumer facing product or a service becomes an issue here. Many would argue that this is a product and not a service but then this is just the beginning and the case in point here is that things are going to get really mixed-up in the future as technology progresses. Any proposal separating one from the other for tax base division purposes would be prone to causing market distortion, arbitrary situations, inequities and manipulation. This differentiation would also force companies to prepare bespoke, segmented financials, which would lead to complexity, uncertainty and dispute amongst authorities³².

The Unified Approach calls for using revenue along with other factors such to determine nexus and as a criteria for allocation of residual profits to markets jurisdiction. One such possible criteria is the user base to take into account situation where the location of non-paying users are different from those in which the relevant revenue is booked. The assignment of taxing rights based on user location creates many issues. First, Businesses generally do not collect data regarding the location of the end users. And if they start doing that then a lot of time and cost will be required to do so. Also, in doing so there may be violation of a lot of privacy laws enacted recently. Secondly, the IP address and other such geo-location indicators are generally accepted to not be fail-proof since virtual private networks (VPNs) and proxy servers that allow users to show that they are acting out of states other than where they are actually located are ubiquitous the market³³.

³¹www.theverge.com, RFID sensor is powered by dirty diapers, Feb 14, 2020.

³²Amazon, Comments on the Secretariat Proposal for a Unified Approach under Pillar one, Nov 11, 2019.

³³Sriram Govind, Unilateralism in Taxing the Digitalized Economy: Comparing the EU Digital Services Tax Proposal and the Indian Equalization Levy, IBFD 2019.

CONFLATION AND CONFLICT—AMOUNT A

The Unified Approach is a conflation of two ideas—destination-based formulary apportionment and the existing origin state-based transfer pricing model. The solution that is on the table currently seeks to blend these two incompatible apportionment systems which is likely to result in a series of alignment problems in all of the areas in which these various apportionment models would, in practice, interact. These alignment problems will create all types of problems of both substantive (e.g., multiple taxation) and administrative natures (e.g., disputes); on top of that, they will occur on a worldwide scale. One system refers to taxpayers, taxable profits, and the arm's length principle whereas the other system refers to multinationals/ business lines, commercial profits, and formulary apportionment. Successfully incorporating Amount A into the current international tax framework would require incorporating a full profit tax apportionment system into national legislation and regulations as well as the tax treaty networks of every country around the world; otherwise stated, tax harmonization on a global scale. The two apportionment systems, in the synthesis as outlined, must not be allowed to result in double taxation. In order to achieve single taxation and prevent mismatches at a tax entity, tax base, and tax base allocation level, therefore, the countries that are affected will also have to reach agreements with each other on all of the reference points, both in policy terms and in a more legal and technical sense. This is an undaunted and extremely difficult process to implement and looking at the way multilateralism has floundered recently, it appears nearly impossible to accomplish³⁴.

³⁴de Wilde, Maarten Floris, On the OECD's 'Unified Approach' As Frankenstein's Monster and a Dented Shape Sorter (November 3, 2019). Available at SSRN: <https://ssrn.com/abstract=3479949> or <http://dx.doi.org/10.2139/ssrn.3479949>.

CAN OF WORMS—AMOUNT B AND AMOUNT C

Although defining baseline marketing and distribution functions is a necessary predicate to the operation of Amounts B and C, it seems unlikely that such activities could be objectively defined. If in market baseline marketing and distribution functions are subjectively defined, then it could lead to a proliferation of tax disputes³⁵.

There is a risk that if the baseline activities are more broadly defined with commensurately higher returns and if actual the actual distribution and marketing activities are significantly less than the baseline amount then the allocation may be under Amount B would be unjustified³⁶. Therefore there is a need to consider the possibility of structuring Amount B as a safe harbor rather than as fixed returns.

While it is understandable that there is an attempt to prescribe fixed returns for marketing and distribution function to provide greater certainty, what is a little perplexing is the idea of fixing returns for all additional activities in a country (e.g., services such as research and development) through Amount C. This is an attempt to go way ahead of the original purpose for which this whole project was conceived. The Unified Approach should stay rooted in advising on marketing and distribution type activities, and that the arm's length standard be left in place with the OECD Guidelines for the rest of the supply chain. While the stronger dispute resolution rules in Amount C is appreciable, however stronger dispute resolution on transfer pricing for the rest of the supply chain would be better addressed in

³⁵Uber, Uber's Comments and Observations with respect to the Unified Approach, November 2019.

³⁶EY, Comments on Public Consultation Document – Secretariat Proposal for a “Unified Approach” Under Pillar One, 12 November 2019.

a separate initiative. Low income countries may see this as attempt to push fixed rates down their throats and limit their administrative flexibilities under the garb of assigning more taxing rights to them.

CONCLUSION

The OECD has come a long way since it first released its 2005 publication of *E-commerce: Transfer Pricing and Business Profits Taxation* to address the challenges arising from the digitalization of multinational enterprises' business models and the evolution of cross-border e-commerce. In this long period of 15 years, the last few have been really productive with OECD accepting the need for a system overhaul, setting the agenda through BEPS and post-BEPS initiatives and doing couple of very dynamic public consultation through which it has considered every possible option on the table and heard every possible voice. But one thing that has set this apart from all previous efforts is the attempt to broaden the discussion by creating an Inclusive Framework and giving a formal position to every interested country. This was something indispensable, without which the whole initiative couldn't progress as overhauling global rules requires that every country comes on board.

However many believe that this ambitious timeline of December 2020 for a final pillar one outcome is resulting in significant policy decisions being made with limited conceptual and empirical understanding of the likely consequences. The amount of administrative and technical pain that is going to result from transitioning to this radical system from a system which has been in place for almost hundred years may not deliver the tax gains and the economic efficiencies that many countries are hoping for.

With multilateralism taking a hit (more severely recently due to the pandemic) and with many countries already having unilateral measures in place, the question now is will they be interested in a solution at all, if at all it exists, especially when it requires an unimaginable level of cooperation and agreements globally and placing their faith in institutions which many see as serving the interest of only a few.

For low income countries (but with high tax jurisdictions), a deeper introspection may make many feel shortchanged. Just consider this for example. If a company's worldwide rate of profit is 25 percent (very few MNE groups operate at this level of operating margins) and its average foreign tax rate is 20 percent, then in all jurisdictions where it is above the local threshold amount, it would pay, and the local government would collect, a tax equal to 0.3 per cent of local sales. This is based on the assumption that the deemed rate of routine-return is 10 per cent and share of market jurisdiction is 10 per cent of residual profits. Now isn't this sum paltry!

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- [28] Martin Sullivan, Economic Analysis: OECD Pillar 1 'Amount A' Shakes Up Worldwide Profit, 97 Tax Notes Int'l 849 (Feb. 24, 2020)

Digital Taxation in India



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Executive Summary

Equalisation Levy (Digital Taxation) was introduced in India (the first country in the world to do so) in Year 2016 on online Advertisement, subsequent to the “Report of the Committee on Taxation of E-Commerce” which proposed Equalisation Levy on Specified Transactions. However it was kept outside the domain of Income Tax Act, which lead certain issues e.g tax credit of Equalisation Levy in other country, no liability of the beneficiary, Tax Neutrality, etc. thereafter the amendments of 2018, introducing the concept of Significant Economic Presence (SEP) and th lately (2020) introduced amendment to Finance Act 2018.

Human race has evolved during the time scale through different forms of revolution, to begin with agricultural revolution occurred between 1750 and 1900. Since the agricultural revolution was a change in the methods of farming, people became more educated and improved the methods of farming and this lead to the industrial revolution. The first Industrial Revolution was characterized by steam and water. The second Industrial Revolution was the introduction of electricity to mass produce things. The third is characterized by the internet, communication technologies, and the digitalization of everything. The fourth Industrial Revolution is the concept of blurring the real world with the technological world¹. With the

advent of ICT², which started to bring the change the way businesses were conventionally done. The ICT has made technologies cheaper, more powerful, and standardized, improving business processes and bolstering innovation across all sectors of the economy³. The rise in use of ICT led the government to frame a law which was known as The Information Technology Act 2000. Act No. 21 of 2000⁴, enacted on 09 June 2000. It provides legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication, commonly referred to as

²Information Communication Technology.

³Evolution of digital economy and taxation challenges, Updated: 13 Oct 2018, 11:40 AM IST (<https://www.livemint.com/Politics/7fPthmfawKPnhF2IsufkmL/Evolution-of-digital-economy-and-taxation-challenges.html>), Vikas Vasal, Vikas Vasal is national leader tax-Grant Thornton India LLP. Accessed on 08-03-2020.

⁴<https://indiacode.nic.in/bitstream/123456789/1999/3/A2000-21.pdf>, accessed on 08-03-2020

¹<https://www.forbes.com/sites/jacobmorgan/2016/02/19/what-is-the-4th-industrial-revolution/#589bb2c5f392> accessed 08-03-2020

‘electronic commercial’ which involves the use of alternatives to paper-based methods of communication and storage of information, to facilitate electronic filing of documents with the Government agencies⁵. However, with parallel to electronic communication arose the ‘Digital Economy’⁶. So, what is the digital economy? It’s the economic activity that results from billions of everyday online connections among people, businesses, devices, data, and processes. The backbone of the digital economy is hyper-connectivity which means growing interconnectedness of people, organizations, and machines that results from the Internet, mobile technology and the internet of things (IoT)⁷. The digital economy is fundamentally different from the traditional economy as it existed during the 20th century when many economic theories were crystallized (and ossified)⁸. The digital economy is also sometimes called the Internet Economy, New Economy, or Web Economy⁹. The current tax rules (International as well as Domestic) were devised decades ago based on the functionality of the brick and mortar economy. Moreover, with the advent of the digital economy, the present tax regime stands redundant. The profits of the digital businesses have been increasing alarmingly, but there do not exist commensurate

⁵<https://indiacode.nic.in/bitstream/123456789/1999/3/A2000-21.pdf> , page – 05, accessed on 08-03-2020

⁶It is often attributed to Don Tapscott in his 1995 book entitled “The Digital Economy: Promise and Peril in the Age of Networked Intelligence.” Since then, many have used it in different ways to describe tech-based economic activity and phenomena. <https://www.techopedia.com/definition/32989/digital-economy> accessed on 09-03-2020.

⁷What is digital economy? Unicorns, transformation and the internet of things. <https://www2.deloitte.com/mt/en/pages/technology/articles/mt-what-is-digital-economy.html> accessed on 09-03-2020.

⁸Chohan, Usman W., Some Precepts of the Digital Economy (January 1, 2020). Critical Blockchain Research Initiative (CBRI) Working Papers, 2020. Available at SSRN: <https://ssrn.com/abstract=3512353> or <http://dx.doi.org/10.2139/ssrn.3512353> accessed on 09-03-2020.

⁹https://en.wikipedia.org/wiki/Digital_economy

tax laws to tax such profits¹⁰. The digital economy is increasingly being viewed by governments as the ‘catalyst’, enabling enterprises to make use of the gaps that existed between different tax systems to reduce taxable income or shift profits to low-tax jurisdictions¹¹. Accordingly, it is the need of the hour for all the countries to devise and revamp their tax laws, as the digital economy is ripe for taxation.¹² However, here it is pertinent to note that ‘Digital Economy’ is different from ‘E-Commerce’.

DIGITAL ECONOMY IN INDIA & TAXATION

As much as \$83 billion of India’s services exports were delivered digitally in 2016–17, according to *the first all-India survey* on exports of services delivered remotely over information and communications technology (ICT) networks, such as internet platforms, telephones, and other computer networks¹³. According to NASSCOM, in 2017, the IT-BPO industry alone earned India a revenue of about US\$154 billion¹⁴. Gradually,

¹⁰Taxation of Digital Economy in India, Siddharth Shah , <https://taxguru.in/income-tax/taxation-digital-economy.html> , accessed on 09-03-2020.

¹¹Digital economy taxation: OECD’s roadmap and implications for India , https://economictimes.indiatimes.com/small-biz/policy-trends/digital-economy-taxation-oecd-roadmap-and-implications-for-india/articleshow/69700760.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst, by Ajay Rotti, accessed on 09-03-2020.

¹²<https://taxguru.in/income-tax/taxation-digital-economy.html> , by Siddharth Shah, accessed on 09-03-2020.

