www.taxguru.in

APRIL–JUNE 2021 ISSUE 8

TAXALOGUE

e-journal by CBDT

Dialogue on Tax

Income Tax Department proudly celebrates...

Azadi Ka Amrit Mahotsav

75th years of **Independence Day**

161st Income Tax Day

24th July, 1860–24th July, 2021

16 Decades in Service of the Nation

Directorate of Legal & Research
Central Board of Direct Taxes

www.taxguru.in

General Information

Editor-in-Chief	**Krishna Mohan Prasad** Member (Audit & Judicial and Income Tax & Revenue), Central Board of Direct Taxes
Chief Editor	**Saroj Deswal** Pr. Director General of Income Tax (Legal & Research)
Editor	**Reena Sinha Puri** CCIT(OSD)
Editor	**Sameer Kumar Srivastava** Addl. DG (Audit & Inspection)
Editor	**Virendra Kumar Sheoran** Addl. DIT (Audit & Inspection)
Editor	**Manoj Aggarwal** DDIT (Audit)
Editorial contact	taxalogue@incometax.gov.in Directorate of Legal & Research Income Tax Department, Govt. of India Drum Shaped Building I.P. Estate, Delhi–110002

TAXALOGUE

Mission

To provide a platform and build a network amongst tax officers, tax practitioners eminent personalities, taxpayers 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 taxpayer service.

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 taxpayers .**
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 professional competency and developing human resources.**

www.taxguru.in

Krishna Mohan Prasad

EDITORIAL

1. This is the 8th issue of e-journal 'Taxalogue', my last as Editor-in-Chief, as I am superannuating on 31st August, 2021. The first issue was released on Aayakar Diwas on 24th July, 2019 at Dr. Ambedkar International Centre, New Delhi by Hon'ble Minister of Finance & Corporate Affairs, Smt. Nirmala Sitharaman.

2. In the last seven issues, kaleidoscope of ideas in the form of 125 articles have been published under the heads 'Assessment', 'Dispute Resolution', 'Best Practices', 'Exemptions', 'International Taxation', 'Penalties', 'Tax History', 'Tax policies', 'TDS', 'Transfer Pricing', 'Faceless e-Assessment', 'Ideation', 'Economy', 'Budget', 'Income-tax Settlement Commission', 'NCLT', 'Angel Taxation', 'Search and Seizure', 'Litigation Management', 'Agriculture Income-tax', 'Leaderspeak', 'Audit', 'Income Computation and Disclosure Standard(ICDS)' and 'Taxpayer Advocacy'. The authors of the articles have been serving and superannuated IRS officers, retired Justice of the Supreme Court and Departmental Counsels. In this issue and in the subsequent issues, list of articles published in the past issues of 'Taxalogue' containing name of the topic, issue number, title of the article and name of the author is proposed to be published for easy referencing.

3. This issue incorporates very interesting articles on a variety of topics. The articles briefly stated are:

   i. 'Sports in Section 2(15) of Income-tax Act, 1961' highlights the need of including sports, a field of eminent importance, in the definition of 'charitable purpose' bringing sports at par with yoga.

   ii. '46 Significant Direct Tax Issues before the Supreme Court' is very useful which brings out highly litigated matters before the Apex Court, the resolution of which will dispose off 791 cases that have disputed tax of more than Rs. 1 Lakh Crore representing approx. 80% of the disputed tax and 20% of the total Departmental SLPs pending in the Apex Court. It shall also have cascading effect on reduction of existing and future litigation.

   iii. 'Evolution of Search Assessments' is a commentary in itself outlining the guiding principles on search assessments.

   iv. 'Alternative Tax Dispute Resolution via Technological (Faceless) Way' is thought provoking.

   v. 'Taxation of Agricultural Income in India' gives a comprehensive view on historical perspective of taxation of Agricultural Income.

www.taxguru.in

vi. 'Demystifying Global Minimum Tax' is a well-researched article on the problem of global corporate tax abuse. It discusses the G7 proposals on this issue, considered very recently.

vii. 'Applicability of provisions of Section 115BBE specifically in the year of Search/Survey where the unrecorded stock/cash etc. are offered suo moto in ROI' is very well written and based on strong arguments.

viii. 'Approval under Section 153D does not mean that search assessment proceedings were jointly done by the AO and the Range Head' is very relevant as it wades into the controversy about the scope of approval given by the Range Head under Section 153D'.

ix. 'The PE's Bloodline' discusses the origin, concept and history of 'Permanent Establishment'.

x. 'Application of Section 115BBE to Income offered in Tax Return in consequence to Detection/ Admission/Surrender during Search & Seizure or Survey Proceedings' explains the provisions and its judicial journey.

xi. 'New Regime of penalty under Section 270A' is very well drafted which made easy the understanding of newly introduced provisions of penalty.

xii. 'Transfer Pricing "Financial Transactions"- Settled Issues & Case Laws in Favour of Revenue' is very well-researched.

xiii. 'Convergence of the wings of International Taxation & Transfer Pricing' gives a detailed overview of the functions of International Taxation and Transfer Pricing wings and the justification for their convergence.

xiv. 'Urban bad debts write off by Banks – A ticklish issue' is very well drafted with examples clearly bringing out the misuse of various provision of section 36 of the Income Tax Act.

4. Most members of the Editorial Board of 'Taxalogue' have shown perseverance, wisdom and enthusiasm, so has most officers of the Directorate of Legal & Research and I am sure, this e-magazine shall continue to be a strong forum of exchange of ideas on tax matters as times go by.

5. Some officers have stated that they do not write article fearing that it may be construed as criticism of existing policy or working and they may face difficulties. Due to this, many wise ideas remain dormant. The writers are expected to identify the problems, discuss the issues involved and suggest solutions and present it in a scientific manner, so that the article is not a criticism of existing policy but an attempt to improve the existing weaknesses. As a couplet of Waseem Barelvi says:

"कौन सी बात कहाँ कैसे कही जाती है,
ये सलीका हो, तो हर बात सुनी जाती है"

6. Our beloved Late FM, Shri Arun Jaitley at the Vibrant Gujarat Global Summit 2017 stated; ***"We are substantially in terms of taxation, a non-compliance society. The narrowness of our tax base is realized by the data. Formal transactions can lead to higher revenues, and make us more compliant."***

For making India a tax compliant nation it is desirable that Paradigm Shift in narrative about tax payment is done. In this regard suggestions are:

www.taxguru.in

(a) **Highlighting** that paying tax is not a burden but a pious national duty;

(b) Inculcating a sense of joy and pride in paying tax;

(c) Emphasizing that paying tax is more charitable than charity itself; as taxes are used for promotion of education, health, environment, relief to poor, national security, national development;

(d) Raising awareness that by tax evasion or avoidance, one keeps nation's money for personal use, mostly for conspicuous consumption;

(e) Shifting emphasis from the pride of being rich by inheritance or having wealth to lifetime tax paid of individual and companies.

6.1 More effective **compliance management is needed** towards Tax Payer's Service and checking tax evasion **following the motto, 'the biggest service to existing honest tax payers is to stop tax leakages'.**

6.2 Tax policy is a constant work in progress and removal of toxicity in tax laws is required so as to also minimize pain of tax litigation.

6.3 Tax education is required to be included in the school curriculum to make Indians tax- literate.

6.4 **Tax Subsidy is a major issue as in last two year as the direct tax subsidy computed in the Budget 2021 is at Rs. 4.23 Lakh Crores.** The Budget, 2021-22 in ANNEX-7, provides Statement of Revenue Impact of Tax Incentive under the Central Tax System. Such impact for Financial Years 2018-19 & 2019-20 for Corporate Tax is at Rs. 1,08,113 Cr. and Rs. 99,842 Cr. respectively, for Firm, AOP, BOI is at Rs. 6,804 Cr. and Rs. 6,283 Cr. respectively and for Individual IT is at Rs. 95,377 Cr. and Rs. 1,06,532 Cr. respectively. Further, the exemption of Income to 2,26,531 Charitable entities for FY 2018-19 has been computed at Rs 7.35 Lakh Crore. It's a matter of serious consideration and research how the tax subsidy may be gradually reduced to augment tax revenue and bring equity amongst tax payers and whether a floor rate of tax on all income of all entities is required to be introduced.

6.5 The Tax Administration must always follow the mantra of efficiency, transparency and accountability.

7. Let's remind ourselves of the beautiful and inspiring words from poem "Stopping by Woods on a Snowy Evening" of Robert Frost:

"The woods are lovely, dark and deep.
But I have promises to keep,
And miles to go before I sleep,
And miles to go before I sleep."

