

Important issues in computation of business income

**Direct Tax Refresher Course
(DTRC Part -II)**

07 June 2015

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Agenda

❖ Methods of computation

❖ Issues related to inclusion in income

- Real income v. Hypothetical income
- Right to receive as a parameter for taxation
- Taxability of interest on “due basis”
- Reliance on deeming provisions

❖ Issues related to deduction for expenditure

- Deduction for expenses u/s 28
- Meaning of “expenditure”
- Depreciation on goodwill
- Applicability of 40(a)(ia) to the payments made during the year
- Applicability of section 43B to employees contribution

❖ Certain other issues

- Income Computation and disclosure Standards (ICDS)
- Section 44DA – Permanent establishment, TDS
- Transactions with self

Methods of Computation of Income under the Act

Methods of Computation of Income

❖ Under the Act

- . Computation Method
- . Presumptive Method
- . Gross taxation

❖ Under the Rules (Rule 10)

- . Percentage of turn over
- . Proportionate Method
- . Discretionary Method

***Few issues related to
inclusion in income***

Real Income v. Hypothetical Income

❖ Meaning

Tax can be levied on real income and not any hypothetical or illusionary income

❖ Judicial precedents supporting the Real Income Theory

- CIT v. Shoorji Vallabhdas & Co. [1962] 46 ITR 144 (SC)
- Godhra Electricity Co. Ltd. v. CIT [1997] 225 ITR 746 (SC)

Real Income Theory....

CIT v. Shoorji Vallabhdas & Co.[1962] 46 ITR 144 (SC)

Facts:

- The assessee firm was managing agent for several shipping companies.
- Under its agreement with two shipping companies, the assessee firm was entitled to receive as its commission 10% of the freight charged.
- These amounts were credited in the books of accounts of the assessee firm with corresponding debits to the two shipping companies.
- Subsequently the assessee firm agreed to reduce its commission @ 2.5% of the freight charged and as a result, it gave up 75% of its earnings during the relevant years of account. The amount of commission given up by the assessee was claimed by the assessee under section 10(2)(xv), but was disallowed.

Real Income Theory....

CIT v. Shoorji Vallabhdas & Co.[1962] 46 ITR 144 (SC)

Views taken by the lower authorities:

- For the assessment year 1948-49, the ITO and the AAC held that the amount of larger commission (@ 10%) had already accrued during the previous year ended 31-March-1948 and hence was assessable.
- The Tribunal however deleted the extra commission on the ground that the larger commission neither accrued nor was received by the assessee firm.
- The High Court agreed with the Tribunal's view and held that the extra commission was not income of the previous year ended March 31, 1948.

Real Income Theory....

CIT v. Shoorji Vallabhdas & Co.[1962] 46 ITR 144 (SC)

The Supreme Court upheld the High Court's view and observed as follows:

“Income-tax is a levy on income. No doubt, the Income-tax Act takes into account two points of time at which the liability to tax is attracted, viz., the accrual of the income or its receipt; but the substance of the matter is the income. If income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made about a "hypothetical income", which does not materialise. Where income has, in fact, been received and is subsequently given up in such circumstances that it remains the income of the recipient, even though given up, the tax may be payable. Where, however, the income can be said not to have resulted at all, there is obviously neither accrual nor receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account.”

Real Income Theory....

Godhra Electricity Co. Ltd. v. CIT [1997] 225 ITR 746 (SC)....

Facts:

- The assessee was engaged in the business of generating and supplying electricity to the consumers.
- The increase in the charges for supply of electricity, made unilaterally by the assessee company, was challenged by the consumers, and the litigation ultimately could not be concluded since the management of the undertaking of the assessee company was taken over by the Government of Gujarat under the Defence of India Rules, 1971.
- During the pendency of this litigation in the various Courts the assessee-company could not realise the enhanced charges from the consumers, although accounted in its books of accounts.
- The charges unrecovered by the assessee company pursuant to the interim relief given to the consumers, was included by the ITO while making the assessment for the assessment year 1969-70, on the ground that the suit filed against the assessee-company by the consumers was decided in favour of the assessee-company during the accounting year 1968-69.

Real Income Theory....

....Godhra Electricity Co. Ltd. v. CIT [1997] 225 ITR 746 (SC)

Views taken by the AAC and the Tribunal:

- The addition made by the ITO was deleted by the AAC on the view that no legally enforceable claim had accrued to the assessee company during the previous year by which the assessee could recover the arrears of the earlier years for enhanced charges.
- The Tribunal also upheld AAC's order holding that the right to receive the increased rate had not crystallised. According to the Tribunal the claim at the increased rates as made by the assessee-company and on the basis of which necessary entries were made in the books, represented only hypothetical income and the impugned amount as brought to tax by the ITO did not represent the income which had accrued to the assessee-company during the relevant previous year.

Real Income Theory....