¹³https://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=1917&Sitemap_x0020_Taxonomy=UNCTAD%20Home;#2045;#Information%20Economy:%20Measurement;#1713;#Information%20and%20Communication%20Technologies , India, with assistance from UNCTAD, conducts a new-style of trade-in-services survey to show the growing value of digitally enabled exports. Accessed on 09-03-2020.

¹⁴<https://www.india-briefing.com/news/india-back-office-world-india-software-hr-digitalmarketing-19476.html>/ India is considered one of the preferred destinations for

with time, the presence of digital economy is increasing its footprint across the length and breadth of the country, be it manufacturing, or providing services, or be it any other ancillary activity. In Indian economy, as in any other economy, the taxation of this digital economy is one major concern, as the current statute which is of the year 1961, when no-one could have anticipated the digital economy. In absence of effective tax rules for digital transactions, the tax authorities tend to force-fit the existing tax rules, designed for a non-digital world, thus resulting in asymmetry, double tax burden and sometimes excessive profit allocation¹⁵.

The *sine qua non* for taxing any person¹⁶ in India is either he should be resident¹⁷ of India, or the income should accrue or arise in India or deemed to accrue or arise in India i.e. the source of income¹⁸ should be from India.

Residence-based and source-based are the two criteria to tax a person. Residence-based is largely followed by the developed nations whereas the source-based principle is largely followed by the developing nations. OECD Model Tax Convention is based on Residence principle. UN Model Double Taxation Convention is based on combination of Residence and Source Principle with key emphasis on the latter¹⁹. India

outsourcing and key back office functions.

- *Apart from IT, jobs in sectors like HR and payroll management, digital marketing, and SEO are being increasingly outsourced to India.*
- *India is expected to be a global delivery center for artificial intelligence in the near future*
- ByNishthaYadav, accessed on 09-03-2020.

¹⁵<https://www.livemint.com/Politics/7fPthmfawKPnhF2IsufkmL/Evolution-of-digital-economy-and-taxation-challenges.html>, Evolution of digital economy and taxation challenges, accessed on 12-03-2020.

¹⁶As defined under Section 2(31) of Income Tax act 1961.]

¹⁷Residence in India. Defined under Section 6 of Income Tax act.

¹⁸Section 2(24) of Income Tax act.

¹⁹<https://www.taxmann.com/blogpost/2000001833/>

is following basically residence-based taxation. Still foreign companies are taxed in accordance with source taxation and domestic companies are taxed on residence principle²⁰.

To tax a domestic company, the scheme of Income-tax Act 1961 is clear and the domestic companies are taxed as per the laid legislation. However, the rules to tax MNCs, having only digital presence are not as clear as that of domestic companies. Over time, two types of cross-border transactions have emerged: (a) doing business with a country, and (b) doing business in a country. The former involves foreign companies being engaged in business transactions with the residents of a country, wherein these companies conduct their business activities without setting up a business presence in this country; for instance, selling products to its residents, but transferring the titles, risks and rewards outside the country. In such a situation, the taxation mechanisms of foreign companies are usually straightforward. Such foreign companies are not taxable in the country in which purchasers of their products are located since they neither have an official presence in it, nor do they undertake any business activities in it.

The latter situation envisages the presence of a company in a country that is not its country of residence. In this case, the company undertakes business activities in the foreign country by establishing its formal presence in it. The activities of such a company may be conducted by its employees or an agent, or from a fixed

double-taxation-avoidance-agreement---all-about-dtaa.aspx Double Taxation Avoidance Agreement - All About DTAA, "Taxation treaties or DTAA's to avoid double taxation between two or more countries are the order of the day now. Dr. Justice Vineet Kothari, a Judge Madras High Court", accessed on 12-03-2020.

²⁰<https://www.indianeconomy.net/splclassroom/what-is-the-difference-between-residence-based-taxation-and-source-based-taxation/What-is-the-difference-between-Residence-Based-Taxation-and-Source-Based-Taxation?> Accessed on 12-03-2020.

base through which it operates in the country. The taxation-related implications of these cross-border transactions are complex. The main questions that arise are two-fold: (a) which country has the right to tax the business profits earned by the foreign company through its formal presence in a country? (b) if the country in which a foreign company has a formal presence has the right to tax the business profits earned by it by utilizing the country's resources, how can the proportion of profits to be taxed be determined?²¹

To tax foreign or any entity, there needs to be two essential things: one is the jurisdiction over the entity to be taxed and the second is taxable income. Jurisdiction is established through the Permanent Establishment and taxable income is as per the tax slabs under the Income-tax act 1961.

With the advent of digital markets/ digital economy the concept of PE has undergone drastic change. All the three model conventions namely, UN (United Nations) Model, OECD (Organization for Economic Co-operation and Development) Model and US (United States of America) Model use PE as the main instrument to establish taxing jurisdiction over a foreigner's business activities. However, with the rise of digital economic activities the conventional PE definition (brick & mortar definition) has blurred. Now, the companies have significant economic presence without even having a single asset in the source state, as worded by Tom Godwin, 'Uber the world's largest taxi company, owns no vehicles. Facebook, the world's most popular media owner, creates no content. Alibaba, the most valuable retailer, has no inventory; and Airbnb, the world's largest accommodation provider, owns no real estate.

²¹<https://www.pwc.in/assets/pdfs/publications/2017/the-past-present-and-future-of-permanent-establishment.pdf>The concept and significance of PE, accessed on 12-03-2020.

Something interesting is happening²². We can feel the presence of either of these or other internet-based companies in our life in one way or other.

The issue of digital taxation was raised in BEPS actions of OECD, the Action 1 (Addressing the tax challenges raised by digitalization), talks of digital taxation, the gravity of the issue could be understood from the fact that digital taxation is the very first action out of total 15 actions and it is given a top priority. Over the period i.e. from 2015, it has evolved significantly and at present two pillars approach is adopted under Programme of Work (PoW) adopted by the OECD/ G20 Inclusive Framework on BEPS (Inclusive Framework) at its meeting of 28-29 May 2019, where Pillar One discusses the Secretariat Proposal for a 'Unified Approach' and Pillar Two deals with Global Anti-Base Erosion (GloBE) Proposal. The PoW explores technical design implementation issues that must be refined to develop a comprehensive and consensus-based solution²³. However, no final outcome is found so far.

In India, the watershed point in field of digital taxation was the year 2016 when India introduced the Equalization levy. This was done in line of OECDs Base Erosion and Profit Shifting (BEPS) project of taxing e-commerce transactions. The Finance Act of 2016 introduced the new Chapter, Chapter VIII titled, "Equalisation Levy". This Equalization Levy was result of the recommendations of Committee on Taxation of E-Commerce formed by the Central Board of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India.

²²<https://techcrunch.com/2015/03/03/in-the-age-of-disintermediation-the-battle-is-all-for-the-customer-interface/>, Tom Goodwin is senior vice president of strategy and innovation at Havas Media. Accessed on 01-06-2020.

²³<https://www.oecd.org/tax/beps/beps-actions/action1/> accessed on 02-06-2020.

Headed by Shri Akhilesh Ranjan, Joint Secretary (FT&TR-I), CBDT, Department of Revenue, Ministry of Finance. This report is also known as 'PROPOSAL FOR EQUALIZATION LEVY ON SPECIFIED TRANSACTIONS' submitted in February 2016.

The reason for constituting the committee in 2016 was the rise e-commerce trade in India, the Information Communication Technology (ICT) gave rise to new business models that rely more on digital and telecommunication networks, without any physical presence, and derive substantial value from data collected and transmitted through such networks. These new ICT based business models have created new tax challenges in terms of nexus, characterization and valuation of data and user contribution. These issues are faced more commonly by countries like India, which have included provisions that allow taxing rights to the source jurisdiction to tax royalty and fee for technical services in their tax treaties, and thereby have a difference in position with the OECD in respect of these provisions. The combination of inadequacy of physical presence based nexus rules in the existing tax treaties and the possibility of taxing such payments as royalty or fee for technical services creates a fertile ground for tax disputes, particularly in countries like India, where the taxpayer rights are fully protected by the appellate authorities, and imposition of tax under ambiguous laws are often not sustained²⁴. Moreover, globally the digital economy is growing at 10% a year, significantly faster than the global economy as a whole. Indian story of growth of digital economy is also almost same. The committee stated that equalization levy is needed to attain the objective of providing greater 'clarity, certainty and predictability'

²⁴<https://www.incometaxindia.gov.in/News/Report-of-Committee-on-Taxation-of-e-Commerce-Feb-2016.pdf> accessed on 02-06-2020.

in terms of the taxation of the digital services and to reduce the cost of compliance. In spite of DTAA's, withholding tax and various other provisions under the IT Act, the equalization levy was required to tax the income earned over services and transactions over digital platforms. The concept of 'equalisation levy' is an aspect of BEPS Action 1 of imposing tax on cross-border supplies of services and intangibles.

Considering the growth of ICT and e-commerce, the committee recommended for the imposition of equalization levy. This equalization levy was not made part of income tax but a separate chapter (Chapter 8, from Section 163 to Section 180) in the Finance Act 2016, the reason for not making it a part of Income-tax Act because it is not the tax on the income and imposing a levy is an easy option that which can be adopted easily under domestic laws without making amendment of a large number of tax treaties²⁵. The equalization levy is a tax on the consideration paid while Withholding tax is a tax on income, therefore, it is different from Withholding tax.

The government adopted the recommendations of the committee and introduced it as a separate chapter in Finance Act 2016. The Equalisation Levy is defined under Sub-section (d) of Section 164 of Finance Act 2016, which reads as 'equalisation levy' means the tax leviable on consideration received or receivable for any specified service [ore-commerce supply or services] under the provisions of this Chapter. This levy has to be imposed on 'Specified Services', the term is defined under Sub-section (i) of Section 164, 'specified service' means online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and

²⁵<https://www.incometaxindia.gov.in/News/Report-of-Committee-on-Taxation-of-e-Commerce-Feb-2016.pdf> accessed on 04-06-2020.

includes any other service as may be notified by the Central Government in this behalf. Therefore, this levy was imposed only on the Online Advertisement, because by this time, Government of India did not notify any other service to fall within the domain of this chapter. Although the committee recommended Xiii services to be covered within the definition of Specified Services, however, the government imposed the levy only on the digital advertising. The charge of the levy is kept @6% (under Section 165 of the Finance Act 2016) of the amount of consideration for specified services and the aggregate amount of consideration for the specified services should exceed one lakh rupees.

It applies on the consideration for the services received/ receivable by a non-resident from a person being resident of India and carrying on business or profession or, a non-resident having a permanent establishment in India.

However, it does not apply to a non-resident providing the specified service having a permanent establishment in India and the specified service is effectively connected with such permanent establishment. The aggregate amount of consideration for specified service received or receivable does not exceed one lakh rupees. If the payment for the specified service by the person resident in India, or the permanent establishment in India is NOT for the purposes of carrying out business, or profession.

The levy so deducted shall be paid to the credit of central government by every seventh day of the month immediately following the calendar month in which the amount is deducted. Every assessee is bound to give the statement of such deduction at the end of financial year in such form and verified in such manner, to the assessing officer. However, on the failure to furnish or on giving a wrong particulars the assessee may furnish

or revise the statement within two years from the end of financial year in which the specified services were provided. However, for processing of statement certain adjustments need to be done, but no adjustment shall be done after the expiry of one year from the end of financial year in which statement is furnished. The time period for making rectification of mistake is one year from end of financial year in which intimation sought to be amended was issued. Opportunity of hearing is to be given to assessee when as a result of any intimation the affect on assessee is adverse. In case of failure to credit the levy or part of it to the Central Government, the assessee is liable to pay the interest @1% for every month or the part of the month. Penalties are also prescribed under Section 171 of the Finance Act 2016. In case of failure to deduct the whole or any part of the amount the penalty is the levy and the actual amount i.e. [Levy + Penalty (where penalty is equal to Levy that he failed to deduct)] and in case of having deducted but fails to pay the amount to the credit of central government, it will be Levy + interest @1% for every month or the part of the month + Penalty of 1000 Rs. for every day during which the failure continues, but it should not exceed the amount of Levy that he failed to pay. In case of failure to furnish statement within specified time he shall be liable to pay 100 Rs. for each day during which delay continues. The penalty shall not be levied where AO is satisfied that there was reasonable cause for the failure. Against the order of penalty, the assessee can make appeal to CIT(A) within 30 days. Here, the Income-tax Act 1961 will come into force. Appeal to ITAT shall be made within 60 days from the date on which the order received by the assessee. The punishment for false statement is imprisonment which may extend to 3 years and with fine and the offence is non-cognizable. The prosecution can only be instituted with previous sanction of

Chief Commissioner of Income Tax.