Krishna Mohan Prasad
Member, CBDT
Editor-in-Chief, 'Taxalogue'
On behalf of Editorial Board

www.taxguru.in

CONTENTS

FEATURED

Editorial
Krishna Mohan Prasad i

Editorial Board vi

From the Directorate of Legal and Research
Pankaj Jindal vii

Tax Policy

"Sports" in Section 2(15) of Income-tax Act, 1961
Krishna Mohan Prasad 1

Agricultural Income

Taxation of Agricultural Income in India
Vasundhara Sinha 7

Assessment

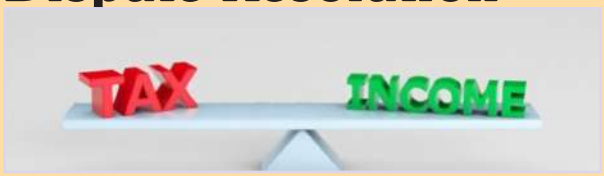
Applicability of Provisions of Section 115BBE Specifically in the Year of Search/Survey where the Unrecorded Stock/Cash etc are Offered suo moto in ROI
Ajay Kumar Srivastava 19

Assessment

Application of Section 115BBE to Income Offered in Tax Return in Consequence to Detection/Admission/Surrender during Search & Seizure or Survey Proceedings
Byomkesh Panda 27

Urban Bad Debts Write-off by Banks: A Ticklish Issue
Dr. Shakir Hussain Shaik 39

Dispute Resolution



Alternative Tax Dispute Resolution via Technological (Faceless) Way
Ashok Kumar Saroha 55

Ideation

Convergence of the Wings of International Taxation & Transfer Pricing
Anantharaman N.V. Iyer 62

Demystifying Global Minimum Tax
Bidisha Chintey 76

International Taxation

The PE's Bloodline
Subhash Jangala 80

www.taxguru.in

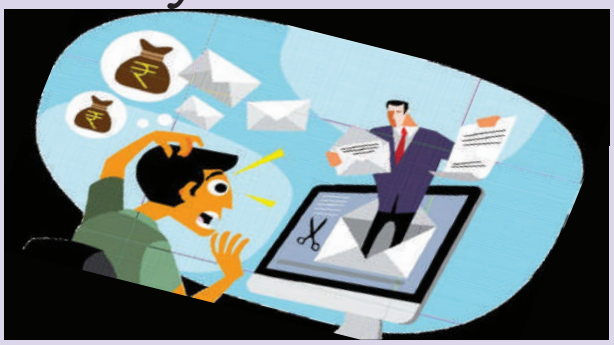
Litigation Management

46 Significant Direct Tax Issues before the Supreme Court
Reena Sinha Puri 89

Tax History-Search Assessments

Evolution of Search Assessments
Satender Singh Rana 115

Penalty



New Regime of Penalty under Section 270A
Satendra Kumar Dixit 98

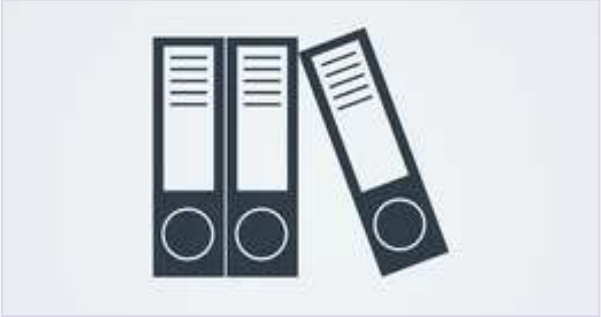
Transfer Pricing

Transfer Pricing "Financial Transactions"—Settled Issues & Case Laws in Favour of Revenue
Shardul 121

Search and Seizures

Approval under Section 153D does not mean that Search Assessment Proceedings were jointly done by the AO and the Range Head
Ramesh Chander 109

Earlier Articles: Issues (1–7)



..... 129

www.taxguru.in

Editorial Board

Krishna Mohan Prasad (IRS: 1984)
Member (Audit & Judicial), CBDT, Delhi
Editor-in-Chief

Saroj Deswal (IRS: 1986)
Pr DGIT (L&R), Delhi
Cheif Editor

Reena Sinha Puri (IRS: 1987)
CCIT (OSD), Delhi
Editor

Sameer Kumar Srivastava (IRS: 1995)
Addl. DG (Audit & Inspections), Delhi
Editor

Virendra Kumar Sheoran, (IRS: 2007)
Addl. DIT (Audit & Inspections)
Editor

Manoj Aggarwal (IRS: 2013)
DDIT (Audit)
Editor

R. Ravichandran (IRS: 1987)
PDIT (Inv), Bengaluru
Member

Ramesh Chander (IRS: 1990)
CIT (Judicial), Delhi
Member

Swati Joshi (IRS: 1994)
CIT (A)-21, Delhi
Member

Rajesh Kumar (IRS: 1994)
CIT (A)-50, Mumbai
Member

Satender Singh Rana (IRS: 1994)
CIT (A)-23, Delhi
Member

N.C. Swain (IRS: 1993)
CIT (A&J), Delhi
Member

Ravi Ramachandran K (IRS: 1994)
CIT (Exemp), Chennai
Member

Chandra Prakash Bhatia (IRS: 2006)
Addl. CIT (ReAC) (Tech. Unit), Kolkata
Member

Kalyan Nath (IRS: 2001)
CIT (OSD), DTRTI, Kolkata
Member

From the Directorate of Legal and Research

Analysis of Decisions of the Supreme Court on Revenue SLPs during Calendar Year 2014 to 2020 (7 years) & Process of Filing of SLP in the Supreme Court

Presented by: Shri Pankaj Jindal, IRS, ADG, (L & R), New Delhi

I. Analysis of Revenue SLP decisions given by Supreme Court during calendar year 2014 to 2020 (7 years)

Analysis of Supreme Court decisions given in the last 7 years i.e. from year 2014 to 2020 has been carried out to find out the fate of SLPs filed by the Revenue. The data that emerges as a result is startling and is as under:

Broadly, following facts stand out from analysis of the above data:

A. In 5920 cases (96.6%), Revenue SLP has been dismissed.

B. In only 78 cases (1.3%), Revenue has succeeded in Supreme Court.

C. In another 130 cases (2.12%) where Revenue succeeded, the decision was only on technical grounds having no impact on tax collection.

Analysis of Revenue's SLPs of Last 7 Years											
Year	Total Revenue SLP Decided	Tax effect (in Rs. Crore)	Dismissed				Allowed				
			Summarily Dismissed (without and a/c of low tax effect/ withdrawal & delay)		Dismissed on merit (E)		Technical Issue		Impacting Tax Collection		
(A)	(B)	(C)	(D)	(D) as % of (B)	(E)	(E) as % of (B)	(F)	(F) as % of (B)	(G)	(G) as % of (B)	Tax effect (in rupees crore)
2014	447	1477	238	53.2	205	45.9	4	0.9	0	0.0	0
2015	1088	4704	397	36.5	647	59.5	28	2.6	16	1.5	4.4
2016	841	7095	496	59	319	37.9	19	2.3	7	0.8	122.9
2017	353	132127	264	74.8	83	23.5	6	1.7	0	0.0	0
2018	1792	131621	1314	73.3	424	23.7	17	0.9	37	2.1	86.2
2019	1218	10045	1128	92.6	16	1.3	56	4.6	18	1.5	64.1
2020	389	1543	389	100	0	0.0	0	0.0	0	0.0	0
Total	**6128**	**288612**	**4226**	**69**	**1694**	**27.6**	**130**	**2.1**	**78**	**1.3**	**277.6**

www.taxguru.in

D. Total amount involved in 6128 SLPs was 2.88 lakh crore rupees. Amount decided in favour of Revenue is only 277.6 crores rupees (0.09% of total amount).

II. Process of filing SLP in the Supreme Court

A. Consideration of High Court order by the field formations: SLP against the order of High Court is required to be filed within 90 days of the order of the High Court. In case an application for grant of certificate of fitness u/s 261 of the Income-tax Act, 1961 is made, the limitation to file Civil Appeal/SLP is 60 days from disposal of the application. The period of 60/90 days start from the date of order/judgment of High Court and not from the date of receipt of certified copy of order by the PCIT concerned. It is the duty of High Court cells & Administrative CITs to track orders/judgments pronounced on daily basis. The proposal for SLP is generally initiated by the administrative CIT by asking for a scrutiny report from the range/assessing officers on the downloaded / ordinary copy of the judgment. This practice of scrutiny report is not a necessity. Infact the CCIT/CsIT are mandated to consider the SLP proposals as per their judicial appreciation of the impugned order. The opinion of AO & Range Head is already available in the judicial folder since the time when appeal was filed before High Court against ITAT order. However, in practice, it is not so. Fresh inputs are sought on the High Court order by way of a scrutiny report. This is one of principal reasons for delay in SLP proposals at the level of field formations. The field formations have been given 21 days for sending the SLP proposal to Directorate of L&R. Of these 21 days, 7 days are given to the jurisdictional CIT to take a view for contesting or accepting and 3 days are given to the CCIT concerned. 3 days are assigned for preparation of proposal complete with all annexures and 4 days are assigned for transit to L&R Directorate. It may be mentioned that appeal to High Court and Supreme Court can only be filed on substantial questions of law (SQL). Perversity in appreciation of facts can also be a substantial question of law. Otherwise, on basis of pure questions of fact, SLP proposal should not be sent, ITAT being the final fact finding authority. However, in practice, facts are many a times presented in form of SQL and proposals are made to L&R for filing SLPs.