....Godhra Electricity Co. Ltd. v. CIT [1997] 225 ITR 746 (SC)

Views taken by the High Court:

- The High Court held that in the mercantile system of accounting it is the real income, as distinguished from a hypothetical income, which can be brought to tax and that income cannot be said to have accrued to an assessee-company if it is based on a mere claim not backed by any legal or contractual right to receive the amount at a subsequent date.
- The High Court however held against the assessee and rejected contention urged on behalf of the assessee-company that no real income had accrued to the assessee-company in the facts and circumstances of this case since the assessee-company was legally entitled to recover the consumption charges from the consumers at the enhanced rates and at no point of time had the assessee-company forgone or given up its right to recover the enhanced rates from its consumers.

Real Income Theory....

....Godhra Electricity Co. Ltd. v. CIT [1997] 225 ITR 746 (SC)

Observation of the Supreme Court:

“The question whether there was real accrual of income to the assessee-company in respect of the enhanced charges for supply of electricity has to be considered by taking the probability or improbability of realisation in a realistic manner. If the matter is considered in this light, it is not possible to hold that there was real accrual of income to the assessee-company in respect of the enhanced charges for supply of electricity which were added by the ITO while passing the assessment orders in respect of the assessment years under consideration. The AAC was right in deleting the said addition made by the ITO and the Tribunal had rightly held that the claim at the increased rates as made by the assessee-company on the basis of which necessary entries were made represented only hypothetical income and the impugned amounts as brought to tax by the ITO did not represent the income which had really accrued to the assessee-company during the relevant previous years. The High Court, in our opinion, was in error in upsetting the said view of the Tribunal.”

Right to receive as a parameter for taxation

E.D. Sassoon & Co. Ltd. v. CIT [1954] 26 ITR 27 (SC)

General understanding

Income accrues when the assessee acquires a right to receive the income. The assessee must have created a debt in his favour and he must have acquired a right to receive the payment.

Right to receive controversy

E.D. Sassoon & Co. Ltd. v. CIT [1954] 26 ITR 27 (SC)

Facts:

- Compensation for managing agencies was payable at the end of the year
- Managing agencies transferred by Sasoons to X before completion of the year
- Sasoons got consideration for the transfer from X
- At the end of the year X got entire years consideration for managing agencies
- Issue before the court: whether part of the consideration received by X was subject to tax in the hands of the Sasoons

Right to receive controversy – E. D. Sassoon

❖ Observations of the Supreme Court

"..... A debt must have come into existence and he must have acquired a right to receive the payment. Unless and until his contribution or parenthood is effective in bringing into existence a debt or a right to receive the payment or in other words a debitum in prasenti, solvendum in futuro it cannot be said that any income has accrued to him. The mere expression "earned" in the sense of rendering the services etc. by itself is of no avail....."

❖ General understanding

Income accrues when the assessee acquires a right to receive the income. The assessee must have created a debt in his favour and he must have acquired a right to receive the payment.

Taxability of interest on “due basis”

....Taxability of interest on due basis

Coupon dates : December 31, 2014 and June 30, 2015

Balance sheet date : March 31, 2015

Issue : Whether interest for three months (Jan – March) is to subject to tax for the year ended March 31, 2015

Judicial precedents

- ❖ Vijaya Bank v. ACIT [1991] 187 ITR 541 (SC)
- ❖ E.D. Sassoon & Co. Ltd. v. CIT [1954] 26 ITR 27 (SC)
- ❖ DIT v. Credit Suisse First Boston (Cyprus) Ltd. [2012] 23 taxmann.com 424 (Bom.)
- ❖ Dresdner Bank AG v. ADIT(IT) [2013] 32 taxmann.com 305 (Mumbai – Trib.)
- ❖ Syndicate Bank v. DCIT [2014] 150 ITD 103 (Bang.)

Principle of accrual – E.D. Sasoon

❖ Observations of the Supreme Court [1954] 26 ITR 27

"..... A debt must have come into existence and he must have acquired a right to receive the payment. Unless and until his contribution or parenthood is effective in bringing into existence a debt or a right to receive the payment or in other words a debitum in prasenti, solvendum in futuro it cannot be said that any income has accrued to him. The mere expression "earned" in the sense of rendering the services etc. by itself is of no avail....."

❖ General understanding

Income accrues when the assessee acquires a right to receive the income. The assessee must have created a debt in his favour and he must have acquired a right to receive the payment.

CBDT Circular no. 2/2002 dated 15.02.2002 on DDB

- ❖ The investor will value a DDB on marked to market basis at the end of each financial year and offer the difference to tax as interest income or business income as the case may be.
- ❖ If the DDB is held till maturity by the original subscriber, the difference between the redemption price and value as on the last valuation date will be taxable as interest income in the hands of the investor.
- ❖ Where the bond is redeemed by an intermediate purchaser, the difference between the redemption price and the cost (the actual cost plus interest, if any, which is already offered to tax by the intermediate purchaser) will be taxable as interest or business income, as the case may be.