The chapter is applicable only for B2B (Business-to-Business) and not for B2C (Business-to-Consumer) or C2C (Consumer-to-Consumer). Therefore, specified services which are availed only for business purposes shall be liable for the levy and not others. However, it won't be easy to ascertain if in the garb of not availing services for business or profession the equalization levy is avoided and subsequently same services were used for carrying the business or profession.

Secondly, Equalization Levy itself is issue, as many countries would not provide the tax credit on levy as it is not leviable on income hence, there arise the possibility of double taxation or non-availability of tax credit to the non-resident service provider.

Thirdly, the big corporate houses like Google, Facebook, Airbnb etc. have big pockets and they can bear the cost or even they may pass on this cost to the consumer, in later case the burden over consumer will increase and this would be detrimental, especially, in the case of start-ups.

Fourthly, in September 2013, the Committee on Fiscal Affairs (CFA) of the OECD had established a Task Force on the Digital Economy (TFDE), TFDE examined three options, i.e. (i) a new nexus in the form of a significant economic presence, (ii) a Withholding tax on certain types of digital transactions, and (iii) an Equalization Levy, and concluded that, we do not recommend any of the three options as internationally agreed standards²⁶.

Fifthly, in report 'Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report' the report mentions that under current

²⁶https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page137 accessed on 04-06-2020.

tax systems, it is very often possible to use artificial structures to ensure the physical presence which either does not create taxable presence, or does not attract significant profits so that the bulk of the profits then can be shifted to no or low tax jurisdiction. It is not clear how would Equalization Levy would help in protecting this act of tax avoidance²⁷.

Sixthly, Tax Neutrality is one of the prime reason to enforce the Levy, however it is difficult to ascertain the same as the Non-Resident Service provider may pass on this burden of levy on the buyer of services in India, as the service provider may not get the credit of same in his parent country, the buyer have to shed more money to avail these services and hence increasing the cost of services. Whereas the Indian service providers may not be able to compete with these big non-resident players, because of the big pockets and wide reach of these big non-resident players.

Seventhly, it is a unilateral measure taken by India, whereas the direction of movement in taxation regime is multilateral.

Finally, the assessee who is already complying to so many different regimes, adding one more compliance under different Act, will add further burden to the assessee, whereas the non-resident is free from any liability.

To make it easier for taxing authorities the government further expended the meaning of 'Business Connection' by bringing amendment in Section 9 of the Income-tax Act 1961, in year 2018 to be effective from 01.04.2019, by including 'Significant Economic Presence' (Explanation 2A of Section 9 of the I-T Act) in its ambit this was in sync with the observations of OECD Action 1 report. The Significant Economic Presence is defined as:

²⁷*ibid*

Explanation 2A.—*For the removal of doubts, it is hereby clarified that the significant economic presence of a non-resident in India shall constitute ‘business connection’ in India and ‘significant economic presence’” for this purpose, shall mean—*

- a. *transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or*
- b. *systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means:*

Provided *that the transactions or activities shall constitute significant economic presence in India, whether or not,—*

- i. *the agreement for such transactions or activities is entered in India; or*
- ii. *the non-resident has a residence or place of business in India; or*
- iii. *the non-resident renders services in India.*

This was done to assert India’s right, as a source country or the market, to tax the revenue from services sold in its territory. The first part of explanation requires the threshold limit which has not been defined yet. The OECD report on taxation of Digital Economy is likely to be published by December, 2020 and thus the threshold will be set after considering the OECD report. The second part of definition doesn’t require any threshold.

In the Financial Act 2020, the government further widen the scope of equalization levy by bringing in the amendment to the Finance Act 2016. It has extended the scope of equalization levy to almost all digital e-commerce transactions in India which will come into effect from April 1, 2020. The amendments so introduced by the Finance Act 2020 was not present in the Finance Bill 2020 that was presented on February 1, 2020. New Section 165A is inserted after Section 165 in Chapter VIII of the Finance Act, 2016. To be effective from 01.04.2020, this is inserted as Part VI of the Finance Act, 2020. It imposes levy of 2 per cent on the amount of consideration received or receivable by an e-commerce operator from ‘e-commerce supply of goods and services. It covers not only the e-com aggregators but also covers the standalone websites. Even any business transacted through e-mail communication is also covered by the levy. The threshold limit is kept at Rs. 2 crore, the levy will be applicable on the whole of the sales, turnover or gross receipts of the non-resident e-commerce operator, for calculation of threshold transactions or business with Indian residents only need to be considered. The equalization levy on e-commerce operator shall apply even in case of personal consumption without any business activity (b2C).

The payment of consideration between two non-residents for advertisement in India or the sale of data of Indian consumers is also covered under this amended Section which is covered under ‘specified circumstances’. But either of the two conditions should be satisfied i.e. either the targeted customer is resident in India, or the internet protocol address is located in India. The collection is to be paid by the e-commerce operator, unlike in the case of advertising levy, where the resident is burdened with the compliance of collection and deposition, to

the credit of the Central Government. The due date of compliance is 7th day of the next month, ended after a quarter except for the quarter ending on 31 March, unlike the levy on advertisement where due date is 7th of every next month after the month in which the levy was deducted. However, whether the equalization levy would be paid on the value of the fee or on the value of goods or services is not made clear. A consequential amendment was introduced in Clause 50 of Section 10 to exempt the income of the non-resident e-commerce operator which suffers equalization levy under Chapter-VIII of the Finance Act, 2016 under the Income-tax Act 1961. The Finance Act 2020 also introduced the TDS on E-commerce by inserting Section 194-O, which will come into force from October 1, 2020. The e-commerce operator shall deduct TDS on all payments or credits to e-commerce participants at the rate of 1% in PAN/ Aadhaar cases and 5% in non-PAN/ Aadhaar cases. This provision shall apply only where the e-commerce participants are residents, but the e-commerce operator may be a resident or non-resident in India.

A welcome step is taken by the government of India to widen the tax base in new and evolving field of digital taxation and to curb the tax avoidance. Today, digital taxation is the most discussed topic and it is difficult to have consensus

based mechanism as the developing countries are largely the importers of these services and developed countries are the exporter of these services, which gives rise to clash of interest, because developed nations want the residence to be the criteria to determine the tax liability and the developing nations want the source to be the criteria for determining the tax liability.

A lot of work still needs to be done, e.g., the precise definition of the term ‘-ecommerce’ is yet to be defined, the absence of which creates confusion, in the minds of assessee. As the e-commerce is very wide and in today’s digital era, it is difficult to confine it within four corners unless a precise definition is given.

Lastly, in today’s global world where geography is history, unilateral measures in taxation are not appreciated much and economies are so inter-connected that it is difficult to sustain unilateral measures on grounds of parity and neutrality.

Since the equalization levy on e-commerce is introduced at times when world is going through pandemic of COVID19, it is difficult to forecast the effects of the latest amendments. However, the steps taken by the government of India are in positive direction and seems to be effective unless the world/ international organizations form some consensus based approach without any bias.

Alternative Investment Funds: Indian Experiments and Way Forward with Tax Efficiency



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Executive Summary

To enable ease of doing business, the taxation framework for Alternative Investment Funds (AIF) provide pass-through status to profits of the AIF (Category I and Category II) to the investors under which any income, barring business income, earned by AIFs would be exempt in the hands of such AIFs, and taxable directly in the hands of its investor(s). A huge taxation relief is accorded to non-resident investors of AIFs in India due to which overseas investment by AIFs of non-resident investors is not taxable in India and thereby leveraging ease of doing business in India. Tax incentives are not only provided to the investors of AIFs, but entities who receive investments from AIFs are also accorded a beneficial taxation position which includes exemption of venture capital undertakings availing funding from Category I and Category II AIFs from Angel Tax, start-ups are allowed to deduct their investments from VCFs while calculating the share capital to deduce whether they are eligible for exemption from taxation of any excess premium received by a closely held company upon the issue of shares. Despite there being an adequate framework for regulation of AIFs by SEBI, certain loopholes which need attention includes tax-pass through status to Category III AIFs and pass through of losses of AIFs which are incurred after March 31, 2019. There was an absence of appropriate provision to cover transactions made between non-residents involving a holding company based outside India of an Indian company. A cross-border uniform AIF taxation structure is required in order to suppress the effect of loopholes existing in taxation structure of different jurisdictions and further motivate investors to park funds in India without bearing the burden of tax related ambiguities. It is also recommended that the Indian regime can introduce a provision which encourages exiting start-ups to infuse or redeploy their investment in new start-up ventures.

ALTERNATIVE INVESTMENT FUNDS

Capital infusion is a major necessity for any economy to shift towards progressive activities. The effect of increased capital infusion can be witnessed across the growth of various sectors. In any economy, one of the major barriers to growth is the inability of the nation to infuse capital for progressive activities. Without adequate capital, the production of goods and services is hindered which in turn impacts consumption thereby, effecting the flow of funds in the economy. So, here the challenge arises as to the methods and routes through which capital can be infused inside the economy to drive it towards growth.

One of the methods for infusing capital in the Indian economy is through the private route of Alternative Investment Funds (AIFs). These funds are important facets of the financial system and economy. As the name suggests, AIFs are alternative investment options acting as privately pooled investment vehicles. The funds from domestic and foreign investors are collected for investing in well-defined investment policies for the benefit of investors.

In the Indian context, the investment momentum in AIFs has gained popularity and investor's attention. In 2018, the commitments raised through AIFs were worth over INR 2 lakh crore, and corporate funds worth INR 1 lakh crore were raised. In the first quarter of 2019, commitments worth INR 1.79 lakh crore were raised and INR 97,611.73 crore worth of funds were raised.¹ The capital pumped in by AIFs rose to nearly INR 1.1 trillion in the January-March quarter of 2019, which is nearly 79% higher than it was in the same period a year ago.²

¹See: <https://www.financialexpress.com/market/alternate-investment-funds-aif-investments-in-india-set-to-hit-record-high/1414360/>

²See: <https://timesofindia.indiatimes.com/business/india-business/aif-investments-surge-79-to-rs-1-10-lakh-cr-in-march-qtr/articleshow/69146567.cms>

As we all understand, AIFs grant support towards economic stability as existing, new and emerging entrepreneurs are accorded with the right financial support for growth. The induced capital enhances the production of goods and services and allows companies to generate revenue for many years by adding or improving production facilities and boosting operational efficiency. This, in turn, grants a strong backbone for economy to remain stable and further in multiplication of GDP.

We believe that AIFs widen the scope of capital infusion as they explore the catena of investment options without residing in traditional investment methods such as stocks, bonds or commodities. The large scope of investment options enable the investors to park funds in India which are recurrently put to use for the furtherance of economic activities, resolving the problems affiliated to economic slowdown in terms of capital infusion to a certain extent. In that regard, AIFs help to reform the macroeconomic drivers, post-crisis financial industry regulation and critical industry trends. The investment in AIFs are largely accommodated by high net worth individuals (HNI) or private equity (PE) investors with higher appetite for risk and return. The investments by HNI and PE investors not only bring in exponential returns for such investors but also promote innovation in the field of technology, finance and for that matter the advanced fin-tech arena.

EXISTING FRAMEWORK

The Securities and Exchange Board of India (SEBI) grants approval to an AIF to commence operations and continues to monitor AIFs through SEBI (Alternative Investment Funds) Regulation 2012 (hereinafter 'SEBI Regulations').