B. Processing of SLP proposal by the Directorate of L&R: The proposal from the field passes through five levels in the Directorate of L&R before it is placed before Member (A&J) for his approval. The file is initiated at the level of Inspector who puts all the orders and the proposals in a file for consideration of ADIT/DDIT. The ADIT/DDIT submits the file to the JDIT/Addl.DIT with his own recommendations to file SLP or otherwise. The proposal is thereafter considered by the ADG and Pr. DG. After the Pr. DG is satisfied that all the facts have been duly considered, questions of law have been appropriately framed and the file is complete in all respects, the matter is placed before the Member (A&J), CBDT. If the proposal is approved by the Member (A&J), it is sent to the Ministry of Law. Total 20 days are assigned to processing within L&R, CBDT & transit to the Ministry of Law.

C. Consideration of the proposal by Ministry of Law: In Ministry of Law, the SLP proposal first traverses through the assistant legislative counsels and legislative counsels who place it before the JS, Law for his consideration. JS (Law) sends the proposal to Central Agency Section (CAS) which seeks advice of one of the Law Officers of Government of India (Ld. ASG/Ld. SG).

It is on the basis of advise of Ld. ASG/ Ld. SG that the decision to file SLP before Apex Court is decided. If Revenue is not satisfied with the advise of Ld. ASG/ Ld. SG, it can only send the file for reconsideration to Ministry of Law and through it for reconsideration of the concerned Law officer or another law officer. This request for reconsideration can be made only with the approval of the Revenue Secretary. However, if the Law officer again tenders same advice, the matter attains finality as Revenue is bound by procedural rules to accept such an advice. Relevant parts of OM No. I-28015/01/2009-Admn.IV(LA) dt. 03.09.2009 of the Ministry of Law and Justice are reproduced as under:-

"4. It is, therefore, re-iterated that once a considered view has been expressed by this Department, the Ministries/Departments should consider acting in terms of the advice tendered. If for some reasons, reconsideration of advice is desired, it should be done only with the approval of the Secretary of the concerned Ministry/ Department. On reconsideration, if the advice is re-iterated, the Department should follow such advice."

D. Filing of SLP after approval by Ld. ASG: In a case, where Ld. ASG/SG advises for filing of SLP, the CAS section marks the file to one of the drafting counsels for preparation of draft SLP. After draft SLP is prepared, it is sent by the CAS section to the Supreme Court cell of the Directorate of L&R for vetting. The draft is forwarded for vetting to the concerned field jurisdictional officers and after the vetted draft is received, SLP is filed before the registry of Apex Court with one of the DDITs of L&R signing the affidavit on behalf of the jurisdictional Commissioner.

E. Timelines for filing SLP to Supreme Court (as per CBDT Instruction No. 4/2011 dt. 9.3.2011)

(i). Time-Line to be observed in the office of the CIT:

S. No		No. of Days	Cumulative Days
1.	Date of pronouncement of the Judgment	0	
2.	Making application for certified copy of the judgment by the standing counsel	3	
3.	Obtaining copy of the judgment from web site	4	4
4.	Scrutiny of the judgment by the CIT to take a view to contest or accept the same	7	11
5.	CCIT's view & specific comment	3	14
6.	Preparation of proposal with annexure ++	3	17
7.	Transit to Directorate of Income tax (L&R)	4	21

(ii).Timeline to be observed in the Directorate of Income Tax (L&R)

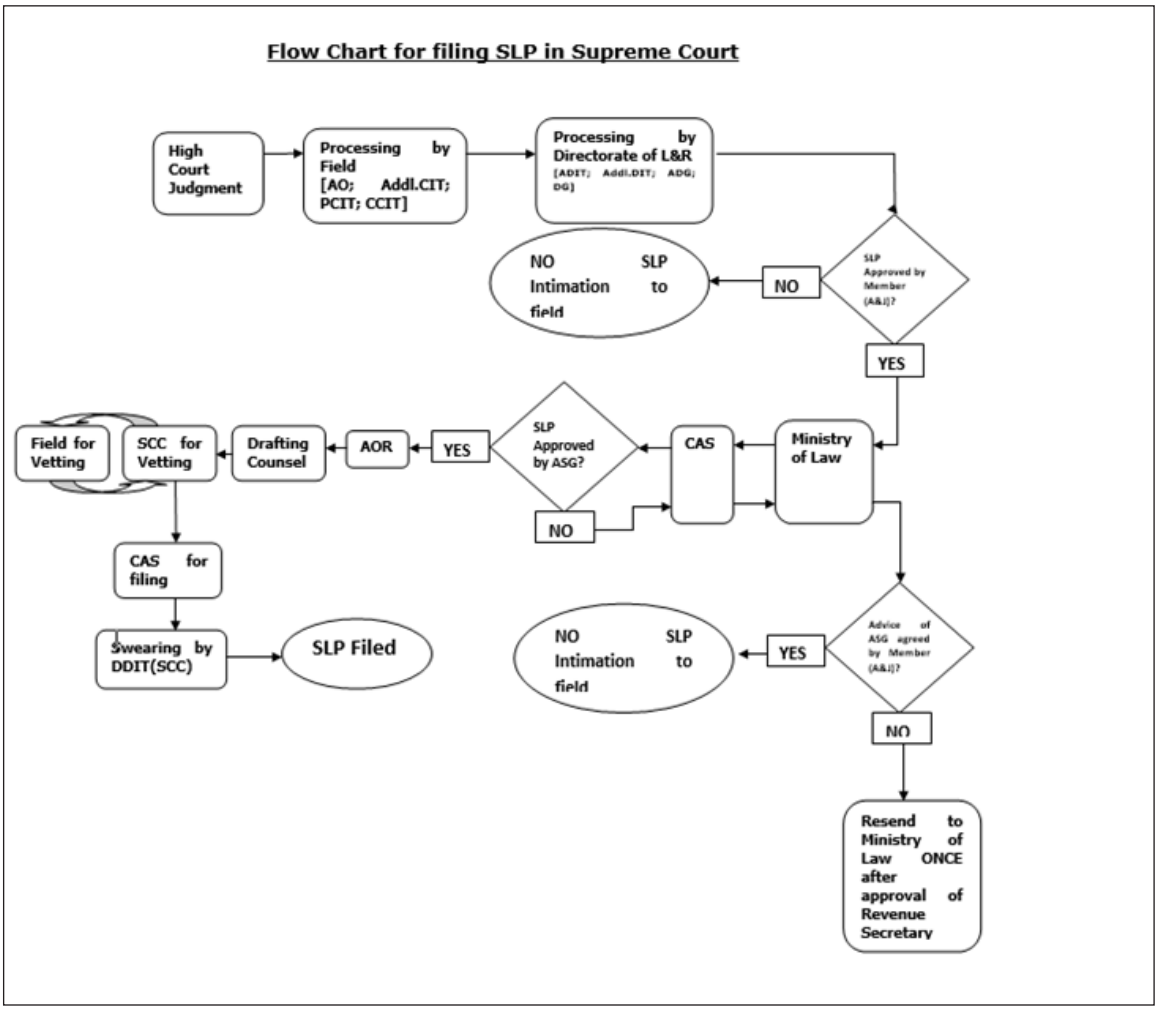
S. No		No. of Days	Cumulative Days
1.	Directorate of Income Tax (L&R)	15	36
2.	Member (A&J)	3	39
3.	Transit to MOL	2	41

www.taxguru.in

(iii). Time line to be observed in the Ministry of Law/Central Agency Section

Sl. No		No. of Days	Cumulative Days
1.	Advice section of MOL	5	46
2.	Transit to CAS	2	48
3.	Marking to Law officer	2	50
4.	Advice by Law officer	7	57
5.	Transit to CAS	1	58
6.	IT unit of CAS (opening of file)	2	60
7.	Transit to drafting counsel	2	62
8.	Drafting of SLP	10	72
9.	Transit to the Directorate	2	74
10.	Vetting in Directorate	7	81
11.	Transit back to CAS	2	83
12.	Paper book preparation	5	88
13.	Affidavit/AOR	1	89
14.	Filing in Registry	1	90

F. SLP Flow Chart



"Sports" in Section 2(15) of Income-tax Act, 1961

Krishna Mohan Prasad
Member (A&J) CBDT

Krishna Mohan Prasad is a Graduate in Economics, Law and Post Graduate in Education. An IRS officer of 1984 batch, he has long experience of working in the fields of assessment, search and seizure operations, tax-policy, tax-administration, judicial, representation before ITAT, Intelligence & Criminal Investigation, Legal & Research and is the first Principal Chief Commissioner of Income-tax, National e-Assessment Centre and Member) Audit & Judicial), Central Board of Direct Tax, Ministry of Finance. He has worked at Delhi, Mumbai, Bihar-Jharkhand and North Eastern Region of India. He has been writing on various aspects of improvement of tax structure in the country and has published article in The Economic Times, The Financial Express, Journal of Indian Institute of Public Administration, besides contributing to the reports of various committees set up by CBDT and publications of the department like Techniques of Investigation, Audit Manual, and Manual for CIT (Appeals) etc. His hobbies include gardening, Yoga, reading, travelling.