Relevant provisions

❖ Section 18. Interest on securities (up to 1989)

“(1) The following amounts due to an assessee in the previous year shall be chargeable to income-tax under the head "Interest on securities", -

- (i) interest on any, security of the Central or State Government;*
- (ii) interest on debentures or other securities for money issued by or on behalf of a local authority or a company or a corporation established by a Central, State or Provincial Act.”*

❖ Proviso to section 145 (1989 to 1995)

"Provided further that where no method of accounting is regularly employed by the assessee, any income by way of interest on securities shall be chargeable to tax as the income of the previous year in which such interest is due to the assessee:"

Reliance on deeming provisions

Increased reliance on deeming provisions

❖ Scope of section 5

Income received or deemed to be received or income ***accruing or arising*** or deemed to be accruing or arising in India

❖ “Accruing” and “arising” are synonymous

❖ Frequent changes in the provisions and difficulties in interpreting “accruing” or “arising”

❖ Reluctance of courts

CIT v. Anamallais Timber Trust Ltd.[1950] 18 ITR 333 (Mad)

“It would be impudence on my part to attempt to evolve a rule of general application relating to foreign transactions or even in respect of sale of goods, when eminent Judges ruled that it is unwise to do so. It would be sufficient to confine the observations to the facts before me and to decide the question in light of the principles embodied in the decision bearing on the point.....”

Increased reliance on deeming provisions

❖ Reluctance of courts

CIT v. Chunilal B. Mehta (Privy Council)

*“If such profits have not been received in or brought into British India it becomes or may become necessary to consider on the facts of the case where they accrued or arose. **Their Lordships are not laying down any rule of general application to all cases of foreign transactions, or even with respect to the sale of goods. To do so would be nearly impossible** and wholly unwise to use the language of Lord Esher in *Erichsn v. Last.*”*

CIT v. Anamallais Timber Trust Ltd. [1950] 18 ITR 333 (Mad)

“Not only have any precise tests for determining the place where income, profits and gains can be said to accrue or arise, not been formulated, but the observations in some of the decided cases have contributed to blur rather than clarify the relevant considerations.”

Increased reliance on deeming provisions

❖ Insertion of deeming provisions in 1976

- Section 9(1)(v)
- Section 9(1)(vi)
- Section 9(1)(vii)

❖ Scope of section 5

Income received or deemed to be received or income ***accruing or arising*** or *deemed to be accruing or arising* in India

***Few issues related to
deduction for
expenditure***

Deduction for expenses u/s 28

- ❖ Section 29 : The income referred to in section 28 shall be computed in accordance with the provisions contained in sections 30 to 43D.
- ❖ Section 28 : The following income shall be chargeable to income tax under the head “profits and gains of business or profession” -
 - ❖ (i) the profits and gains of any business or profession which was carried on by the assessee at any time during the previous year

...Deduction for expenses u/s 28

Illustrative judicial precedents allowing deduction for expenses / losses under section 28(i) [or under section 10(1) of Income-tax Act, 1922]

- ❖ Badridas Daga v. CIT [1958] 34 ITR 10 (SC)
- ❖ Calcutta Co. Ltd. v. CIT [1959] 37 ITR 1 (SC)

...Deduction for expenses u/s 28

Badridas Daga v. CIT [1958] 34 ITR 10 (SC)....

Facts:

- Assessee, a sole proprietor of a firm, carried on business as money-lenders, dealers in shares and bullion and commission agents.
- One of the agents of the firm misappropriated the firm's money and the portion of the money unrecovered from the agent had to be written off as irrevocable.
- The dispute before the tax-authorities related to the question whether the amount written off as irrevocable was an admissible deduction.
- The Tribunal held that the loss by misappropriation of money **was not a trading loss and hence could not be allowed** as a deduction.
- Upon further appeal, the question raised before the High Court was whether the amount embezzled by the assessee's agent was allowable as deduction under the Indian Income-tax Act either under section 10(1) or under the general principles of determining the profit and loss of the assessee or under section 10(1)(xv) [i.e. the section equivalent to section 37(1)]. This question was answered by the High Court against the assessee.

...Deduction for expenses u/s 28

....Badridas Daga v. CIT [1958] 34 ITR 10 (SC)....

Issue before the SC:

Whether monies embezzled by an agent are allowable as deduction in computing the profits of a business under section 10 of the Act.

The SC observed that:

- The deduction cannot be claimed under section 10(2)(xi) ***as bad debts***. This was held on the ground that a debt arises out of a contract between the parties, and when an agent misappropriates monies belonging to his employer in fraud of him, it cannot be said that the agent owes those monies under any agreement.
- Nor can a claim for deduction be admitted under section 10(2)(xv) [equivalent to section 37(1)], because moneys which are withdrawn by the employee out of the business without authority and in fraud of the proprietor can in no sense be said to be "an expenditure laid out or expended wholly and exclusively" for the purpose of the business.

...Deduction for expenses u/s 28

...Badridas Daga v. CIT [1958] 34 ITR 10 (SC)....