AIFs can be structured in the form of a company, trust, corporate body or limited liability partnerships (LLPs) with funds from either domestic or foreign investors.³

³Regulation 3(4)(a), SEBI (Alternative Investment Funds)

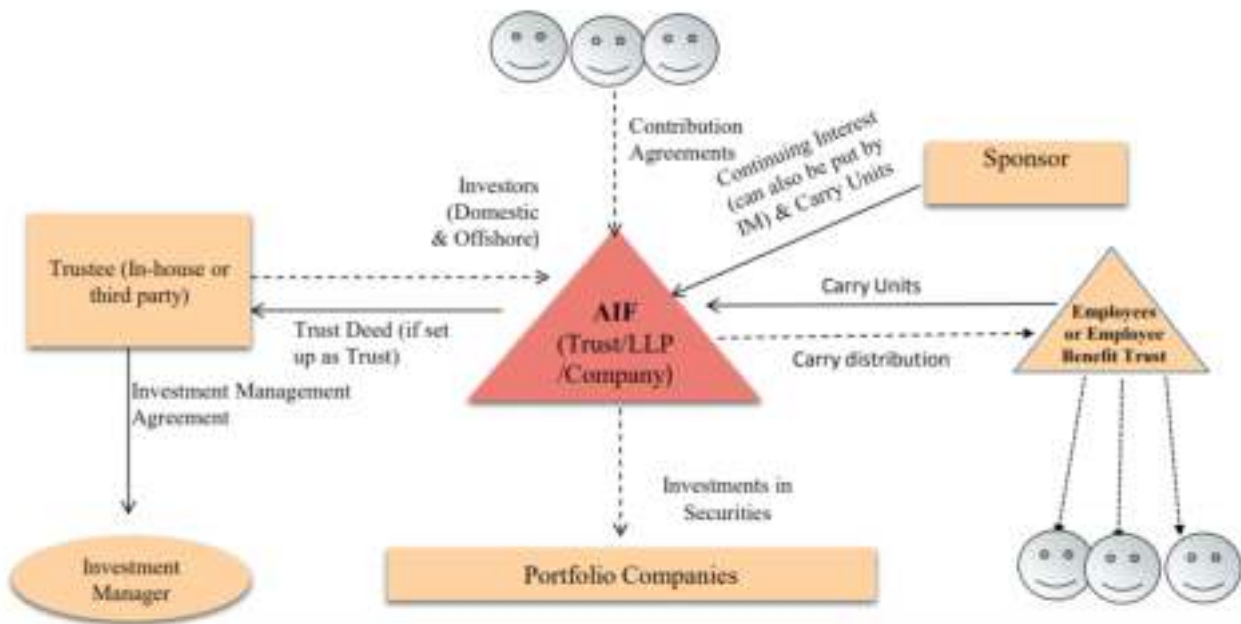


Fig. 1

CATEGORIES OF ALTERNATIVE INVESTMENT FUNDS

Under the SEBI Regulations, the private investment funds can be structured under any of the three categories as per the functioning of the fund. The minimum corpus amount for each scheme of these AIFs shall be at least INR 20 Crores with the exception of one sub-category of AIF-I which is Angel Funds. Angel Funds are prescribed to have a lesser corpus amount of INR 10 Crores.⁴

Table 1

Title	Category I AIF	Category II AIF	Category III AIF
Investment	Start-ups, early stage ventures, small and medium enterprises (SMEs), sectors with beneficial socio-economic impact as defined by the regulator or government	Funds which do not fall within Category I or II; Funds which do not undertake leverage or borrowing except for meeting operational requirements	Employ diverse or complex trading strategies and may use leverage in listed or unlisted derivatives
Class of Funds	Venture Capital Funds, SME funds, Social Venture Funds, Infrastructure Funds	Private Equity Funds, Real-estate Funds, Debt Funds	Hedge Funds, Funds which trade to make short-term investments, open ended funds
Additional incentives by regulator or government	Specific concessions or incentives are granted for beneficial socio-economic funds	No specific concessions or incentives are granted	No specific concessions or incentives are granted
Pass-over benefit of taxation	Liability to pay tax on income passed over to investors	Liability to pay tax on income passed over to investors	Liability to pay tax on income cannot be passed over to investors (Double Taxation) ¹
Open-ended/ Closed-ended	Only closed-ended	Only closed-ended	Can be open-ended and closed ended
Listing of fund	Cannot list fund	Cannot list fund	Can list open-ended fund post closure of the scheme

Regulation 2012.

⁴The income is taxed twice, firstly, in the hands of the Category III AIF and secondly, as the income of individual investor.

TAXATION OF ALTERNATIVE INVESTMENT FUNDS

Prior to 2007, venture capital funds (VCF) registered with SEBI were regulated by Securities and Exchange Board of India (Venture Capital Funds) Regulations 1996 (Old VCF Regulations). Under the Old VCF Regulations, VCFs were accorded a tax pass-through⁵ benefit on their income. The income of a VCF earned from its investment in any venture capital undertaking was exempt from tax in the hands of the fund and was only taxable in the hands of the limited partners of the fund thereby prohibiting double taxation.⁶ In 2007, this tax 'pass-through' benefit was restricted only to income from venture capital undertakings that operated in nine specified sectors. However, the Finance Bill 2012 once again reverted to the pre-2007 position by extending this tax 'pass-through' benefit to income of a venture capital fund arising from investment in any venture capital undertaking, regardless of the sector in which the venture capital undertaking operates.

Post notification of Securities and Exchange Board of India (Alternative Investment Funds) Regulations 2012 (AIF Regulations), the tax 'pass-through' status was only accorded to Category I AIF which was later extended to Category II AIF. This tax 'pass-through' status is comparable to the position under Old VCF Regulations under which the liability to pay tax is shifted to the investors. For doing so, the investment in AIF is presumed to be made directly by the investor without routing the same through the financial intermediary.⁷

⁵Tax pass-through status implies that the liability to pay tax on the income earned by the AIF shall be passed from the hands of the AIF to the individual income attributable to each investor.

⁶Section 10(23FB) read with Section 115UB, Income Tax Act 1961.

⁷Section 33, Finance Act 2015 and Section 115UB (1), Income-tax Act 1961.

In order to avail this tax pass-through status, such Fund has to comply with the conditions under Section 10(23FB) the Income Tax Act 1961 and shall not violate the SEBI Regulations.⁸ However, when the income of the investment fund is characterized as 'Profits and gains of business or profession, the liability to pay tax is upon the investment fund for such income at a maximum marginal rate of tax. In relation to the losses incurred by the AIFs, no tax pass through status has been accorded through which they can pass their losses to their investors which is a rising concern among investors.

No tax pass-through has been granted to Category III AIF due to which the income from the investment of these funds is taxed twice, firstly when such income arises or accrues in favour of the AIF and secondly when such income accrues or arises in the favour of individual investor. In 2015, SEBI constituted the Alternative Investment Policy Advisory Committee (AIPAC) headed by Infosys Ltd co-founder Murthy which recommended that the tax pass-through status shall be accorded to Category III AIF as well.

The Income Tax Act 1961, exempts the income earned by a VCF from investments in a venture capital undertaking. However, to avail this exemption, the VCF shall operate under a duly registered trust deed with a certificate of registration before May 21, 2012 under Old VCF regulations.⁹

RECENT DEVELOPMENTS

TAX TREATMENT OF OFFSHORE INVESTMENTS BY NON-RESIDENTS THROUGH AIFs

Many non-resident investors contribute into AIFs. The AIFs often use such capital investments to

⁸M/s HDFC Property Fund vs. Income Tax Officer, February 2019.

⁹Section 10(23FB), Income Tax Act, 1961

make overseas investments. Multiple references were made seeking clarity over the tax treatment of these investments in India under Section 5 which defines the scope of total income for the purpose of computation under the Income Tax Act 1961. Section 5(2)¹⁰ of the Income Tax Act 1961 imposes source-based taxation on non-residents whereby income received or arising or deemed to be received or arising to a non-resident in India would be subject to tax in India.

The CBDT in its recent circular¹¹ stated that an income earned from such off-shore investments made through AIFs of Category I and II by Non-Residents could be deemed to be direct investment by a non-resident, and hence not subject to tax in India under the Income-tax Act. The circular also went on to clarify that any losses suffered from such offshore investments, shall not be allowed to be set-off or carried forward against the income of the AIFs of Category I and II.

PASS-THROUGH TREATMENT EXTENDED TO LOSSES OF AIFs

The Finance Act 2015 had extended the tax pass-through status to Cat I and Cat II AIFs. As per the existing provisions, any income, barring business income, earned by such AIFs would be exempt in the hands of such AIFs, and taxable directly in the hands of its investor(s) in the same manner and proportion as it would have been, had such investor received such income directly and not through such AIFs. With respect to the losses incurred by such AIFs, whether in the nature of business losses or otherwise, the same could be set-off or carried forward by such AIFs. However, losses suffered by such AIFs (not being

in the nature of business losses) could not be passed through to its investors for them to claim set-off of such losses against income earned by them.

In order to address the above anomaly, the Finance Act 2019 has allowed losses incurred by such AIFs (those not in the nature of business losses) to be passed through to its investors to be able to set-off or carry forward such losses while computing their income. However, in order to avail such pass-through benefit, such investors should have held the unit in the AIF for a period of more than 12 months.

In addition to this, the Finance Act 2019 has inserted a new Sub-section under Section 115UB¹² of the Income-tax Act whereby, accumulated or unabsorbed losses (those not in the nature of business losses) of such AIFs as on March 31, 2019 would be passed through to its investors to be carried forward/ set-off against their income, provided that the investor was a holder of units of the AIF as on March 31, 2019. Such losses could be carried forward and accordingly set-off by investors from the year in which the loss first occurred, subject to the period of limitation provided with respect to set-off and carry forward of losses under the Income-tax Act 1961.

This provision shall not be applicable to the investors that acquire units of an AIF on or after April 1, 2019 and it would not be applicable to investors holding units as on March 31, 2019, who have been accorded the set-off/ carrying forward loss pass-through status.

REVISIONS TO ANGEL TAX PROVISIONS

In the Finance Act of 2012, a 30% tax was imposed on this excess value to arrest laundering of funds. Angel tax is a term used to refer to the

¹⁰Section 5, Income Tax Act, 1961

¹¹CBDT Circular dated 3 July 2019 on 'Clarification regarding taxability of income earned by a non-resident investor from off-shore investments routed through an Alternate Investment Fund reg', Circular No. 14/2019, https://www.incometaxindia.gov.in/communications/circular/circular_no_14_2019.pdf

¹²Section 115UB, Income Tax Act, 1961

income-tax payable on capital raised by unlisted companies via issue of shares where the share price is seen in excess of the fair market value of the shares sold under Section 56(2)(viib)¹³ of the Income-tax Act 1961. It lays down that the difference between the excess of the fair market value of the shares shall be considered for taxation under the head ‘income from other sources’. It does not apply to firms registered as ‘start-ups’, with the government or those raising money from venture capital funds, which come under Category I of AIFs¹⁴ or by a company from a class or classes of persons as may be notified by the Government in this behalf.

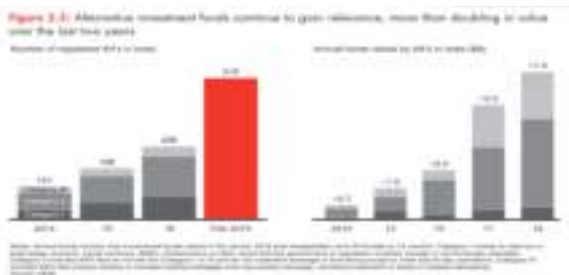


Fig. 2

Source: India Private Equity Report 2019 by Indian Private Equity & Venture Capital Association and Bain & Company¹⁵

¹³Section 56(2) In particular, and without prejudice to the generality of the provisions of Sub-section (1), the following incomes, shall be chargeable to income-tax under the head “Income from other sources”, namely:—

(viib) Where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares:

Provided that this clause shall not apply where the consideration for issue of shares is received—

- (i) by a venture capital undertaking from a venture capital company or a venture capital fund [or a specified fund]; or
- (ii) by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

¹⁴Gazette Notification No. G.S.R. 127(E) dated February 19, 2019 of Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, <https://dpncindia.com/blog/wp-content/uploads/2019/02/DIPP-Notification-dated-19-Feb-2019.pdf>

¹⁵<https://www.bain.com/>

Under the Finance Act 2019, this exemption has been extended to venture capital undertakings to receive funds from Category II of AIFs as well. This is seen as a good move, since most AIFs fall under Category II.