Executive Summary

The role of sports in social, national and International and individual's life is extremely significant as it not only plays major role in physical and mental health of a person but also a major source of entertainment and contributes enormously to the economy. The sports develop human capital, increase productivity, improve social harmony and create employment and is education in itself. To give a boost to sports, it should be included in the definition of 'Charitable Purpose' in section 2(15) of the Income-tax Act, 1961which will promote the sports by giving more financial liberty by alleviating the need of paying taxes. It will also put an end to the ongoing litigation being faced by Sports Associations.

1. It is desirable that 'Sports' be brought at par with 'Yoga' and 'Education' and be included in the definition of 'Charitable Purpose' in Section 2(15) of the Income-tax Act, 1961, in view of reasons discussed hereunder.

2. The role of sports in social, national and international and individual's life is extremely significant. Sports play major role in physical and mental health of a person. It is a major source of entertainment and it contributes enormously to the economy. The Preamble of National Sports Policy, 2001 states as under:

"Activities relating to Sports and Physical Education are essential components of human resource development, helping to promote good health, comradeship and a spirit of friendly competition, which, in turn, has positive impact on the overall development of personality of the youth. Excellence in sports enhances the sense of achievement, national pride and patriotism. Sports also provide beneficial recreation, improve productivity and foster social harmony and discipline."

www.taxguru.in

3. It is a matter of great satisfaction that sports like Cricket, Football, Hockey, Kabbadi, Badminton etc. are not only generating huge revenue to sports organization and income to sportspersons but also attracting new talents from remote corners of the country. The success of IPL has resulted in increase in income of many Cricket players coming from humble backgrounds. The allied professions of commentating, broadcasting, videography, sports journalism, telecast, etc. have got great boost. Similar success stories are being repeated in various other sports like Football, Hockey, and Kabbadi. The sports develop human capital, increase productivity, improve social harmony and create employment-as a matter of fact, it defines nation as whole. It is well recognized that sports are integral part of education and is education in itself.

4. Considering the important role that sports play in the holistic development of human resources and in the growth of the economy, a paradigm shift in the thinking about sports and 'money in sports' is the need of the hour. The more money there is in sports, the better it is.

5. Various sports federations like Indian Olympic Association, All India Football Federation, Amateur Athletics Federation of India, Goregaon Sports Club and many others are facing constant litigation at the levels of CIT (A), ITAT, High Court and Supreme Court. Even if they get relief at CIT(A), the Department files appeal at ITAT and despite losing in ITAT files appeal in High Court and even after losing in High Court files appeal in Supreme Court. The resources and valuable time of the Sports Association and the Government are unnecessarily wasted on unwarranted litigation.

6. It is therefore desired that the definition of 'Charitable Purpose' in Section 2(15) in the Income-tax Act should be widened to include 'Sports', so as to overcome the hardships faced by Sports Associations and reduce burden of litigation on the Income-tax Department, ITAT, High Court, Supreme Court.

7. Moreover, even otherwise, most Sports Organizations are availing exemption of Income, albeit, relief through litigation process at High Courts, ITAT even CIT (A) levels. Large numbers of cases have been decided by High Courts against Revenue and Revenue has filed SLPs in numerous cases. Details of some of such pending SLPs are (See Table 1):

8. Since sports is not included in the definition of 'Charitable Purpose', the trusts or societies or institutions promoting sports fall in the last limb of the definition of 'charitable purpose' which reads as: 'the advancement of any other object of general public utility'. Therefore, for sports institutions, the proviso to Section 2(15) is applicable in cases where receipt from sponsorship and telecast rights exceeds certain specified limit.

9. Prior to Assessment Year 2009–10, business income of a charitable trust or institution was also eligible for exemption subject to conditions that such business should be incidental to the attainment of its objects, and that separate books of account are maintained for such business. With effect from 01.04.2009 (i.e., from Assessment Year 2009–10 onwards), however, the "advancement of any other object of general public utility"' shall not qualify as a "'charitable purpose"' if the same involves the carrying on of any activity in the nature

www.taxguru.in

Table 1: Details of Some of such Pending SLPs

S No	Station	Name of the Assessee	A.Y.	Issue Involved	Tax Effect In Rs
1.	Jaipur	Rajasthan Cricket Association	AY 09–10	Allowability of exemption under Section 11 of the Act consequent to the withdrawal of registration under Section 12AA of the Act.	4,85,63,058
2.	Jaipur	Rajasthan Cricket Association	AY 08–09	Allowabilty of exemption under Section 11 of the Act consequent to the withdrawal of registration under Section 12AA of the Act.	1,38,53,817
3.	Ahmedabad	Gujarat Cricket Association	AY 09–10	1. Whether on the facts and circumstances of the case and in law, the Hon'ble High Court is correct in confirming the view of the Tribunal thereby allowing the benefit of Sections 11 and 12 when the Assessing Officer has clearly brought on record that asses see is covered under the proviso to Section 2(15) read with Section 13(8) of the Act? 2. Whether, on the facts and in the circumstances of the case the Hon'ble High Court is correct in holding that the assessee is not covered under the proviso to Section 2(15) when the Officer has clearly brought on record that assessee is engaged in the activity of "advancement of objects of general public utility. 3. Whether on the facts and circumstances of the case and in law, the Hon'ble High Court is correct in confirming the view of the Tribunal thereby in deleting the addition made in respect of corpus donations under Section 11(1)(d) of the Act without appreciating that the assessee failed to discharge its onus by bringing anything on records in support of its claim of corpus donation? 4. Whether on the facts and circumstances of the case and in law, the Hon'ble High Court is correct in confirming the view of the Tribunal thereby in deleting the addition made on account of infrastructure subsidy of Rs. 2,13,34,033/-, treating it as capital receipts without appreciating the findings of the Assessing Officer?	7,72,84,442
4.	Ahmedabad	Gujarat Cricket Association	AY 08–09		5,88,63,361
5.	Ahmedabad	Baroda Cricket Association	AY 14–15		1,365,42,618
6	Ahmedabad	Gujarat Cricket Association	AY 14–15		28,30,63,770
7	Ahmedabad	Gujarat Cricket Association	AY 06–07		3,97,63,493
8	Ahmedabad	Gujarat Cricket Association	AY 07–08		9,21,06,466
9	Ahmedabad	Saurastra Cricket Association	AY 14–15		16,43,86,700
10	Ahmedabad	Gujarat Cricket Association	AY 12–13		4,26,73,007
11	Ahmedabad	Baroda Cricket Association	AY 11–12		6,56,82,073
12	Ahmedabad	Saurastra Cricket Association	AY 12–13		10,30,36,624
13	Ahmedabad	Gujarat Cricket Association	AY 06–07		3,97,63,493
14	Ahmedabad	Saurastra Cricket Association	AY 13–14		14,39,19,890
15	Ahmedabad	Gujarat Cricket Association	AY 07–08		9,21,06,466
16	Ahmedabad	Gujarat Cricket Association	AY 11–12		8,91,48,468
17	Ahmedabad	Baroda Cricket Association	AY 09–10		5,06,43,122
18	Ahmedabad	Gujarat Cricket Association	AY 10–11		78,70,2000
19	Ahmedabad	Baroda Cricket Association	AY 12–13		14,58,46,125

Table (Contd.)...

www.taxguru.in

...Table (Contd.)

20.	Ahmedabad	Gujarat Cricket Association	AY 04–05	Whether on the facts and circumstances of the case and in law, the Hon'ble High Court is correct in allowing approval under Section 12A of the Act not taking cognizance the latest amendment in nature of proviso to Section 2(15) of the 1. T. Act inserted with effect from 01/04/2009?	
21.	Ahmedabad	Saurashtra Cricket Association		Whether on the facts and circumstances of the case and in law, the Hon'ble High Court is correct in allowing approval under Section 12A of the Act not taking cognizance the latest amendment in nature of proviso to Section 2(15) of the 1. T. Act inserted with effect from 01/04/2009?	
22.	Ahmedabad	Cricket For Rajkot District		Whether on the facts and circumstances of the case and in law, the Hon'ble High Court is correct in allowing approval under Section 12A of the Act not taking cognizance the latest amendment in nature of proviso to Section 2(15) of the 1.T. Act inserted with effect from 01/04/2009?	
23.	Bangalore	Karnataka Badmintion Assn			
24.	Delhi	Indian Olympic Association	AY 11–12	Whether High Court is justified in allowing the benefit of Sections 11 and 12 to the assessee society without appreciating that the activities of the assessee are commercial in nature and cannot be held to be charitable in view of proviso to Section 2(15) of the Income Tax Act?	3,15,97,201
25.	Chennai	The Tamil Nadu Cricket Association		Cricket, Charitable	
26.	Jaipur	Rajasthan Cricket Association	AY 05–06	Validity of registration granted under Section 12A of the Income Tax Act subsequent to the substantial changes in the objects of the trust.	
27.	Jaipur	Rajasthan Cricket Association	AY 09–10	Allowability of exemption under Section 11 of the Act consequent to the withdrawal of registration under Section 12AA of the Act.	4,85,63,058

Table (Contd.)...