The SC allowed such loss under section 10(1) [equivalent to section 28(i)] on the ground that such loss was incidental to the carrying on of the assessee's business. In this context, the SC observed as follows:

"...when a claim is made for a deduction for which there is no specific provision in section 10(2), whether it is admissible or not will depend on whether, having regard to accepted commercial practice and trading principles, it can be said to arise out of the carrying on of the business and to be incidental to it. If that is established, then the deduction must be allowed, provided of course there is no prohibition against it, express or implied, in the Act.

These being the governing principles, in deciding whether loss resulting from embezzlement by an employee in a business is admissible as a deduction under section 10(1) what has to be considered is whether it arises out of the carrying on of the business and is incidental to it. Viewing the question as a businessman would, it seems difficult to maintain that it does not."

...Deduction for expenses u/s 28

Calcutta Co. Ltd. v. CIT [1959] 37 ITR 1 (SC)....

Facts:

- The assessee carried on land developing business wherein he used to buy land, develop it to make it fit for building purposes and sell plots.
- The developments undertaken were to lay out roads, to provide drainage system, install street lights and they were to be maintained till the same were taken over by the municipality.
- Pursuant to the mercantile system of accounting followed by the assessee, the entire portion of sales price of the plots sold was credited to the profit and loss account, although a portion of the amount was not actually received.
- In the course of assessment, the assessee claimed a deduction for the estimated expenditure for the developments to be carried out in respect of the plots sold, although no part of such expenditure represented any expenditure actually incurred during the year.
- The ITO disallowed the claim on the ground that the expenditure was not actually incurred during the year. The claim was also disallowed by the AAC, the Tribunal and the High Court.

....Deduction for expenses u/s 28

....Calcutta Co. Ltd. v. CIT [1959] 37 ITR 1 (SC)....

Issue before the SC:

Whether having regard to the fact that the appellant's method of accounting, *viz.*, the mercantile method, was accepted by the Income-tax Officer and the receipts appearing in the books of account included the unpaid balance of the sale price of the plots sold, the amount of liability undertaken by the appellant to earn those receipts was to be deducted even if there had not been actual disbursement made by it during the accounting year.

Supreme Court observed that:

- The undertaking for the developments was absolute and not contingent merely because it was to be carried out within 6 months from the date of sale of the plots. Accordingly, it accrued on the date of sale of the plots.
- The difficulty in the estimation would not convert an accrued liability into a conditional one

...Deduction for expenses u/s 28

....Calcutta Co. Ltd. v. CIT [1959] 37 ITR 1 (SC)....

Supreme Court allowed the deduction of the estimated expenditure holding the below:

“Apart, however, from the question whether section 10(2)(xv) of the Income-tax Act would apply to the facts of the present case, the case is, in our opinion, well within the purview of section 10(1) of the Income-tax Act. The appellant here is being assessed in respect of the profits and gains of its business and the profits and gains of the business cannot be determined unless and until the expenses or the obligations which have been incurred are set off against the receipts. The expression "profits and gains" has to be understood in its commercial sense and there can be no computation of such profits and gains until the expenditure which is necessary for the purpose of earning the receipts is deducted therefrom—whether the expenditure is actually incurred or the liability in respect thereof has accrued even though it may have to be discharged at some future date.”

....Deduction for expenses u/s 28

....Calcutta Co. Ltd. v. CIT [1959] 37 ITR 1 (SC)

Supreme Court concluded its finding in the following words:

*“We are definitely of opinion that the sum of Rs. 24,809 represented the estimated amount which would have to be expended by the appellant in the course of carrying on its business and was incidental to the same and having regard to the accepted commercial practice and trading principles was a deduction which, **if there was no specific provision for it under section 10(2) of the Act, was certainly allowable deduction, in arriving at the profits and gains of the business of the appellant under section 10(1) of the Act, there being no prohibition against it, express or implied, in the Act.**”*

Deduction for expenses u/s 28....

Madeva Upendra v. Union of India [1975] 98 ITR 209 (SC):

*“Section 28(i) makes the "profits and gains of any business or profession which was carried on by the assessee at any time during the previous year" chargeable to income-tax. Section 29 requires that the income referred to in section 28 shall be computed in accordance with the provisions including those for deductions contained in sections 30 to 43A. Since the tax is chargeable on "profits and gains" and not on gross receipts, the profits to be assessed must be the real profits computed, subject to the special requirements of the Act in accordance with the ordinary principles of commercial accounting. **It follows that if the deduction of a particular item from the incomings of the business or profession is neither expressly covered by the aforesaid sections, nor prohibited expressly or by necessary implication by those provisions, it can be allowed under section 28(i) provided, on ordinary commercial principles, it is a proper item to be debited against the incomings in ascertaining the "profits and gains" properly so called**”*

Meaning of “expenditure”

Deductibility u/s 37(1) – SC in case of Indian Molasses Co.