TAXATION AND INVESTMENT IN START-UP COMPANIES

Through a February 2019 circular¹⁶ issued by the DPIIT, start-up companies which have registered themselves with the DPIIT shall be eligible for tax exemption under Section 56(2)(viib) of the Income-tax Act 1961. To be eligible for this exemption, the aggregate amount of paid up share capital and share premium of these start-up companies, after issue or proposed issue of shares, must not exceed INR 25 Crore. While calculating the share capital, shares issued to a non-resident or a venture capital company or a venture capital fund have not been included.

To provide a conducive environment for start-up companies, some relaxations with regard to direct tax assessment of start-up entities for Section 56(2)(viib) of the Income-tax Act 1961 were introduced¹⁷. Where the start-up company has been recognized by the DPIIT but the case is selected under ‘limited scrutiny’ on the single issue of applicability of the section, no verification on such issues will be done by the Assessment Officers during the proceedings under Section 143(3) and Section 147 of the Income-tax Act 1961 and the contention of such recognized start-up companies on these issues will be summarily

contentassets/1b165fbff096473685e36a3b10df09a0/bain_report_india_private_equity_report_2019.pdf

¹⁶G.S.R. 127, 19 February 2019, Notification, Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India, New Delhi.

¹⁷‘Clarification with respect to assessment of Startup companies involving application of sSection 56(2)(viib) of Income Tax Act, 1961-reg.’, Circular No. 16/2019, Central Board of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India, New Delhi.

accepted. Secondly, if the case is selected under 'limited scrutiny' with multiple issues or under 'complete scrutiny' under the section, the issue of applicability of the section will not be pursued during the assessment proceedings as well. For the companies which have not been approved by DPIIT, the case is selected for scrutiny, *inter alia* on the grounds of applicability of Section 56(2)(viib), then inquiry or verification in such cases shall be carried out by the Assessment Officers, as per due procedure, only after obtaining approval of their supervisory officer.

The CBDT circular in March 2019 provided exemption from Section 56(2)(viib) for entities recognized by the DPIIT from taxation on consideration received by a company for issue of shares received from a resident person.

These exemptions were extended to a recognized start-up entities which would have filed a declaration under Form 2. In addition to this, the proceedings appeal against the assessment is pending before the Commissioner of Income-tax (Appeal), the appellate order should be passed by CIT(A) on or before 31st December, 2019 and the department shall not file an appeal in the same matter. As for the appeal before Income Tax Appellate Tribunal, the Department shall not press the ground relating to addition under Section 56(2)(viib) of the Income-tax Act 1961.¹⁸

INTERNATIONAL BEST PRACTICES IN TAXATION OF AIFS

LUXEMBOURG

The Reserved Alternative Investment Fund (RAIF) vehicle was set to change Luxembourg's Alternative Investment Fund (AIF) landscape when it was introduced in July 2016 due to its

¹⁸'Consolidated circular for assessment of Startups - reg.', Circular No.22/2019, 30 August 2019, Central Board of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India, New Delhi.

flexibility and ability to be deployed quickly. The credit for the same is attributable to regulation through an Alternative Investment Fund Manager (AIFM).¹⁹

A fund set up under Part II of the Luxembourg Law of 17 December 2010 on undertakings for collective investment (UCIs) is an investment fund that can invest in all types of assets. It qualifies as alternative investment fund (AIF) and can be sold to all types of investors.²⁰ These Part II funds are exempted from any Luxembourg tax on income, withholding, capital gains or net wealth tax or any other direct tax.

No withholding tax is levied on distribution made by a Luxembourg based AIF to residents or non-resident, whereas the distribution made by an unregulated AIF is subjected to a withholding tax of 15%. The income distributed by AIF should not be taxed in the country of residence or the non-resident or pension fund investor. The capital gains can only be taxed for the unregulated AIFs, where no Dividend Distribution Tax is available or under certain specific circumstances. Capital gains arising from the sale of the shares of AIF or units, except the speculative gains (considered to be the ones which are realized within 6 months after acquisition) are exempted in the hands of the resident individual investor. However, investors holding more than 10% of the capital of the SICAV²¹ or SICAF²² the 10% being determined

¹⁹<http://www.mondaq.com/x/731878/>

Fund+Management+REITs/
What+has+the+RAIF+brought+Luxembourg

²⁰<https://www.luxembourgforfinance.com/publication/a-non-ucits-part-ii-fund/>

²¹A SICAV (Société d'Investissement à Capital Variable) in Luxembourg is an investment fund in the form of an Investment Company whose share capital is variable and the value of which at any time matches the value of the net assets of all the sub-funds, constituted as shares without a statement of their nominal value.

²²A SICAF Investment Fund (Société d'Investissement à Capital Fixe) in Luxembourg exists in the form of an Investment Company whose share capital is fixed.

on the umbrella fund. Dividend distributed by the AIF is subjected to a progressive tax rate depending on the income level of the recipient and matrimonial situation with the marginal tax rate of 45.78% (including the employment contribution fund).²³

SINGAPORE

Limited partnerships are not treated by Revenue Authority of Singapore (IRAS) as legal person and hence no tax is levied at the partnership level. However, the number of shares held by the partners shall be taxed at the applicable rate. Although Singapore taxes income accruing in or derived from Singapore and on foreign-sourced income received or construed to have been received in Singapore, subject to certain exceptions. Singapore does not tax on capital gains, but the income arising out of disposal of any investment shall be considered for the purposes of taxation. However, where a gain is considered to be revenue in nature, such gain could be subject to tax if it is sourced in Singapore or in the case of foreign-sourced gain, if it is remitted into Singapore.²⁴

AIFs in Singapore often face an issue, whether gains are capital in nature and hence not taxable or they are taxable as trading income. AIFs in Singapore are generally taxed at a fixed rate of 17% on their chargeable income. However, there exists an exemption where if an AIF holds 20% or more of the share capital of another company for a time period of 24 months or more, then the gains will be exempted from tax, provided that they are disposed of between 1 June 2012 and 31 May 2022.

Singapore also offers various tax incentives for AIF to promote the use of city-based managers

²³<https://iclg.com/practice-areas/alternative-investment-funds-laws-and-regulations/luxembourg>

²⁴<https://home.kpmg/content/dam/kpmg/pdf/2015/11/singapore-asean-tax-2015.pdf>

in the AIF structure. Monetary Authority of Singapore rolls out various schemes for such AIFs, including qualifying conditions to enjoy complete exemption from all incidents of income tax for income sources from immovable properties in Singapore. This regime can be viewed to be a well-balanced regime.

FOOD FOR THOUGHT

PREFERRED COUNTRY TO ROUTE INVESTMENTS IN ASIA

From companies encouraging consumption of fresh foods to food delivery and ride-hailing apps, all are causing behavioural changes whose momentum is changing habits, preferences, and lifestyles. Venture Capital Funds capitalize on the growth trajectory of the Indian start-up ecosystem and behavioural changes permeating Indian society. The venture capital space in India also has government backing in the form of frameworks that institutionalize it. Such institutionalization gives investors clarity about the structure, process, and due diligence of investments in start-ups making investing in Venture Capital Funds attractive. The recent government decision to ease norms for start-ups including exemptions for AIFs investing in start-ups makes Venture Capital Funds even more attractive. With certain relaxation in the regime, the venture capital business in India is expected to flourish. It can additionally act as the base of Alternative Investment Funds in South Asia.

UNIFORM TAXATION STRUCTURE

A cross-border uniform AIF taxation structure is required in order to suppress the effect of loopholes existing in taxation structure of different jurisdictions and further motivate investors to park funds in India without bearing the burden of tax related ambiguities. The investors seek benefits of these existing loopholes and route transactions in a way to gain maximum benefits

from the deficient structures. To the extent that all investments are taxed similarly, there will be no incentive to try to come within the scope of tax-favoured treatment. Moreover, there will be incentive for investors to invest in a taxation regime which is uniform and free of ambiguities and discrepancies. A uniform taxation structure shall further enable equitable sharing of tax revenue between transacting countries which is generally leaked due to evasion and avoidance. This shall help in furtherance of the government's objective of 'ease of doing business in India' and clarity in the taxation structure will provide a competitive edge to the domestic fund managers and will improve the prospects of an appropriate risk-return profile of these pooled investment vehicle.

IDENTIFICATION OF ULTIMATE BENEFICIARY AND EASIER COMPLIANCE

One single efficient system is required which discourages forum shopping. The government needs to devise a strategy to ascertain whether tax benefits shall be given to the AIFs or the investors. If AIFs are incentivized then another issue at hand which emerges is other investment platforms shall also be looking forward for the upcoming incentives. In that regard, the revenue loss and market consequences needs to be weighed appropriately. The absence of a complex structure allows easier compliance with tax regulatory requirements which encourages investors to infuse capital in the Indian economy.

Moratorium under Insolvency and Bankruptcy Code, 2016 and Initiation/ Continuation of Assessment Proceedings under the Income-tax Act 1961



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Executive Summary

The Resolution Professional, appointed by the order of the National Company Law Tribunal routinely writes to the Assessing Officer of the Corporate Debtor attaching a copy of the order passed by the Tribunal admitting the application for initiation of corporate insolvency resolution process in respect of the Corporate Debtor. S/ he also draws attention to a reference to sec 14 of the Insolvency and Bankruptcy Code 2016 in the Order which provides for moratorium for prohibiting any proceedings against the Corporate Debtor. There seems to be some lack of clarity as to whether assessment proceedings under the Income-tax Act 1961 could be initiated/ continued against the Corporate Debtor in the face of declaration of moratorium under Section 14 of the Insolvency and Bankruptcy Code 2016. In this article, the term ‘the corporate debtor’ and ‘the assessee’ are used to mean one and the same entity.

The Insolvency and Bankruptcy Code 2016 (Act No. 31 of 2016) was enacted on 28th May 2016. The provisions of the Insolvency and Bankruptcy Code 2016 overrides other law. Section 238 of the Insolvency and Bankruptcy Code 2016 reads as under:

238. Provisions of this Code to Override Other Laws:

The provisions of this Code shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.

In order to avoid any possible future conflict, the legislature in its wisdom has also amended the *Section 178 ‘Company in Liquidation’* of the Income-tax Act 1961. The Sub-section 6 of the Section 178 of the Income-tax Act 1961 subsequent to amendment [Inserted by the Insolvency and Bankruptcy Code 2016, w.e.f. 01.11.2016] reads as under:

178(6) The provisions of this section shall have effect notwithstanding anything to the contrary contained in any other law for the time being in force except the provisions of the Insolvency and Bankruptcy Code 2016 [Emphasis added]

In view of Section 238 of the Insolvency and Bankruptcy Code 2016 read with Sub-section 6 of Section 178 of the Income-tax Act, 1961, the provisions of the Insolvency and Bankruptcy Code 2016 shall override the provisions of the Income-tax Act 1961.

As per Section 3 (8) of the Insolvency and Bankruptcy Code 2016, 'corporate debtor' means a corporate person who owes a debt to any person. The Code provides for initiation of what is called corporate insolvency resolution process (**CIRP** in short) in respect of such corporate debtor in case of any default committed by it. The Section 6 of the Insolvency and Bankruptcy Code 2016 provides as under:

6. Persons who may initiate corporate insolvency resolution process. – Where any corporate debtor commits a default, a financial creditor, an operational creditor or the corporate debtor itself may initiate corporate insolvency resolution process in respect of such corporate debtor in the manner as provided under this Chapter. [Chapter II Corporate Insolvency Resolution Process]

Section 13 of the Insolvency and Bankruptcy Code 2016 requires that after admission of the application for initiation of CIRP, the Adjudicating Authority shall, by an order, declare a moratorium for the purposes referred to in Section 14 of the Insolvency and Bankruptcy Code 2016. The Central Government has constituted various benches of the National Company Law Tribunal who, under the Code, are the adjudicating authority. The said Section 14 reads as under:

14. *Moratorium:* (1) Subject to provisions of Sub-sections (2) and (3), on the insolvency commencement date, the Adjudicating Authority

shall by order declare moratorium for prohibiting all of the following, namely: -

- a. the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgement, decree or order in any court of law, tribunal, arbitration panel or other authority;
- b. transferring, encumbering, alienating or disposing off by the corporate debtor any of its assets or any legal right or beneficial interest therein;
- c. any action to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property including any action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002);
- d. the recovery of any property by an owner or lessor where such property is occupied by or in the possession of the corporate debtor.