...Table (Contd.)

28.	Ahmedabad	Gujarat Cricket Association	AY 09–10	1. Whether on the facts and circumstances of the case and in law, the Hon'ble High Court is correct in confirming the view of the Tribunal thereby allowing the benefit of Section 11 and 12 when the Assessing Officer has clearly brought on record that asses see is covered under the proviso to Section 2(15) read with Section 13(8) of the Act? 2. Whether, on the facts and in the circumstances of the case the Hon'ble High Court is correct in holding that the assessee is not covered under the proviso to Section 2(15) when the Officer has clearly brought on record that assessee is engaged in the activity of "advancement of objects of general public utility. 3. Whether on the facts and circumstances of the case and in law, the Hon'ble High Court is correct in confirming the view of the Tribunal thereby in deleting the addition made in respect of corpus donations under Section 11(1)(d) of the Act without appreciating that the assessee failed to discharge its onus by bringing anything on records in support of its claim of corpus donation? 4. Whether on the facts and circumstances of the case and in law, the Hon'ble High Court is correct in confirming the view of the Tribunal thereby in deleting the addition made on account of infrastructure subsidy of Rs.2,13,34,033, treating it as capital receipts without appreciating the findings of the Assessing Officer?	7,72,84,442

of trade, commerce or business, or rendering of any service in relation to any trade, commerce or business, for a consideration. This new restriction applies irrespective of the nature of use or application of the income arising from such activity. However, the rigour of this amendment has been reduced somewhat by a subsequent amendment brought in by the Finance Act, 2010 (with retrospective effect from 01 April 2009) to the effect that the said restriction shall not apply if the aggregate value of receipts from such activity during the given financial year does not exceed Rs. 10,00,000, The limit was increased to Rs. 25,00,000 by the Finance Act, 2011 and the limit of 20 percent of total

www.taxguru.in

receipt was prescribed by the Finance Act, 2015.

10. With a view to reduce unwarranted litigation in present and future and also to give boost to Sports, it is required that 'Sports' be included in the definition of charitable purpose in Section 2(15) of the Income-tax Act. The instant definition of 'charitable purpose' reads as under: *(15) "charitable purpose" includes relief of the poor, education, yoga, medical relief, preservation of environment (including watersheds, forests and wildlife) and preservation of monuments or places or objects of artistic or historic interest, and the advancement of any other object of general public utility: Provided that the advancement of any other object of general public utility shall not be a charitable purpose, if it involves the carrying on of any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to any trade, commerce or business, for a cess or fee or any other consideration, irrespective of the nature of use or application, or retention, of the income from such activity, unless— (i) such activity is undertaken in the course of actual carrying out of such advancement of any other object of general public utility; and (ii) the aggregate receipts from such activity or activities during the previous year, do not exceed twenty per cent of the total receipts, of the trust or institution undertaking such activity or activities, of that previous year;*

11. In line with the amendments in the definition of "charitable purpose" inserting the terms 'preservation of environment (including water-sheds, forests and wild life) and preservation of monuments or places or objects of artistic or historical interest' by the Finance (No. 2) Act, 2009 and 'Yoga' by the Finance Act, 2015, it is desirable that 'Sports' be included in the definition of 'charitable purpose' in Section 2(15) of the Income-tax Act, 1961.

* * * * * * * * *

Taxation of Agricultural Income in India

Vasundhara Sinha
(IRS: 1988)
CCIT (OSD)(ReFAC)(AU)-2

Vasundhara Sinha is an Indian Revenue Service officer of 1988 batch, currently posted as CCIT(OSD)(ReFAC)(AU)-2, Hyderabad. A post graduate in Economics from Patna University, she has worked in the Department at various levels dealing with assessment, TDS, administration, Central, appeals and Tribunal. She has also worked as Addl. Director General of Foreign Trade, Ministry of Commerce, New Delhi.

Executive Summary

This article traces the history of tax on agricultural income in modern India. The roots of the present legal framework, encompassing the administrative structure and the definition of agricultural income, lie in these initiatives during the British rule. While the Constitution permits taxation of agricultural income, most states have been reluctant to do so. Various committees over the years have strongly recommended levy of tax on agricultural income. The academic view on the advisability of such tax, and the options for its form and administration, particularly in the Indian context, has also been examined. Lastly, the article reviews the estimation of the revenue potential of agricultural income tax.

'It is not hard to find a tax expert who has not at any time of his/her career made a recommendation for increased taxation of agriculture, while it was even harder to find one whose recommendations were accepted.'

—Richard Bird

Literature on the subject is overwhelmingly in favour of taxing the agricultural sector in some form or the other. Tax structure and administration exists in a specific social, cultural, political and economic ecosystem; not only must its edifice be built in response to this ecosystem but it must also be responsive to changes in the latter.

PRE-INDEPENDENCE HISTORY

The Exemption (under Section 10(1) of the Income Tax Act, 1961) to agricultural income from taxation is such an integral part of the ethos and philosophy of taxation in India, that it is difficult to imagine that it enjoyed no such exemption to begin with.

Indeed, agricultural income was subjected to tax in the very first attempt at introducing income tax as we know it, in modern India in 1860. The Income-tax Act, 1860, while making agricultural income taxable, made a distinction between landowners and tenant farmers. Ryots and

www.taxguru.in

persons in the occupation of lands for agricultural purposes and actually engaged in cultivation and paying less than Rs.600 as land revenue, were exempted from tax. Those who paid more land revenue than this were deemed to make a profit amounting to a third of their rent, taxable as income under the First Schedule, unless they could prove profits were lower. In challenging this deemed profit, landholders risked liability to double duty if they failed to prove their claim to the satisfaction of the Commissioner or Collector.

The Income-Tax Act of 1860 lapsed in 1865. In 1867, the British Government introduced the Licence Tax on all trades and professions. Among the exceptions to its levy were cultivators of land (who were not keeping a shop for sale of produce, which would be equivalent to practising a trade), landlords and householders.

Faced with a financial crunch, the Government re-introduced income tax in 1869. This Act applied to all incomes, including agricultural income. The exemptions criteria and assessment methods were also the same as the Act of 1860. The 1869 Act expired in 1873.

The 1886 Act (Act II of 1886) contained the seeds of the future scheme of taxation in the Income Tax Act, 1961. The 1886 Act excluded agricultural income from the ambit of income-tax as it was viewed as a violation of the Permanent Settlement agreement. The exemption has continued to be a feature of central income tax ever since. The 1886 Act also defined 'agricultural income' as follows:

'(a) any rent or revenue derived from land which is used for agricultural purposes and is either assessed to revenue or subject to a local rate assessed and collected by officials of the Government as such or

(b) any income derived from

(i) agriculture, or

(ii) the performance by a cultivator or receiver of rent-in-kind of any process ordinarily employed by a cultivator or receiver of rent-in-kind to render the produce raised or received by him fit to be taken, to market or

(iii) the sale by a cultivator or receiver of rent-in-kind of the produce raised or received by him, when he does not keep a shop or stall for the sale of such produce, or

(c) any building owned or occupied by the receiver of the rent or revenue of any such land as is referred to in clause (a), or by the cultivator, or the receiver of the rent-in-kind, of any land with respect to which or the produce whereof any operation mentioned in clause (b) is carried on:

Provided that the building is on or in the immediate vicinity of the land, and is a building which the receiver of the rent or revenue, or the receiver of the rent-in-kind, by reason of his connection with the land requires as a dwelling house, or as a storehouse, factory or other out-building.'

The definition of agricultural income in the current Income Tax Act is broadly on the same lines.

In his research thesis on 'The Indian Income Tax: Its History, Theory, and Practice', Pagar made the following observations regarding the exemption provided under this 1886 Act to agricultural income:

'These elaborate provisions are necessary to exempt all those incomes derived from agricultural lands which pay the land revenue and their taxation under the income tax would be evidently double taxation, which should be the aim of

every tax system to avoid. The houses and buildings owned and occupied by the peasant proprietors or by their actual landlords, and situated on or near the lands are also exempted on the ground that the cultivators or landlords pay, beside the land revenue, a local cess, really a percentage of the land revenue paid to the State and to tax them again would be unjust.

This exemption of agricultural income is, however, unfair, especially in those tracts where the land revenue and the local cess are paid by the permanent land holders, while a special class of tenure holders exists who neither till nor own the land, nor can they be assessed to the land revenue. Now this class probably does pay a trifle in the shape of land cess, but it is doubtful if it comes under the income tax.

Then again, take the case of the European tea plantations, notably in Assam. Is tea industry an agricultural industry? The Indian Government regards it as such and taxes these plantations under the land revenue, instead of to the income tax. Similarly, the coffee and rubber plantations of Southern India pay under the land revenue. These industries, as is well known, are very prosperous, but unfortunately they pay no income tax, while they are taxed rather lightly under the land revenue. Moreover, almost all the profits of the tea industry go to the United Kingdom, where they are apparently taxed to the British Income Tax.'