Facts:

- Managing director (**MD**) of the assessee company, having served the company for 13 years by 1948, was **due to retire at the age of 55 years in 1955.**
- The assessee company under an agreement was under an **obligation to provide pension to the MD** after his retirement.
- Under a trust deed executed **in 1948** by the assessee company in favour of the three trustees, the assessee company **paid a sum of Rs.109,643/- and further undertook to pay Rs.4364 for six years.**
- The trustees undertook to hold the said sums upon trust to spend the same in taking out a deferred annuity policy with an Insurance Society in the name of the trustees but on the life of the MD from the date of his superannuation.
- The Trust deed also provided that should the MD die before attaining the age of 55 years, the trustees would stand possessed of the capital value of the deferred annuity policy and upon trust would purchase therewith an annuity for wife of the MD.

Deductibility u/s 37(1) – SC in case of Indian Molasses Co.

Facts (cont. ...):

- In January 1948, the Trustees took a policy.
- The relevant terms of the policy were as follows:
 - the trustees were allowed to surrender the annuity by written notice to that effect on the option anniversary (i.e. Sept. 1955).
 - If both nominees shall die before the option anniversary, all the premiums paid were to be repaid by the Society to the trustees.
- The assessee paid the initial sum and the yearly premia for some years before the MD died and claimed deduction under section 10(2)(xv) for such premia for assessment years 1949-50 to 1952-53.

Issue before the SC:

Whether the payment made by the assessee company constitute “expenditure” within the meaning of that word in section 10(2)(xv) of the Indian Income-tax Act, 1922?

Deductibility u/s 37(1) – SC in case of Indian Molasses Co.

Stand taken by the lower authorities:

- The Tribunal disallowed the claim on the ground that there was no expenditure at all, since in Tribunal's view what had been done amounted to a provision for a contingency which may never arise.
- The high court held that the money could not be held to have been expended, since there was always a possibility of the money coming back to the company.

Argument of the Revenue before the Supreme Court:

Setting apart of money was for a contingent liability and till the liability became real, there was no expenditure.

Deductibility u/s 37(1) – SC in case of Indian Molasses Co.

Supreme Court disallowed the claim observing the following:

“....."Expenditure" is equal to "expense" and "expense" is money laid out by calculation and intention though in many uses of the word this element may not be present, as when we speak of a joke at another's expense. But the idea of "spending" in the sense of "paying out or away" money is the primary meaning and it is with that meaning that we are concerned. "Expenditure" is thus what is "paid out or away" and is something which is gone irretrievably.

“A distinction is made between an actual liability in praesenti and a liability de futuro which, for the time being, is only contingent. The former is deductible but not the latter.

To be a payment which is made irrevocably there should be no possibility of the money forming, once again, a part of the funds of the assessee company.”

Depreciation on goodwill

Depreciation on Goodwill....

CIT v. Smifs Securities Ltd. [2012] 348 ITR 302 (SC)....

Facts:

- Assessee company claimed deduction for depreciation on goodwill.
- The assessee contended that the goodwill arose upon amalgamation of a company into the assessee company
- As explained by the assessee, the excess consideration paid by the assessee company over the value of the net assets acquired of the amalgamating company should be considered as goodwill arising on amalgamation.
- The AO held that the goodwill was not an asset falling under Explanation 3 to section 32(1).

Question before the SC:

Whether goodwill is an 'asset' within the meaning of Section 32 of the Income Tax Act, 1961, and whether depreciation on 'goodwill' is allowable under the said Section?

....Depreciation on Goodwill

....CIT v. Smifs Securities Ltd. [2012] 348 ITR 302 (SC)

Supreme Court:

- Noted that Explanation 3 states that the expression “asset” shall mean an intangible asset, being know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature.
- Held that 'Goodwill' is an asset under Explanation 3(b) to Section 32(1) of the Act on the ground that goodwill would fall under the expression “any other business or commercial right of a similar nature” keeping in view the principle of ejusdem generis .
- Denied to interfere with the factual finding by the Tribunal that the difference between the cost of an asset and the amount paid constituted goodwill and that the assessee-Company in the process of amalgamation had acquired a capital right in the form of goodwill because of which the market worth of the assessee-Company stood increased.
- Mentioned that before the High Court the Revenue did not file an appeal on the finding of fact but raised only the question as to whether goodwill is an asset u/s 32.

Applicability of 40(a)(ia) to the payments made during the year

Section 40(a)(ia) – amount paid during the year

Disallowance under section 40(a)(ia):

*“(ia) thirty per cent of any **sum payable** to a resident, on which tax is deductible at source under Chapter XVII-B and such tax has not been deducted or, after deduction, has not been paid on or before the due date specified in sub-section (1) of section 139:”*

Issue:

Whether the disallowance u/s 40(a)(ia) should be restricted only to the amounts remaining outstanding as at March 31 of the relevant financial year? In other words, whether no disallowance can be made u/s 40(a)(ia) in relation to the expenditure incurred and already paid during the year, where no tax has been deducted from such expenditure or after deduction has not been paid?