(2) The supply of essential goods or services to the corporate debtor as may be specified shall not be terminated or suspended or interrupted during moratorium period.

(3) The provisions of Sub-section (1) shall not apply to:

- a. such transaction as may be notified by the Central Government in consultation with any financial regulator;
- b. a surety in a contract of guarantee to a corporate debtor.

(4) The order of moratorium shall have effect from the date of such order till the completion of the corporate insolvency resolution process:

Provided that where at any time during the corporate insolvency resolution process period, if the Adjudicating Authority approves the resolution plan under Sub-section (1) of Section 31 or passes an order for liquidation of corporate debtor under Section 33, the moratorium shall cease to have effect from the date of such approval or liquidation order, as the case may be.

The order passed by the Adjudicating Authority (National Company Law Tribunal) admitting application for initiation of CIRP declare moratorium and usually reproduce Section 14 of the Code. A resolution professional (liquidator) is simultaneously appointed to conduct the CIRP under the said Order. The resolution professional so appointed routinely writes to the Assessing Officer of the corporate debtor attaching a copy of the order passed by the Tribunal admitting the application for initiation of CIRP in respect of the Corporate Debtor. S/he also draws attention of the Assessing Officer to a reference to Section 14 of the Insolvency and Bankruptcy Code 2016 in the Order which provides for moratorium for prohibiting any proceedings against the Corporate Debtor. There seems to be some lack of clarity as to whether the Assessing Officer in such circumstances is competent to initiate/continue the assessment proceedings against the corporate debtor.

Section 14 of the Code is widely worded. The true meaning of the term 'proceedings' as used in Section 14 (1)(a), 'the institution of suits or continuation of pending suits or proceedings against the corporate debtor' is to be ascertained to arrive at any conclusion as to what action under the Income-tax Act 1961 are permissible/prohibited subsequent to the operation of Section 14 of the Code.

Neither Section 3 Definitions in the Code nor Section 2 Definitions in the Income-tax Act 1961

contain any definition of 'proceedings'. The term 'proceeding' is very wide and is ordinarily used in relation to any action for enforcement of right by an aggrieved party.

There are penal consequences under various sections of the Income-tax Act, 1961. In terms of Section 139 of the Income-tax Act, 1961 every person shall, on or before the due date, furnish a return of his income in the prescribed form and verified in the prescribed manner and setting forth such other particulars as may be prescribed. Section 234F provides Fee for default in furnishing return within the time prescribed. The corporate debtor, at no stage, is not exempted from filing return of income. A moratorium under Section 14 of the Insolvency and Bankruptcy Code 2016 will not prohibit the Assessing Officer and/ or no leave of the Tribunal is required in initiating action under Section 234F of the Act against the Corporate Debtor for failure to file return of income. There may be similar other instances where moratorium under Section 14 will not prohibit the Assessing Officer to initiate or continue proceedings.

The assessment proceedings under the Income-tax Act 1961 is *ordinarily* initiated at the behest of an assessee upon filing of return of income by an assessee. At the time of commencement of proceedings, the Assessing Officer is not aware that as to whether on completion of assessment, what will accrue would be a demand or no demand or refund of excess tax paid.

Section 140A of the Income-tax Act 1961 'Self-assessment' casts as obligation upon the Assessee to compute and pay its tax liability. The return of income is computation of income and tax liability by the assessee and a record of payment of tax and claim of refund if any. The assessment proceeding is to verify the correctness of computation made by the assessee, of its total income and tax liability.

The return of income as computed and filed by the assessee may contain refund on account of excess tax paid. However, if the assessment proceeding under the Income-tax Act 1961 is prohibited by the operation of Section 14 of the Code, then it will lead to absurd consequences. The assessee will either not get the refund of excess tax paid on the ground that the assessment proceedings are prohibited and therefore, the correctness of refund claimed by the assessee could not be verified by the Assessing Officer, or the refund may be required to be paid to the assessee even without assessment proceedings. This certainly cannot be intended by Section 14 of the Code. A refund cannot be made to the assessee without first completing the assessment proceedings.

The object of moratorium under Section 14 of the Code is to save the corporate debtor from protracted and/ or expensive litigation which would further deteriorate the financial health of the corporate debtor. The initiation/ continuation of assessment proceedings under the Income-tax Act 1961, which may result in accrual of refund to the assessee, will promote the object behind Section 14 of the Code. In view of above, the assessment proceedings under the Income-tax Act 1961 will not be prohibited against the assessee/ corporate debtor despite the operation of moratorium under Section 14 of the Code.

There may be a demand upon the assessee/ corporate debtor pursuant to finalization of assessment proceedings. The Assessing Officer is empowered under the Income-tax Act 1961 to initiate recovery proceedings. However, no recovery proceedings may be initiated/ continued against the assessee/ corporate debtor till the moratorium under Section 14 Code continues.

It may be noted that Section 14 of the Insolvency and Bankruptcy Code 2016 is in

pari materia to Section 446 of the Companies Act 1956. The Sub-section 1 of Section 446 of the Companies Act 1956 is reproduced below:

446. Suits Stayed on Winding Up Order

(1) When a winding up order has been made or the Official Liquidator has been appointed as provisional liquidator, no suit or other legal proceeding shall be commenced, or if pending at the date of the winding up order, shall be proceeded with, against the company, except by leave of the Court (subsequently substituted by 'Tribunal') and subject to such terms as the Court (subsequently substituted by 'Tribunal') may impose.

In the case of *S.V. Kandeekar vs. V.M. Deshpande & Anr.*, [(1972) 1 SCC 438] a Constitution Bench of the Supreme Court, while considering the provisions of Section 446 of the Companies Act, vis-a-vis, the provisions of Section 148 of the Income-tax Act 1961 pertaining to initiation of reassessment proceedings against a company under liquidation, held that, obtaining of leave from Liquidating Court under Section 446 of the Companies Act is not a condition precedent for initiating reassessment proceedings against a Company under liquidation. While elaborately dealing with the provisions of the Income-tax Act 1961 and the terms used in Section 446(1) and (2) of the Companies Act, like, 'other legal proceedings', the Supreme Court has observed as follows:

17. Turning now to the Income-tax Act it is noteworthy that Section 148 occurs in Chapter XIV which beginning with Section 139 prescribes the procedure for assessment and Section 147 provides for assessment or re-assessment of income escaping assessment. This section empowers the Income-tax Officer concerned subject to the provisions of Section 148 to 153 to assess or re-assess escaped

income. While holding these assessment proceedings the Income-tax Officer does not, in our view, perform the functions of a Court as contemplated by Section 446 (2) of the Act. Looking at the legislative history and the scheme of the Indian Companies Act, particularly the language of S. 446 read as a whole, it appears to us that the expression “other legal proceeding” in Sub-section (1) and the expression “legal proceeding” in Sub-section (2) convey the same sense and the proceedings in both the Sub-sections must be such as can appropriately be dealt with by the winding up court. The Income-Tax Act is, in our opinion, a complete code and it is particularly so with respect to the assessment and re-assessment of income-tax with which alone we are concerned in the present case. The fact that after the amount of tax payable by an assessee has been determined or quantified, its realisation from a company in liquidation is governed by the (Companies) Act because the income-tax payable also being a debt has to rank pari passu with other debts due from the company does not mean that the assessment proceedings for computing the amount of tax must be held to be such other legal proceedings as can only

be started or continued with the leave of the liquidation court under Section 446 of the Act.

18. The argument that the proceedings for assessment or re-assessment of a company which is being wound up can only be started or continued with the leave of the liquidation Court is also, on the scheme both of the Act and of the Income-tax Act, unacceptable.

In view of the above, it may be reasonably concluded that during the operation moratorium under Section 14 of the Insolvency and Bankruptcy Code 2016:

- a. The Assessing Officer is not prohibited to initiate/ continue the assessment proceedings;
- b. Leave of the Tribunal is not required to initiate/ continue the assessment proceedings;
- c. On finalization of assessment proceedings, refund if any, shall be paid to the assessee/ Corporate Debtor;
- d. On finalization of assessment proceedings, demand if any shall not be enforced.

NOTE: The article contains the personal views of the author. Comments are invited at akhil2406@gmail.com

Summary of Some Judgements of Honourable Supreme Court in FY 2019-20 in the Favour of Revenue

S.No.	Name of Case	Date of Judgement	Summary
1	<p>Super Malls Private Limited v. Principal Commissioner of Income-tax 8, New Delhi</p> <p>NJRS Citation: 2020-LL-0305-11</p> <p>Taxmann Citation: [2020] 115 taxmann.com 105 (SC)</p>	05.03.2020	<p>Issue relating to Section 153C-Whether there was a sufficient compliance of sec 153C, where the satisfaction note by the AO clearly stated that the documents so seized belonged to the assessee and not the searched person? Held that, the AO was satisfied that the documents so seized from the residence of the searched person belonged to the assessee—the other person. The satisfaction note by the AO clearly stated that the documents so seized belonged to the other person—the assessee and not the searched person. Thus, the HC was justified in observing that the requirement of sec 153C was fulfilled. On facts, thus, the SC was in complete agreement with the view taken by the HC on the requirement of sec 153C being fulfilled by the AO before initiating the proceedings u/s 153C.</p>
2	<p>Vardhman Textiles Limited v. Commissioner of Income-tax</p> <p>NJRS Citation: 2020-LL-0218-11</p>	18.02.2020	<p>Issue related to Section 80HHC(Explanation) (baa)-Whether 90 percent of interest received from customers on belated payments could be reduced from profit and gains of business under clause (baa) of Explanation below sec 80HHC(4B)? Held that, the stated issue in reference to AY 1998-99 was answered by the HC on 05.09.2008. That decision having become final would apply proprio vigore to the subject AY i.e. 1996-97, in terms of aforementioned order of the Tribunal.</p>
3	<p>Maruti Suzuki India Ltd. (Earlier Known as Maruti Udyog Ltd.) v. Commissioner of Income-tax, Delhi</p> <p>NJRS Citation: 2020-LL-0207-11</p> <p>Taxmann Citation: [2020] 114 taxmann.com 129 (SC)</p>	07.02.2020	<p>Issues relating to Section 43B:</p> <p>Whether deduction could be allowed in respect of MODVAT credit of excise duty that remained unutilised at the end of the relevant accounting year?</p> <p>Whether deduction could be claimed u/s 43B in respect of Sales Tax Recoverable Account?</p> <p>Whether deduction could be allowed in respect of unutilised MODVAT credit of excise duty on the ground that the unutilised credit was utilised for payment of excise duty on the manufactured vehicles?</p> <p>Held that, the deductions u/s 43B was allowable only when sum was actually paid by the assessee. In the present case, the excise duty leviable on assessee</p>

		<p>on manufacture of vehicles was already adjusted in the concerned AY from the credit of excise duty under the MODVAT scheme. The unutilised credit in the MODVAT scheme could not be treated as sum actually paid by the assessee. The assessee when paid the cost of raw materials where the duty was embedded, it did not ipso facto mean that the assessee was the one who was liable to pay excise duty on such raw material/inputs. It was merely the incident of excise duty that had shifted from the manufacturer to the purchaser and not the liability to the same. Thus, the unutilised credit under MODVAT scheme did not qualify for deductions.</p> <p>Held that, the sales tax paid by the assessee was debited to a separate account titled sales tax recoverable account. The assessee could have set off sales tax against his liability on the sales of finished goods i.e. vehicles. Thus, deduction could not be claimed u/s 43B in respect of sales tax recoverable account.</p> <p>Held that, there was no liability to adjust the unutilised MODVAT credit in the year in question since had there been liability to pay excise duty by the assessee on manufacture of vehicles, the unutilised MODVAT credit could have been adjusted against the payment of such excisedDuty. In the present case, the liability to pay excise duty of the assessee was incurred on the removal of finished goods in the subsequent year i.e. year beginning from 01.04.1999 and what the SC was concerned with is unutilised MODVAT credit as on 31.03.1999 on which date the assessee was not liable to pay any more excise duty. Hence, present was not a case where the assessee could claim benefit of proviso to sec. 43B. Thus, deduction could not be allowed in respect of unutilised MODVAT credit of excise duty.</p>
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Summary