The observations regarding tax on plantation farming interestingly seem to have echoed in the later concerns regarding their liability to agricultural income tax.

Such views, advocating taxation of agricultural income, led to a proposal in 1918 that agricultural incomes should be included in determining the tax rate applicable to income from other sources. The proposal was rejected by the Government. In 1925, the Indian Taxation Inquiry Committee, headed by Sir Charles Todhunter, advocated inclusion of agricultural income for income tax, observing that there was no historical or theoretical justification for its continued exemption. The Committee endorsed the 1918 proposal for clubbing of agricultural income with other income for rate purposes. However, nothing came of these recommendations.

In due course, however, in response to the recommendations of the Todhunter Committee, the need for tax on agricultural income was recognised in the Government of India Act, 1935, though rights of levy were assigned to provinces under Section 138(1) which stated as follows:

'138.-(1) Taxes on income other than agricultural income shall be levied and collected by the Federation…'

Pursuant to these provisions, Bihar was the first province to levy agricultural income tax in 1938, followed by Assam & Bengal in 1944.

In 1936, the Income Tax Inquiry Committee repeated the recommendation that agricultural and other income should be clubbed for the determination of the rate applicable to non-agricultural income. The recommendation was not accepted.

TAX ON AGRICULTURAL INCOME IN INDEPENDENT INDIA

Dr. B.R. Ambedkar, while being critical of the land revenue system for its inherently oppressive nature (the liability arising irrespective of any income from the land), was of the view that tax should be levied on tax-paying capacity or

www.taxguru.in

income of the taxpayer, that the rich must be taxed more and the poor less, that agriculture may be an important tax base, and that there should be a unified system of taxation of agricultural and non-agricultural sectors.

Under the Constituent Assembly, the taxation of agricultural income received detailed attention. The Report of the Expert Committee on Financial Provisions of the Union Constitution opined as follows:

> *'49. It is obvious that the taxation of agricultural income by the Provinces, while all other income is taxed by the Centre, stands in the way of a theoretically sound system of income-tax in the country. We should, therefore, have liked to take this opportunity to do away with this segregation. In view of the ease with which the origin of agricultural income can be traced, it could be arranged that the tax from such income, even though levied and collected by the Centre as part of an integrated system of income-taxes, should be handed back to Provinces; and it could be further arranged that till such time as the Centre in fact levied a tax on agricultural income, the Provinces already levying this tax might continue to levy without restriction and with full power to vary the rates of tax. The interests of Provinces could thus be fully protected, and there could, therefore, be no financial objections from them. On the other hand, the present arrangement has the political merit of keeping together in one place both benefit and responsibility, a rather important point, seeing that the Provinces will have full control over but few important heads of revenue. A few Provinces have, in fact, levied the tax and are administering it for some time. Perhaps also, the provinces can administer this particular tax with greater facility than the Centre. For the present, therefore, we have decided to continue the status quo, but, in view of the importance of the matter, would recommend that the Provinces should be consulted at once and if a majority, including of course those now levying the tax, agree, tax on agricultural income may be omitted from the Provincial List of subjects, consequential changes being made elsewhere in the Constitution. Our foregoing remarks apply mutatis mutandis on succession and estate duties on agricultural property also.'*

As can be seen, the assigning of the power to tax agricultural income to the states emerged as a British legacy. The Constituent Assembly decided to continue with such division of financial powers merely for convenience, that too with a caveat that it should be reviewed at a later stage.

REPORTS OF POST-INDEPENDENCE COMMITTEES

Post-independence, the issue of taxation of agricultural income consistently engaged the attention of policy makers.

In 1954, the Taxation Enquiry Commission or John Mathai Commission was set up to carry out an in-depth study of the tax laws and their administration. The Commission observed that the rural classes were escaping their fair share of taxation. In 1950–51, land revenue constituted only one per cent of the gross value of agricultural output. Taking the income-tax and the land revenue together, the Commission concluded that the tax system was distinctly progressive only for the urban groups with expenditure levels over Rs. 300 a month. The system lacked

progression in the case of similar groups in the rural sector except in certain States where there was an agricultural income-tax at fairly steep rates. The Commission recommended that there was greater room for increased taxation of higher rural incomes. One of the means of doing so was suggested to be an increase in the rates and an extension of the territorial coverage of agricultural income-tax.

In 1956, famous economist Prof. Nicholas Kaldor examined the tax policies of the country at the request of the Government of India and made several proposals for broadening the tax base and removing the prevalent inequalities. A number of these proposals were incorporated in the tax policy. However, in an article in the *Economic & Political Weekly* in January 1959, Kaldor expressed disappointment with the manner in which his recommendations had been implemented, noting, inter alia that the non-integration, or incomplete integration, of total family wealth and income had led to loopholes. He argued that to close these loopholes, it was necessary to include agricultural income and property within the scope of the Union income tax, wealth tax and capital gains tax. He felt that the States may be willing to support the requisite Constitutional amendment if the revenue resulting from the extension of these taxes to agriculture was earmarked to the States.

The present Income Tax Act, 1961 came into operation on 1st April, 1962. The primary structure therein, related to taxation of agricultural income, was largely a historical legacy that continued the federal separation of powers. Land revenue remains in place in most states. Agricultural income tax is levied by only 6 states that have substantial plantation agriculture, though all states enjoy the right to levy. Plantation agriculture, which of all agricultural activity is closest to manufacturing in its larger scale, year round operation, formal record of accounts and links to the banking system, is the only agricultural activity that has proved revenue productive through a conventional tax based on self-declaration.

REPORTS OF LATER STUDIES

Raj Committee (1972) recommended a progressive Agricultural Holdings Tax (AHT) which was norm-based, calculated from regional average crop yields, but its critical defect was the attempt at universal coverage of all crops, which required information on the cropping pattern of each cultivator in each assessment year. The recommendations were not implemented.

The Committee also suggested 'partial integration' of agricultural income as calculated for purposes of the AHT with non-agricultural income, for determination of the tax rates applicable to the non-agricultural component (a concept first proposed in 1918). This recommendation was implemented in the Finance Act of 1973, and remains in force to this very day though its effectiveness in plugging the revenue leak from non-agricultural income classified as agricultural has been questioned. That neither the AHT, nor its variants suggested by Bagchi (1979) and others found acceptability in any state seemed to have set the final seal of infeasibility on agricultural taxation. The rejection of the AHT calls for an examination of the design of the AHT and its variants from which any fresh proposal for taxation of agricultural income must be differentiated.

The Fifth Finance Commission recommended that the central income tax cover all, including agricultural, income. The Fourth Five-Year Plan and the Direct Taxes Enquiry (Wanchoo) Committee of 1971 called not for unification

www.taxguru.in

but for parity in the rate structure between the taxation of agricultural income at state level and the central income tax on non-agricultural income.

In 1992, the Tax Reform Committee (Prof. Raja J. Chelliah Committee) suggested that agricultural income in excess of Rs. 25,000 accruing to non-agriculturists should be brought to tax to promote equity and reduce tax evasion.

In 2002, Report of Task Force (Vijay Kelkar) on Direct Taxes made the point that not taxing agricultural income violates horizontal and vertical equity and 'encourages laundering of non-agricultural income as agricultural income, i.e., it has become a conduit for tax evasion.' Empirical validation of both the arguments was done on the basis of tax returns in Mumbai. This Report proposed that a tax rental arrangement should be designed whereby states should pass a resolution under Article 252 of the Constitution authorizing the Central Government to impose income tax on agricultural income. In order to ensure cooperation of the states, the taxes so collected were to be assigned to the states. It was expected that 95% of the farmers would fall below the threshold and continue to remain out of the tax net.

The Third Report of TARC (2014) (Parthasarathi Shome Committee), drew attention to the use of agricultural income by non-agriculturists as a conduit to avoid tax and for laundering funds, resulting in leakage to the tune of crores in revenues annually. The report also noted that a narrow tax base led to a higher tax rate structure and burdened other tax payers. The Committee suggested taxation of large farmers, placing the threshold of tax at, say, Rs. 50 lakhs. While recognising that this required political consensus, the Committee hoped that the States could pass resolution under Article 252, authorising the Centre to collect the tax on agricultural income, with the tax being assigned to the states, with the larger aim of an improved tax culture and performance.

GLOBAL PRACTICES

PAKISTAN: India and Pakistan share a common legacy (obviously) and a common post-independence trajectory. While agricultural income tax is the domain of the provincial government, its share in revenue is miniscule.

BANGLADESH: Agricultural income tax was first imposed in 1944–45. Agricultural income tax was merged with general income tax in 1976 and became liable to tax along with other sources of income. However, a separate basic exemption limit applies to such income. Certain activities are presumed to have a percentage of agricultural income, e.g. sale of tea, rubber etc. Certain activities like horticulture, cattle rearing, dairy farming etc. are also considered to be agriculture.

NEPAL: Income tax was introduced in 1959 by the first elected government on business and salary income. Agricultural income was not covered. In 1962, it was extended to income from all sources of income. In 1966–67, agricultural income was excluded from the income tax net. It was made liable to income tax in 1973–74 but excluded again in 1977–78. Since then, it has not been brought to tax.