Section 40(a)(ia) – amount paid during the year

Merilyn Shipping & Transports v. ACIT [2012] 136 ITD 23 (ITAT, Visakhapatnam)(SB):

The provisions of section 40(a)(ia) are applicable only to expenditure which is payable and outstanding as at March 31 of every year and cannot be invoked to disallow amounts which have already been paid during the previous year, without TDS. This was held mainly on the ground that the words **“amount credited” or “paid” were replaced by the word “payable”** in the final enactment of the provisions of section 40(a)(ia).

Judicial precedents adopting the view taken by the Tribunal’s case of Merilyn Shipping:

- CIT v. Vector Shipping Services (P.) Ltd. [2013] 357 ITR 642 (Allahabad)
- ITO v. Theekathir Press [ITA No.2076(Mds)/2012](ITAT, Chennai)
- ITO v. Cross Tab Marketing Services (P.) Ltd. [2014] 149 ITD 678 (ITAT, Bangalore)

Section 40(a)(ia) – amount paid during the year

CBDT's Circular No. 10/DV/2013 dated 16th December 2013

*“4. After careful examination of the issue, the 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(1)(ia) of the Act **the term “payable” would include “amounts which are paid during the previous year”**”*

5. Where any High Court decides an issue contrary to the ‘Departmental View’, the ‘Departmental View’ thereon shall not be operative in the area falling in the jurisdiction of the relevant High Court. ...”

Section 40(a)(ia) – amount paid during the year

Judicial precedents not following the view adopted by the Tribunal in case of Merilyn Shipping:

- CIT v. Sikandarkhan N. Tunvar [2013] 357 ITR 312 (Gujarat)
- CIT v. Crescent Export Syndicate [2013] 216 Taxman 258 (Calcutta)
- CIT v. Md. Jakir Hossain Mondal [2013] 33 taxmann.com 123 (Calcutta)
- STCI Commodities Ltd. v. ACIT [2014] 147 ITD 696 (ITAT, Mumbai)
- ACIT v. Rishti Stock & Shares (P.) Ltd. [2015] 152 ITD 868 (ITAT, Mumbai)
- Manzoor Ahmad Walvir v. DCIT [2014] 61 SOT 70 (ITAT, Amritsar)

***Applicability of section 43B to employees
contribution***

Applicability of section 43B to employees contribution

Relevant provisions of the Act:

- ***Section 2(24)(x): Employees' contribution*** to any provident fund / superannuation fund, etc. - **regarded as “income”**
- ***Section 36(1)(va): Deduction allowed*** for the **employee's contribution – if paid on or before the due date.**
 - Explanation: **“due date”** - as per the relevant law

Applicability of section 43B to employees contribution

Section 43B: Notwithstanding anything contained in any other provision of this Act, a deduction otherwise allowable under this Act in respect of—

...

(b) 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, [or]

...

shall be allowed (irrespective of the previous year in which the liability to pay such sum was incurred by the assessee according to the method of accounting regularly employed by him) only in computing the income referred to in of that previous year in which such sum is actually paid by him :

Applicability of section 43B to employees contribution

Issue:

Whether deduction under section 43B can be claimed for the employee's contribution, which is paid after the due date under the relevant law but before the due date of furnishing ROI?

Relevant Historical Background:

- **Section 43B** - inserted in the Act vide **Finance Act, 1983**
 - object was to curb practice of claiming deduction on mercantile basis even if the sum were not actually paid for long period of time.
- **Section 2(24)(x) and 36(1)(va) (including the Explanation)**
 - inserted in the Act vide **Finance Act, 1987**
 - object was to penalise employer who not used to credit the contribution to the provident / state insurance fund.

Applicability of section 43B to employees contribution

Relevant Historical Background (cont. ...):

- Vide Finance Act, 1987 – two Provisos to section 43B were inserted:
 - Nothing in s. 43B to apply if sum paid on or before due date for furnishing ROI
 - No deduction shall be allowed for sum referred in clause (b) to section 43B (i.e. for contribution to provident/ superannuation/ gratuity/ other employee welfare fund) unless such sum is actually paid during the previous year on or before the due date as defined in Explanation to section 36(1)(va)
- Vide Finance Act, 2003 – the 2nd Proviso to section 43B was deleted
 - so as to allow the deduction of contribution in the year of actual payment.

Other guidance on the issue holding – 43B not to apply to employee's contribution

- ICAI's Guidance Note on Tax Audit u/s 44AB
- Tax Audit Manual of the Bombay Chartered Accountant's Society

Applicability of section 43B to employees contribution

Illustrative Judicial precedents – in favour of assessee – 43B to apply even for employee's contribution

- CIT v. Aimil Lintied and others [2009] 321 ITR 508 (Delhi)
- Kuber Hinges Pvt. Ltd. v. ITO [2009] 120 TTJ 284 (ITAT, Delhi)
- CIT v. Nipso Polyfabriks Ltd. [2012] 350 ITR 327 (Himachal Pradesh)
- CIT v. Kichha Sugar Co. Ltd. [2013] 216 Taxman 90 (Uttarakhand)