4	<p>Seshasayee Steels P. Ltd. v. Assistant Commissioner of Income-tax, Company Circle VI(2), Chennai</p> <p>NJRS Citation: 2019-LL-1204-102</p> <p>Taxmann Citation: [2020] 115 taxmann.com 5 (SC)</p>	04.12.2019	<p>Issues related to 2(47)(vi):</p> <p>Whether entire sale consideration received by the assessee could not be treated as a capital gain and brought to tax on the ground that the assessee's case fell within sec. 2(47)(vi), where owner's rights were completely intact both as to ownership and to possession even de facto? Whether entire sale consideration received by the assessee could not be treated as a capital gain and brought to tax on the ground that compromise deed did not fall within any of the clauses u/s 2(47), where all the cheques mentioned in the compromise were encashed? Held that, the expression "enabling the enjoyment of" must take colour from the earlier expression "transferring", so that it could be stated on the facts of a case, that a de facto transfer of immovable property had, in fact, taken place making it clear that the de facto owner's rights stood extinguished. It was clear that as on the date of the agreement to sell, the owner's rights were completely intact both as to ownership and to possession even de facto, so that this section equally, could not be said to be attracted.</p> <p>Held that, all the cheques mentioned in the compromise deed were encashed. This being the case, it was clear that the assessee's rights in the said immovable property were extinguished on the receipt of the last cheque, as also that the compromise deed could be stated to be a transaction which had the effect of transferring the immovable property in question. The pigeonhole, therefore, that would support the orders under appeal would be sec 2(47) (ii) and (vi) in the facts of the present case.</p>
5	<p>Genpact India Private Limited v. Deputy Commissioner of Income-tax & Anr.</p> <p>NJRS Citation: 2019-LL-1122-6</p> <p>Taxmann Citation: [2019] 111 taxmann.com 402 (SC)</p>	22.11.2019	<p>Issue related to Section 115QA-Whether appellate remedy was available in the matter regarding determination of liability u/s 115QA?</p> <p>General-Whether writ petition could be entertained by the HC, where adequate appellate remedy was available? Held that, sec 115QA stipulated that in case of buy back of shares referred to in the provisions of said section, the company shall be liable to pay additional income tax at the rate of 20 percent on the distributed income. Any determination in that behalf, be it regarding quantification of the liability or the question whether such company was liable or not would be matters coming within the ambit of the first postulate referred to hereinabove. Similar was the situation with respect to provisions of sec 246A(1)(a) where again</p>

			<p>out of certain situations contemplated, one of them was “an order against the assessee, where the assessee denied his liability to be assessed under this Act”. The computation and extent of liability was determined under the provisions of sec 115QA. Such determination under the Act would squarely get covered under said expression. There was no reason why the scope of the such expression be restricted and confined to issues arising out of or touching upon assessment proceedings either u/s 143 or sec 144. The SC, therefore, rejected the submissions advanced by the assessee and held that an appeal would be maintainable against the determination of liability u/s 115QA. Held that, there was no infirmity in the approach adopted by the HC in refusing to entertain the writ petition. The submission that once the threshold was crossed despite the preliminary objection being raised, the HC ought not to have considered the issue regarding alternate remedy, might not be correct. The SC, therefore, find no error in the approach of and conclusion arrived at by the HC. Consequently, the appellant, as a matter of fact, would have a fuller, adequate and efficacious remedy by way of appeal before the appellate authority.</p>
6	<p>H.S. Ramchandra Rao v. Commissioner of Income-tax, Bangalore & Anr.</p> <p>NJRS Citation: 2019-LL-1121-44</p> <p>Taxmann Citation: [2019] 112 taxmann.com 135 (SC)</p>	21.11.2019	<p>Issue-Whether amount received the assessee could be treated as capital receipt, where the assessee was holding the post of secretary in a institution, which he left after new members were elected? Held that, the assessee was holding the post of secretary of the Institution, which he left after new members were elected. That being the case, the question of assessee invoking the principle of capital asset did not arise. It might have been a different matter if it was a case of life time appointment of the assessee as secretary of the concerned institution. No such evidence was produced by the assessee. Taking over-all view of the matter, the court upheld the conclusion reached by the HC that the amount received in the hands of assessee could not be treated as capital receipt. Thus, the order of the AO was affirmed.</p>
7	<p>Principal Commissioner of Income-tax (Central)-1 v. NRA Iron & Steel Pvt. Ltd.</p> <p>NJRS Citation: 2019-LL-1025-13</p> <p>Taxmann Citation: [2019] 110 taxmann.com 491 (SC)</p>	25.10.2019	<p>Issue-Whether ex parte judgment could be recalled on the ground that the assessee was not served with the notice of the SLP, where the notice was duly served on the assessee through its power of attorney holder? Held that, this court was satisfied that the assessee was duly served through their authorized representative, and were provided sufficient opportunities to appear before this court, and contest the matter. The assessee chose to let the matter proceed exparte. The grounds for recall of the judgment are devoid of any merit whatsoever. The assessee having failed to make out any credible or cogent ground for recall of the judgment, the application for recall was dismissed.</p>

Summary

8	Motilal Khatri v. Commissioner of Income-tax I NJRS Citation: 2019-LL-1017-48	17.10.2019	Issue related to Sec. 69-Whether addition could be made by invoking provisions of sec. 69, where explanation offered by the assessee was not satisfactory? Held that, the HC had considered all relevant aspects of the matter and concluded that the Appellate Tribunal misdirected itself in assuming certain facts which were not relevant and unsubstantiated. In opinion of the court, the approach of the HC was in accord with the material on record and the legal position. That being a possible view, no interference was warranted. Thus, addition could be made by invoking provisions of sec. 69, where explanation offered by the assessee was not satisfactory.
9	Murlibhai Fatandas Sawlani v. Income-tax Officer NJRS Citation: 2019-LL-0712-29	12.07.2019	Issue related to Section 148-Whether appeal against notice u/s 148 could be entertained, where the assessee had proper remedy to raise all pleas before the AO? Held that, the proper remedy of the assessee would be to raise all pleas before the AO in assessment proceedings and if it was decided against him then to carry the issue further in appeal to the CIT(A) and then to the Tribunal in second appeal and then to the HC u/s 260A, if the occasion so arose in appeal. The court was not, therefore, inclined to interfere with order passed by the HC in view of the liberty granted above.
10	Snowtex Investment Limited v. Principal Commissioner of Income-tax, Central-2, Kolkata NJRS Citation: 2019-LL-0430-117 Taxmann Citation: [2019] 105 taxmann.com 282 (SC)	30.04.2019	Issue related to Section 43(5)-Whether loss from speculation for the AY 2008-09 could be set off against the profits from business, where amendment to explanation to sec. 73 was w.e.f 1 April 2015? Held that, the amendment which was brought to the Explanation to Section 73 by the Finance (No 2) Act 2014 was w.e.f 1 April 2015. In its legislative wisdom, the Parliament amended sec. 43(5) w.e.f 1 April 2006 in relation to the business of trading in derivatives, Parliament brought about a specific amendment in the Explanation to sec. 73, insofar as trading in shares was concerned, w.e.f 1 April 2015. The latter amendment was intended to take effect from the date stipulated by Parliament and the court saw no reason to hold either that it was clarificatory or that the intent of Parliament was to give it retrospective effect. The consequence was that in AY 2008-09, the loss which occurred to the assessee as a result of its activity of trading in shares (a loss arising from the business of speculation) was not capable of being set off against the profits which it had earned against the business of futures and options since the latter did not constitute profits and gains of a speculative business. For the reasons the court found no error in the decision of the HC. The appeal was, accordingly, dismissed.

The above summaries are just indicative. The readers are advised to refer to complete Judgements (available on NJRS) for using/quoting them.

CBDT Circulars to Reduce Litigation

S.No.	Section of Income Tax Act	Circular No. & Date	Summary of Circular
1	2(22)(e)	Circular No.19/2017 [F.No.279/Misc./140/2015/ITJ], Dated 12-6-2017	Trade advances, which are in the nature of commercial transactions, would not fall within the ambit of the word 'advance' in Section 2(22)(e) of the Act
2	12AA	Circular No - 21/2016, Dated: May 27, 2016	It shall not be mandatory to cancel the registration already granted u/s 12AA to a charitable institution merely on the ground that the cut-off specified in the proviso to Section 2(15) of the Act is exceeded in a particular year without there being any change in the nature of activities of the institution.
3	43B	Circular No.22/2015 Dated 17-12-2015	Accordingly, w.e.f. 1.4.1988, the settled position is that if the assessee deposits any sum payable by it by way of tax, duty, cess or fee by whatever name called under any law for the time being in force, or any sum payable by the assessee as an employer by way of contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees, on or before the 'due date' applicable in his case for furnishing the return of income under Section 139(1) of the Act, no disallowance can be made under Section 43B of the Act.
4	80IA(5)	Circular No.1/2016	It is abundantly clear from Sub-section (2) that an assessee who is eligible to claim deduction u/s 80-IA has the option to choose the initial/ first year from which it may desire the claim of deduction for ten consecutive years, out of a slab of fifteen (or twenty) years, as prescribed under that Sub-section. It is hereby clarified that once such initial assessment year has been opted for by the assessee, he shall be entitled to claim deduction u/s 80-IA for ten consecutive years beginning from the year in respect of which he has exercised such option subject to the fulfilment of conditions prescribed in the Section. Hence, the term 'initial assessment year' would mean the first year opted for by the assessee for claiming deduction u/s 80-IA. However, the total number of years for claiming deduction should not transgress the prescribed slab of fifteen or twenty years, as the case may be and the period of claim should be availed in continuity.

5	153C	Circular No.24/2015	<p>2. The Hon'ble Supreme Court in the case of M/s Calcutta Knitwears in its detailed judgment in Civil Appeal No. 3958 of 2014 dated 12-3-2014 [2014] 43 taxmann.com 446 (SC) (available in NJRS at 2014-LL-0312-51) has laid down that for the purpose of Section 158BD of the Act, recording of a satisfaction note is a prerequisite and the satisfaction note must be prepared by the AO before he transmits the record to the other AO who has jurisdiction over such other person u/s 158BD. The Hon'ble Court held that "the satisfaction note could be prepared at any of the following stages:</p> <ol style="list-style-type: none"> a. at the time of or along with the initiation of proceedings against the searched person under Section 158BC of the Act; or b. in the course of the assessment proceedings under Section 158BC of the Act; or c. immediately after the assessment proceedings are completed under Section 158BC of the Act of the searched person. " <p>3. Several High Courts have held that the provisions of Section 153C of the Act are substantially similar/ pari-materia to the provisions of Section 158BD of the Act and therefore, the above guidelines of the Hon'ble SC, apply to proceedings u/s 153C of the IT Act, for the purposes of assessment of income of other than the searched person. This view has been accepted by CBDT.</p>
6	244A	Circular No.11/2016	<p>If a resident deductor is entitled for the refund of tax deposited under Section 195 of the Act, then it has to be refunded with interest under Section 244A of the Act, from the date of payment of such tax</p>
7	271D & 271E	Circular No.09/DV/2016	<p>The Hon'ble Kerala High Court judgment in the case of Grihalaxmi Vision v. Addl. Commissioner of Income Tax, Range 1, Kozhikode, vide its order dated 7-8-2015 in ITA Nos. 83 & 86 of 2014 reflects the «Departmental View». Accordingly, the Assessing Officers (below the rank of Joint Commissioner of Income Tax.) may be advised to make a reference to the Range Head, regarding any violation of the provisions of Section 269SS and Section 269T of the Act, as the case may be, in the course of the assessment proceedings (or any other proceedings under the Act). The Assessing Officer, (below the rank of Joint Commissioner of Income Tax) shall not issue the notice in this regard. The Range Head will issue the penalty notice and shall dispose/complete the proceedings within the limitation prescribed under Section 275(1)(c) of the Act.</p>

8	32(1)(ia)	Circular No.15/2016	It is a settled position that the business of printing or printing and publishing amounts to manufacture or production of an article or thing and is accordingly eligible for additional depreciation u/s 32(1)(ia) of the Act.
9	2(1A), Read with Section 2(14)(iii)	Circular No.17/2015	The Nagpur Bench of the Hon'ble Bombay High Court vide order dated 30-3-2015 in ITA 151 of 2013 in the case of Smt. Maltibai R Kadu has held that the amendment prescribing distance to be measured aerially, applies prospectively i.e. in relation to assessment year 2014-15 and subsequent assessment years. For the period prior to assessment year 2014-15, the High Court held that the distance between the municipal limit and the agricultural land is to be measured having regard to the shortest road distance. The said decision of the High Court has been accepted and the aforesaid disputed issue has not been further contested.
10	SECTION 45, Read with Section 28(i)	Circular No.6/2016	<p>As regards shares and other securities, CBDT instructs that the Assessing Officers in holding whether the surplus generated from sale of listed shares or other securities would be treated as Capital Gain or Business Income, shall take into account the following—</p> <ol style="list-style-type: none"> a. Where the assessee itself, irrespective of the period of holding the listed shares and securities, opts to treat them as stock-in-trade, the income arising from transfer of such shares/securities would be treated as its business income, b. In respect of listed shares and securities held for a period of more than 12 months immediately preceding the date of its transfer, if the assessee desires to treat the income arising from the transfer thereof as Capital Gain, the same shall not be put to dispute by the Assessing Officer. However, this stand, once taken by the assessee in a particular Assessment Year, shall remain applicable in subsequent Assessment Years also and the taxpayers shall not be allowed to adopt a different/contrary stand in this regard in subsequent years; c. In all other cases, the nature of transaction (i.e. whether the same is in the nature of capital gain or business income) shall continue to be decided keeping in view the aforesaid Circulars issued by the CBDT.