UK: There is no preferential treatment for farmers. Income averaging is permitted for agricultural income.

USA: Agricultural income is treated as any other income and taxed. However, specified persons below a specified threshold may use cash system of accounting. Averaging of income over three

years is also permitted. Capital expenditure is allowed to be deducted in year of purchase.

CANADA: Income from farming and forestry is treated as business income, though certain benefits are available to farmers. Cash accounting and set-off of farming loss is permitted.

ITALY: Income from farming and forestry is treated as income from real estate and is linked to 1938 cadastral values (and not actual yields or income generated), adjusted by a revaluation coefficient and by a co-efficient fixed annually be the Ministry of Finance in relation to prevailing product and input prices. Yields in the land register are estimated as average values of land and buildings and are very low.

FRANCE: Income smoothing measures are available. Taxable income is equal to the three-year average of revenues for the tax year and the two previous years minus a flat rate of 87% deduction for expenses.

PHILOSOPHICAL UNDERPINNINGS: TO TAX OR NOT TO TAX

Economists have acknowledged that agriculture may be one of the most difficult sectors to tax due to its small scale and spatial spread. It is also plagued by an absence of standard account-keeping and the prevalence of cash transactions. These difficulties may be circumnavigated in case of large commercial farmers (where formal accounting would be the practice) and rent receiving landlords.

However, more significant than these logistical hurdles in taxing agricultural income are the psychological and emotional factors, e.g. intense political resistance by large and vocal landlords. Agricultural tax has popularly been perceived as a tool of oppression, due to the historical association with high rates enforced mercilessly by colonial regimes without regard for local or seasonal fluctuations.

Despite these issues, there is overwhelming consensus among economists on the need for taxing agriculture effectively and in acknowledging that agriculture was under-taxed. Indira Rajaraman notes that a land tax helps to establish a jurisdictional link between taxes paid and public goods provided, and therefore carries externalities in terms of promoting consciousness of the need for collective action, extending far beyond revenue actually collected.

Sebastian James estimated (in the year 2004) that given the existence of a sizable number of rural rich combined with the prevalence of and level of inequality, the per-capita income of the rural rich may be 30% higher than the per-capita income of the urban residents with half of it constituting tax-free agricultural income. He concluded that the rural rich had been the main beneficiaries of the exemption of agricultural income from taxation and that in the interest of equity, the agricultural income of the rural rich should be subjected to increased taxation.

An exemption to agricultural income from tax provides an easy route for tax evasion. James observes that while it should be possible to improve tax compliance by increasing the detection of evasion and by the threat of penalty, the presence of a large untaxed sector places limits on the ability of the tax administration to detect tax evasion.

Academics have also pointed out that agriculture is one sector where there is a strong link between growth and poverty reduction, so that the key to acceptance of and voluntary compliance to agricultural tax would be retention of resources raised from agriculture for rural, and particularly, agricultural infrastructure development.

www.taxguru.in

PHILOSOPHICAL UNDERPINNINGS: TAX STRUCTURE

Agriculture as a source of income is not a homogeneous activity; plantation agriculture, for example, is akin to any other organised economic activity and amenable to tax. The difficulties relating to taxation of agricultural income are confined to the non-plantation agricultural sector.

Precise assessment of agricultural income is not considered cost-effective: it involves costly collection of information from a large number of taxpayers on the one hand and on the other, it imposes a cost on taxpayers for maintenance of detailed accounts and documentation. Thus, presumptive taxation in the agriculture context has been adopted and accepted over the years as reasonable and effective. Rajaraman notes that the more universal land revenue is also presumptive in concept, being related in principle to average returns to the land. A more widely based presumptive scheme for taxation of profitable crops should, therefore, pass the test of legal and assessee acceptability. Indeed, presumptive assessment as a concept is now well-established in the Indian tax laws for several similarly unorganised sectors like retail trade and construction.

Land revenue, being based on area of land and not on yield, suffers from the limitation of inequity in as much as it fails to distinguish between the productivity of plots of land, whether natural or arising out of the differences in inputs and agricultural practices by the owners.

Rajaraman notes that the twin difficulties posed by agriculture are the need to evolve crop-specific norms of returns to land while retaining the flexibility to accommodate legitimate external shocks so as to approximate to the risk sharing properties of conventional income taxation. She suggests that agricultural taxation should be feasible in an efficient and equitable manner with the appropriate form of taxation levied at the appropriate level of government, jurisdictional retention of revenues, reasonable rates of levy, and a systematic catastrophe exemption provision. She suggests a crop specific levy per acre sown with a designated crop applicable when the yield crosses a specified threshold.

This method calls for the following recurring information:

1. A list of cultivators growing each of the crops in the selected subset for each season.
2. Area sown by those cultivators in each list whose yields fall above a stipulated exemption yield (failure) threshold.

Rajaraman has suggested that such information can be obtained, either through region-specific field surveys, or through secondary data from official surveys.

This method is superior to land revenue since it is based on yield, rather than land area, and takes into account higher yield accruing to a rich farmer on account of better inputs used by him (as compared to a poor farmer). It also has equity built into it in the form of yield threshold below which the tax would not be leviable and thereby covers the risk element that dogs agricultural operations.

Though Rajaraman believes that the tax being applicable to the cultivator, information regarding the total holding of the cultivator or whether he is owner or lessee would be irrelevant, James has pointed out that there may be practical issues of ascertaining the statutory cultivator in cases of, for example, oral tenancies often taken by rich landlords, or periodical change in tenancies so as to avoid creation of ownership-like rights.

A key component of any tax structure must be the exemption limit below which tax would not be levied. The Kelkar Report had recommended keeping an exemption level of Rs. 1 lakh for agricultural income. The Shome Committee had placed it even higher, at Rs. 50 lakhs. A high threshold would reduce the number of potential taxpayers in the rural areas and reduce the administrative difficulty of taxing agricultural income. Such higher exemption also addresses the handicap of higher risk that plagues agriculture, to a far greater extent than in any other sector.

Rajaraman also argues that one reason for the revenue insignificance of agricultural taxation has been the fact that it has been attempted at the wrong level of government and it is appropriate for local governments. James, on the other hand, believes that the taxation of agricultural income by an authority other than the Central Government as is presently the case involves a duplication of tax effort in respect of those taxpayers who have both taxable agricultural and taxable non-agricultural income. What both agree on is that the proceeds of such tax must be invested in local infrastructure, particularly rural infrastructure, to generate emotional ownership over the tax.

EXTENT OF TAX EVASION THROUGH AGRICULTURAL INCOME

The narrative against taxation of agricultural income has often rested on the imagery of the 'poor farmer'. This narrative ignores the relief of tax threshold afforded to the poor non-farmer, a benefit that would be available (and that can be calibrated further) for farmers as well.

This narrative also raised the issue of how 'poor' the 'poor farmer' actually is. There are no authoritative comprehensive information in the public domain though the little data available may be taken as indicative.

In 2012, Sengupta and Rao estimated the potential of revenue from agricultural income at about 1.2% of the GDP in FY08 or 9% of the agriculture GDP. This estimate was made through a land-based, crop-specific, agricultural income calculation for all major crops: food grains, pulses, cereals, oilseeds, fibre crops, horticulture and floriculture.

The GDP for FY 2020–21 was estimated at Rs.197.46 lakh crore at current prices (as per Press Note dated 31.05.2021 of the NSSO). At 1.2% of the GDP, the loss of revenue from agricultural income would amount to a substantial sum of Rs. 2.37 lakh crore. This is 19.6% of the gross direct tax collection (Rs.9.45 lakh crore) and 11.7% of the gross tax revenue (Rs. 20.16 lakh crore) for FY 20–21.

Sengupta and Rao had also pointed out the growing presence of corporate sector in agriculture and that more than 50 companies reported income of over Rs. 100 crore from agriculture in FY10,totalling Rs.31,313 crore.

In 2016, in response to an RTI petition filed by Vijay Sharma, a retired IRS officer, the Directorate of Income Tax (Systems) furnished the following information regarding agricultural income between AY 2004–05 and 2013–14 (Rs. in Crore):

However, in an affidavit filed later before the Patna High Court against a writ filed by Vijay Sharma, the DIT(Systems) admitted that the data submitted in the RTI application was not wholly correct (though he did not furnish the correct figures of agricultural income). The abnormally high figures of agricultural income for AY 2011 and 2012 may therefore, be presumed to be erroneous.

www.taxguru.in

Thereafter, in 2019, the CAG audited the process of assessment of agricultural income, the results of which were published in its Report no. 9 of 2019. In its Report, the CAG also examined issues of data entry errors referred to in the decision of the Patna High Court in the PIL filed by Sharma. It noted that DGIT(Systems) identified 2,746 cases showing agricultural income above Rs.1 crore in the ITRs of the AYs 2007–08 to 2014–15 for verification and status report, that of the 136 PCITs selected by audit where status reports had been sought, 26 PCITs had submitted the report in respect of 327 cases, and that of these 327 cases, data entry error was found in 36 cases. The data entry error resulted in returned agricultural income of Rs. 7.69 crores in these returns being recorded in AST as Rs.54472.58 crores. While the Report refrained from arriving at any conclusions in the absence of full information, it appears that the quantum of returned agricultural income was grossly over-reported.