Illustrative Judicial precedents – in favour of the Revenue – 43B cannot be applied to employee's contribution

- JCIT v. ITC Ltd. [2008] 115 TTJ 45 (ITAT, Kolkatta)(SB)
- Suizer Pumps India Ltd. v. JCIT [2006] 7 SOT 533 (ITAT, Mumbai)
- A.P.L. (India)(P.) Ltd. v. DCIT [2005] 96 ITD 227 (ITAT, Mumbai)
- DCIT v. Ashika Stock Broking Ltd. [2011] 55 SOT 556 (ITAT, Kolkatta)
- DCIT v. Bengal Chemicals & Pharmaceuticals Ltd. [2011] 11 taxmann.com 328 (ITAT, Kolkatta)
- ITO v. LKP Securities Ltd. [2013][ITA No. 638,1093/Mum/2012]

Certain other issues

Certain other issues – Income Computation and Disclosure Standards (ICDS)

ICDS implications....

Amendment to section 145

- Now empowers the Central Government to notify ICDS
 - to be followed by any class of assessee or
 - in respect of any class of income.
- Consequent amendment in section 145(3) empowering Assessing Officer to make assessment under section 144, if the income is not computed in accordance with the ICDS.
- Notification No. SO 892 (E) dated 31-March-2015
 - notified 10 ICDS
 - to be followed from assessment year 2016-17
 - by all assessees following the mercantile system of accounting
 - for the purposes of computation of income chargeable to income-tax under the head “Profit and gains of business or profession” or “Income from other sources”

...ICDS implications...

Amendment to section 2(24)

Para 4.2 of ICDS – VII relating to government grants

- Provides for no exception for government grants that can be regarded as capital receipt and hence not “income”
- Definition of the expression “income” under section 2(24) now expanded to include (with effect from 1-4-2016):

“assistance in the form of a subsidy or grant or cash incentive or duty drawback or waiver or concession or reimbursement (by whatever name called) by the Central Government or a State Government or any authority or body or agency in cash or kind to the assessee other than the subsidy or grant or reimbursement which is taken into account for determination of the actual cost of the asset in accordance with the provisions of Explanation 10 to clause (1) of section 43;”

...ICDS implications...

Amendment to section 36(1)(vii)

Background

- Pursuant to section 36(1)(vii), deduction is allowed, in computing the income referred to in section 28, for an amount of any bad debt or part thereof which is **written off as irrevocable in the accounts of the assessee** for the previous year.
- There may be certain items such as “**interest on NPA**” which may not be recognised in the accounts of the assessee on accrual basis, pursuant to the prudential norms which the assessee is bound to follow.
- Similarly, **retention money** may not be recognised by a construction contractor in its books of accounts on the ground that such retention money is contingent and hence does not accrue until fulfilment of certain conditions.

...ICDS implications...

Amendment to section 36(1)(vii):

Position under ICDS

- Para 7 of ICDS – IV relating to revenue recognition requires recognition of interest on time basis.
- Similarly, as per Para 9 and 10 of ICDS – III relating to construction contracts, contract revenue (which includes even the retention money) shall be recognised when there is reasonable certainty of its ultimate collection.
- Thus, even if an income is not recognised in the accounts, the same gets considered while computing taxable income pursuant to the ICDS notified.
- Upon such income becoming irrevocable, there could have been an issue to claim a deduction for bad debt under section 36(1)(vii), since in absence of initial recognition of such income in the accounts, there may not be any write off in the accounts upon the income turning into a bad debt.

...ICDS implications

Amendment to section 36(1)(vii):

Insertion of the 2nd Proviso to section 36(1)(vii)

- To allow a deduction under section 36(1)(vii) for bad debts of income, which was not recognised initially in the accounts of the assessee.
- With effect from 1-April-2016
- The Proviso reads as under:
“Provided further that where the amount of such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof becomes irrecoverable or of an earlier previous year on the basis of income computation and disclosure standards notified under sub-section (2) of section 145 without recording the same in the accounts, then, such debt or part thereof shall be allowed in the previous year in which such debt or part thereof becomes irrecoverable and it shall be deemed that such debt or part thereof has been written off as irrevocable in the accounts for the purposes of this clause.”

Implications of ICDS on judicial precedents

145. (1) Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall, **subject to the provisions of sub-section (2)**, be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

(2) The Central Government may notify in the Official Gazette from time to time [income computation and disclosure standards] to be followed by any class of assesseees or in respect of any class of income.

In the case of conflict between the provisions of the Income Tax Act, 1961 (the Act) and this income computation and disclosure standard, the provisions of the Act shall prevail to that extent.

Implications of ICDS

❖ Disclosure requirements

Certain other issues – section 44DA

Section 44DA - PE définition

- ❖ **Section 44DA:** Royalty / Fees for Technical Services (FTS) to a non-resident - if effectively connected to a Permanent Establishment in India - computed under the head “Profits and gains of business or profession” (**i.e. taxable on net basis @ 40%**).