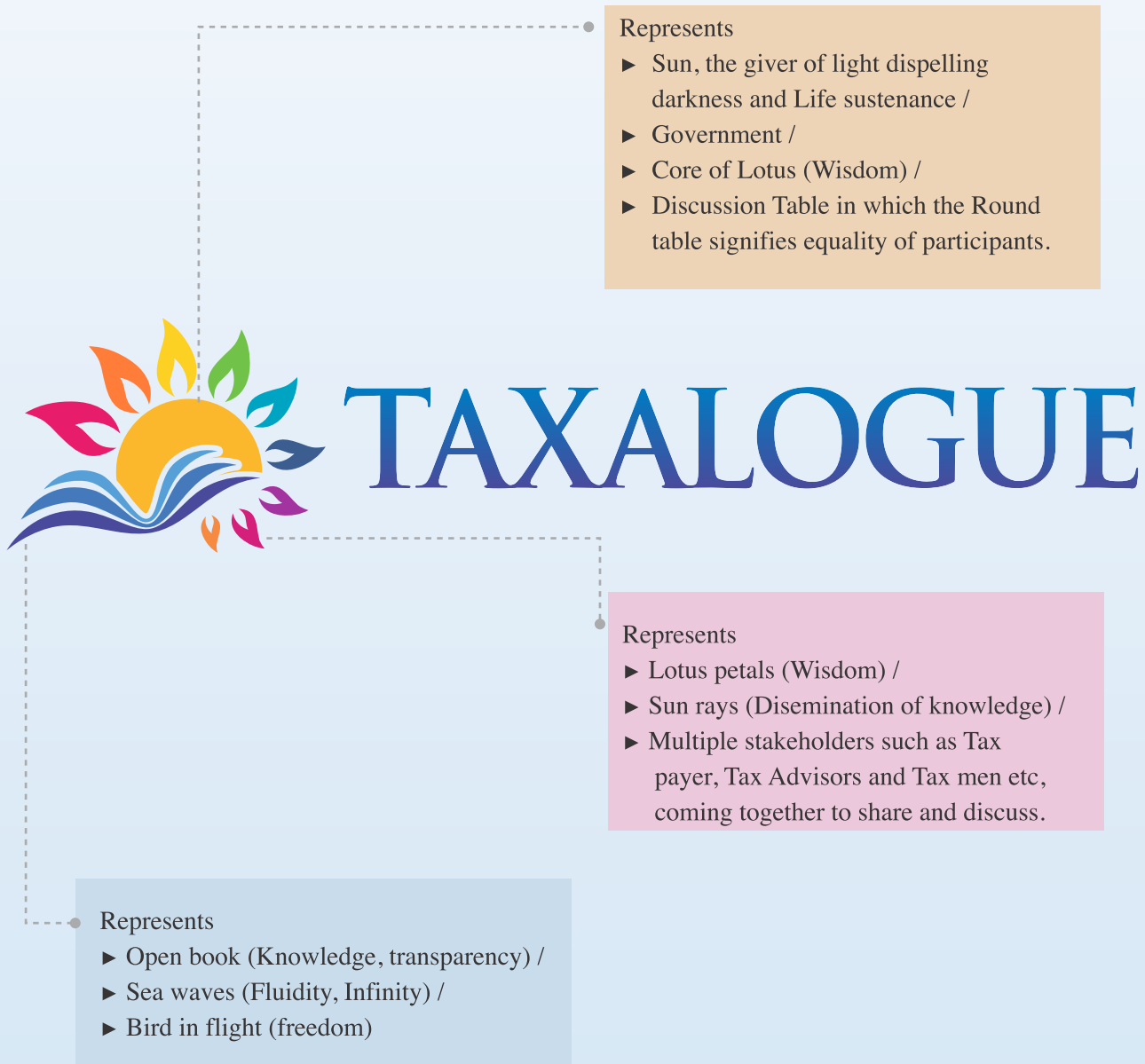
11	10AA & 10B	Circular No.7/ DV/2013	<p>5.2 The income computed under various heads of income in accordance with the provisions of Chapter IV of the IT Act shall be aggregated in accordance with the provisions of Chapter VI of the IT Act,1961. This means that first the income/loss from various sources i.e. eligible and ineligible units, under the same head are aggregated in accordance with the provisions of Section 70 of the Act. Thereafter, the income from one ahead is aggregated with the income or loss of the other head in accordance with the provisions of Section 71 of the Act. If after giving effect to the provisions of Sections 70 and 71 of the Act there is any income (where there is no brought forward loss to be set off in accordance with the provisions of Section 72 of the Act) and the same is eligible for deduction in accordance with the provisions of Chapter VI-A or Sections 10A, 10B etc. of the Act, the same shall be allowed in computing the total income of the assessee.</p> <p>5.3 If after aggregation of income in accordance with the provisions of Sections 70 and 71 of the Act, the resultant amount is a loss (pertaining to assessment year 2001-02 and any subsequent year) from eligible unit it shall be eligible for carry forward and set off in accordance with the provisions of Section 72 of the Act. Similarly, if there is a loss from an ineligible unit, it shall be carried forward and may be set off against the profits of eligible unit or ineligible unit as the case may be, in accordance with the provisions of Section 72 of the Act.</p> <p>6. The provisions of Chapter IV and Chapter VI shall also apply in computing the income for the purpose of deduction under Sections 10AA and 10BA of the Act subject to the conditions specified in the said Sections.</p>
12	269SS Read with 271D & 271E	Circular No.10/2016	<p>It is a settled position that the period of limitation of penalty proceedings under Sections 271D and 271E of the Act is governed by the provisions of Section 275(1)(c) of the Act. Therefore, the limitation period for the imposition of penalty under these provisions would be the expiry of the financial year in which the proceedings, in the course of which action for the imposition of penalty has been initiated, are completed, or six months from the end of the month in which action for imposition of penalty is initiated, whichever period expires later. The limitation period is not dependent on the pendency of appeal against the assessment or other order referred to in Section 275(1)(a) of the Act.</p>

13	36(1)(vii) Read with Section 36(2) – Bad Debt	Circular No.12/2016	Claim for any debt or part thereof in any previous year, shall be admissible under Section 36(1)(vii) of the Act, if it is written off as irrecoverable in the books of account of the assessee for that previous year and it fulfills the conditions stipulated in Sub-section (2) of Sub-section 36(2) of the Act.
14	40(a)(ia)	Circular No.10/DV/2013	Board is of the considered view that the provision of Section 40(a)(ia) of the Act would cover not only the amounts which are payable as on 31st March of a previous year but also amounts which are payable at any time during the year. The statutory provisions are amply clear and in the context of Section 40(a)(ia) of the Act the term “payable” would include “amounts which are paid during the previous year”.
15	37(1) - Abandoned Feature Films	Circular No.16/2015	The order of the Hon’ble Bombay High Court dated 28-1-2015 in ITA 310 of 2013 in the case of Venus Records and Tapes Pvt. Ltd. on this issue has been accepted and the aforesaid disputed issue has not been further contested. Consequently, it is clarified that Rule 9A does not apply to abandoned feature films and that the expenditure incurred on such abandoned feature films is not to be treated as a capital expenditure. The cost of production of an abandoned feature film, is to be treated as revenue expenditure and allowed, as per the provisions of Section 37 of the Income-tax Act.
16	Indirect Transfer Provisions	Circular No.41/2016	Income deemed to accrue or arise in india - clarifications on indirect transfer provisions under said Act There are 19 Questions & Answers in the Circular
17	Interest from Non-SLR Securities of Banks – 80P	Circular No.18/2015	In the case of CIT v. Nawanshahar Central Cooperative Bank Ltd.(SC), the Apex Court held that the investments made by a banking concern are part of the business of banking. Therefore, the income arising from such investments is attributable to the business of banking falling under the head “Profits and Gains of Business and Profession”. 3.2 Even though the abovementioned decision was in the context of co-operative societies/Banks claiming deduction under Section 80P(2)(a)(i) of the Act, the principle is equally applicable to all banks/ commercial banks, to which Banking Regulation Act, 1949 applies.
18	37(1) - Keyman Insurance Policy in case of a Partner	Circular No.38/2016	It is a settled position that in case of a firm, premium paid by the firm on the Keyman Insurance Policy of a partner, to safeguard the firm against a disruption of the business, is an admissible expenditure under Section 37 of the Act.

19	Section 115JB, Read with Sections 115JA and 271(1)(c)	Circular No.25/2015	<p>in view of the Delhi High Court judgment in the case of Nalwa Sons Investment Ltd. and substitution of Explanation 4 of Section 271 of the Act with prospective effect, it is now a settled position that prior to 1-4-2016, where the income tax payable on the total income as computed under the normal provisions of the Act is less than the tax payable on the book profits u/s 115JB of the Act, then penalty under Section 271(1)(c) of the Act, is not attracted with reference to additions /disallowances made under normal provisions. It is further clarified that in cases prior to 1-4-2016, if any adjustment is made in the income computed for the purpose of MAT, then the levy of penalty u/s 271(1)(c) of the Act, will depend on the nature of adjustment.</p> <p>6. The above settled position is to be followed in respect of Section 115JC of the Act also.</p>
20	Section 4, Read with Section 10(37) - RFCTLARR ACT	Circular No.36/2016	<p>It is hereby clarified that compensation received in respect of award or agreement which has been exempted from levy of income-tax vide Section 96 of the RFCTLARR Act shall also not be taxable under the provisions of Income-tax Act, 1961 even if there is no specific provision of exemption for such compensation in the Income-tax Act, 1961.</p>
21	80IB & 80IC	Circular No.39/2016	<p>It is a settled position that revenue subsidies received from the Government towards reimbursement of cost of production/manufacture or for sale of the manufactured goods are part of profits and gains of business derived from the Industrial Undertaking /eligible business, and are thus, admissible for applicable deduction under Chapter VI-A of the Act.</p>
22	194A	Circular No.23/2015	<p>It is clarified that interest on FDRs made in the name of Registrar General of the Court or the depositor of the fund on the directions of the Court, will not be subject to TDS till the matter is decided by the Court. However, once the Court decides the ownership of the money lying in the fixed deposit, the provisions of Section 194A will apply to the recipient of the income.</p>
23	80-IA - Chapter VIA Deductions on Enhanced Profits	Circular No.37/2016	<p>Board has accepted the settled position that the disallowances made under Sections 32, 40(a)(ia), 40A(3), 43B, etc. of the Act and other specific disallowances, related to the business activity against which the Chapter VI-A deduction has been claimed, result in enhancement of the profits of the eligible business, and that deduction under Chapter VI-A is admissible on the profits so enhanced by the disallowance.</p>

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