*“Permanent Establishment” for this purpose includes a **fixed place of business** through which the business of the enterprise is wholly or partly carried on. [section 92F(iia)]*

- ❖ **Whether Service PE or Agency PE is to be treated as PE u/s 92F(iia)?**
 - Circular no. 14 of 2001 : No definition but meaning to be drawn from treaties
 - Memorandum : “on the lines of definition found in the tax treaties”
 - Observations in Morgan Stanley [2007] 292 ITR 416 (SC)

Section 44DA - PE définition....TDS obligation

- ❖ **Section 195:** requires deduction of tax by the payer - from the sum payable to a non-resident - at the “rates in force” – where such sum is chargeable to tax in the hands of the non-resident. “rates in force” generally works out @ 10% of FTS payable (**i.e. tax is deducted on gross basis @ 10%**)
- ❖ Is there a sufficient compliance of section 195, where income is taxable @ 40% on net basis and taxes withheld @ 10% on gross basis?

Certain other issues – Transactions with self

Transactions with self

❖ **Can a person:**

- Transact with himself?
- Earn profits from himself?
- Sale goods to himself?
- Declare dividend to himself?
- Invest in himself?

Transactions with self

❖ Provisions recognizing transactions with self

- **Section 2(47)(iv)**

“in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment;”

- **Section 92F(iii)**

*“enterprise means a person (**including a permanent establishment of such person**) who is, or has been, or proposed to be, engaged in any activity, relating to the production, storage.....”*

- **Explanation to section 9(1)(v)**

- **Article 7 of the tax treaties**

Transactions with self

❖ **CBDT Circulars recognizing transactions with self for the purpose of TDS**

- **CBDT Circular no. 649 dated March 31, 1993**

Payment of fees for technical services by an Indian PE to its head office

- **CBDT Circular No. 740 dated April 17, 1996**

Payment of interest by an Indian PE to its head office

Transactions with self

Judicial precedents not recognising transactions with self

Sir Kikabhai Premchand v. CIT [1953] 24 ITR 506 (SC)

- Assessee carried on business of shares and silver bars as proprietary concern
- The closing stock was valued at cost and market price was recognised only when the stock was sold
- Assessee withdrew some shares, silver bars and contributed a trust
- The AO contended the market value on the date of withdrawal should be credited to the P & LL a/c
- The Supreme Court decided in favour of the assessee

Ram Lal Bechai Ram [1946] 14 ITR 1 (All HC)

Betts Hartley Huett and Co. Ltd. [1979] 116 ITR 425 (Cal HC)

Transactions with self

Can a person sale good to himself?

Castrol India Limited v. State of Tamil Nadu (Mad HC)

- Merger of Castrol & ISCL, retrospective effect (1/1/92), ISCL ceased to exist
- Sales tax on goods sold after the effective date (1/1/92 to 31/3/92)
- Held transaction with self not possible
- Section 33C of Bombay Sales Tax Act amended in 2002

Transactions with self

Can a person pay interest to himself?

Transactions between Indian branch of a foreign bank and its head office

ABN Amro Bank 98 TTJ 295 (Kol Trib)

***Sumitomo Mitsui Banking Corpn [2012] 19 taxmann.com 364
ITAT Mumbai Special Bench***

- Interest paid by Indian branch to foreign HO not subject to tax in India on the basis of “payment to self”.
- Explanation to section 9(1)(v)

Transactions with self

Can a person sale good to himself?

Castrol India Limited v. State of Tamil Nadu (Mad HC)

- Merger of Castrol & ISCL, retrospective effect (1/1/92), ISCL ceased to exist
- Sales tax on goods sold after the effective date (1/1/92 to 31/3/92)
- Held transaction with self not possible
- Section 33C of Bombay Sales Tax Act amended in 2002

Transactions with self

Can a pay dividend to himself?

Mafatlal Gangabhai And Company (Pvt.) Limited v. CIT (Bom)

- September 2, 1968: The Jute Company declared dividend.
- January 6, 1969: The High Court sanctioned the scheme of amalgamation.
- April 1, 1968: The date from which the amalgamation was to become effective
- Held dividend to self not possible

Torrent P. Ltd. v. CIT [2013] 35 taxmann.com 300 (Guj)

Transactions with self

Judicial precedents recognising transactions with self

CIT v. Bai Shrinbai K.Kooka [1953] 24 ITR 506 (SC)

- Assessee held shares as investments and then converted into stock in trade
- For the purpose of determination of capital gains on sale of such shares, market value on the date of conversion was considered as 'cost of acquisition' by the revenue by the assessee
- Revenue contended that it would amount to transfer to self and such transaction with self cannot be recognised
- Six out of seven judges upheld assessee's contention

Transactions with self

Can a person invest in himself?

Industrial Development Bank of India v. DCIT 91 ITD 34 (Bom Trib)

- IDBI earned long term capital gains and invested in IDBI bonds
- IDBI claimed deduction u/s 54E
- IDBI was allowed deduction u/s 54E – it did not have control over the funds

Thank You

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