Be that as it may, the information in the Audit Report is still revealing. As part of its audit, the CAG reviewed 6,778 cases out of 22,195 scrutiny assessments carried out between FY 14-15 and FY 16–17 of those who had claimed more than Rs. 5 lakh in agricultural income. The details of the agricultural income returned and assessed is as follows (Rs. in crores):

The fact that companies accounted for 57% of the returned agricultural income shows that agriculture is no longer the prerogative of traditional ownership by individuals and HUFs.

The average agricultural income returned in these cases was Rs. 54 lakhs. Again, the average had been pulled up to this level by a mere 729 companies which had an average returned agricultural income of Rs. 2.87 crore. The average agricultural income returned by companies was more than ten-fold that of individuals whose average returned agricultural income of Rs. 25 lakhs was itself more than ten-fold of the minimum income tax exemption limit of Rs. 1.5–2 lakhs during the relevant period.

While the estimation of agricultural income may remain open to question, what jumps out from these figures is firstly, that agricultural income is a significant, if not substantial, part of the income being returned by taxpayers, and secondly, that the agricultural income being returned presents a portrait of an affluent agricultural class.

Table 1

AY	Individual	Firm	Company	Others	Total
2004	0.03				0.03
2005	0.01				0.01
2006	1.65	0.23	585.28	0.17	587.33
2007	2361.73	31.49	656.19	101.44	3150.86
2008	17116.48	53.50	632.54	825.99	18628.51
2009	16482.98	48.04	800.87	543.37	17875.27
2010	83875.74	70.39	840.79	2246.96	87033.88
2011	199867251.62	86.08	747.92	1275.72	199869361.34
2012	67566074.64	102.55	1351.51	1429.26	67568957.96
2013	17063.87	141.33	1384.58	65324.28	83914.07

Table 2

Type of assessee	No. of assessee	Agricultural income claimed	Average agricultural income claimed	Agricultural income allowed	Average agricultural income allowed
Individual	5410	1349.39	0.25	1185.82	0.22
Company	729	2093.82	2.87	1161.47	1.59
HUF	365	111.73	0.30	99.50	0.27
Firm	160	69.18	0.43	68.24	0.42
Others	26	25.8	0.99	22.88	0.88
Non-PAN cases	88	6.33	0.07	6.30	0.07
Total	6778	3656.25	0.54	2544.21	0.38

CONCLUSION

Liability of agricultural income to be subjected to tax is not denied by the Constitution, it merely assigns the power to tax to the state governments. While such taxation is not a novelty in India and has been on the statute in Bihar (1938), Assam (1939), Bengal (1944), Orissa (1948), Uttar Pradesh (1948), Hyderabad (1950), Travancore and Cochin (1951), Madras and Old Mysore State (1955) and while most of them are still in force, the power has been sparingly, if at all, used by the states .

The need for taxation of agricultural income in India has been universally acknowledged by academicians and experts, consistently over the years. The logistics of implementing such tax may require thought but is not impossible to implement. An adequately generous exemption limit would not only deal with the logistical hurdles of its implementation but would also address the emotional opposition to such tax.

At the very least, information about high agricultural income should be shared by the Income Tax Department with the state governments that still have agricultural income tax, either directly or through the REIC. This exercise requires neither legislative will nor administrative effort since data can be culled and collated easily from the online returns of income.

What may certainly be advisable is to take measures to bolster public (and in particular, taxpayer) confidence in the ability of such taxes to return benefits to the economy from where the taxes came in the form of reinvestments in the rural sector. Such investment may even precede the levy of tax in order to pre-empt opposition on behalf of the rural poor.

REFERENCES

[1] C.L. Jenkins (2012). 'Legislative Comment 1860: India's First Income Tax', *British Tax Review*.

[2] S.M. Pagar (1920). *The Indian Income Tax: Its History, Theory and Practice,* Lakshmi Vilas P. Press Co.

[3] Indira Rajaraman and M.J. Bhende (1998). 'A Land-based Agricultural Presumptive Tax Designed for Levy by Panchayats', NIPFP, reprinted from *Economic & Political Weekly*, Vol.33, No.14.

[4] Indira Rajaraman (January 2005). 'Taxing Agriculture in a Developing Country: A Possible Approach', in *Contributions to Economic Analysis,* Reserve Bank of India.

[5] Richard M. Bird (1974). *Agricultural Taxation in Developing Countries: A Discussion of the Policy Issues in Designing an Effective System*

www.taxguru.in

of Agricultural Taxation, International Monetary Fund, External Relations Dept.

[6] Sebastian S. James (2004). *Policy Options for the Taxation of Agriculture Land and Agricultural Income in India*, Lincoln Institute of Land Policy.

[7] D.P. Sengupta and R. Kavita Rao (2012): 'Direct Tax Code and Taxation of Agricultural Income: A Missed Opportunity', *Economic and Political Weekly*, Vol. 47, No. 15 (April 14, 2012).

[8] Nicholas Kaldor (1959): 'Tax Reform in India', *Economic & Political Weekly*, January, 1959.

[9] 'The Matthai Gospel of Taxation', *The Economic Weekly*, March 5, 1955

[10] Taxation in Agriculture (2020), OECD iLibrary.

[11] Report of the Expert Committee on Taxation: Constituent Assembly, published in *Dr. Rajendra Prasad: Correspondence and Select Documents*, Vol. 8.

[12] Third Report of the Tax Administration Reforms Committee

[13] CAG Report No.9 of 2019

* * * * * * * * * *

www.taxguru.in

Applicability of Provisions of Section 115BBE Specifically in the Year of Search/Survey where the Unrecorded Stock/Cash etc are Offered suo moto in ROI

Ajay Kumar Srivastava
(IRS: 1988)
CCIT (OSD)

Ajay Kumar Srivastava is 1988 Batch of IRS, currently posted as CCIT[OSD] on in-situ basis as PCIT Central Lucknow. During service he has worked at various positions such as Asstt units, Head Quarters of CCIT(CCA) Investigation, I&CI, ITAT, International taxation and Central charges. He has vast experience of 5 years in the area of Intl Taxation at CIT level itself and also about 4 years supervision experience as PCIT in central charges. He had been posted at Kanpur, Agra, Meerut, Dehradun, Ghaziabad, Pune, Mumbai and Lucknow in my career. He has passion to continuously strive to evolve the available legal arguments to converge them into at a correct conclusion wherever required.

Executive Summary

Instances have come to notice where any unrecorded stock/cash/investments are found pertaining to the year of search/survey for which the ROI was not due on the date of search/survey, the assessees are claiming such unrecorded stock/cash/investments as proceeds from the regular unrecorded business receipts of that year and accordingly offering the same as regular business income at normal rates and not @ 60% as provided u/s 115BBE. The simple argument claimed by assessees is that since the source any such unrecorded stock/cash/investments was from a known business activity only and no other business activity was detected by revenue, hence even if it was unrecorded on date of search/survey and time to file ROI had not elapsed, such income having being sourced from regular business activity would be assessable as business income only. This article attempts to analyse as to how and why the above claims cannot be accepted and such income is liable to be taxed under Section 115BBE only.

ARGUMENTS

1. The applicability of Section 115BBE is attracted only when the income either offered in return suo moto by assessee or as determined by AO, is in nature of deemed incomes under Sections 68 to 69D. The unexplained stock/ investment in assets/ cash etc. which are found not recorded in books of accounts and the explanation offered regarding nature and source is not satisfactory, then value of such investments/ assets are required to be added under Section 69/69A etc. Therefore, examination of fulfilment of conditions of 69/69A is pre-requisite before Section 115BBE can be invoked.

www.taxguru.in

2. For ease of understanding, the Section 69 is reproduced as under:

*"Where **in the financial year** immediately preceding the assessment year the assessee has made investments which are **not recorded in the books of accounts, if any, maintained by him for any source of income, AND** the assessee **offers no explanation about the nature and source** of the investments or the explanation offered by him is not, in the opinion of the Assessing Officer, satisfactory, the value of the investments may be deemed to be the income of the assessee of such financial year."*

3. Sections 69 & 69A are almost similar to the extent that both of them require fulfilment of twin conditions:

(i) During the financial year, the investments/ money/ bullion/ article/ valuable thing is ***not recorded in books of accounts***, **if any, maintained by him for any source of income; *and***,

(ii) Assessee ***fails to offer satisfactory explanation*** about the nature and source thereof.

4.1 Though a cursory look at above conditions may suggest that due to use of word 'and' in between the above twin conditions, the satisfaction of the twin conditions must be simultaneously to invoke the above provision. But, in my opinion, the above conditions are required to be read disjointly and not simultaneously, even if the two conditions are separated by the word 'and'. The expression "not recorded in the books of accounts, if any, maintained by him for any source of income" in Section 69 clearly indicates that by the use of words 'if any' in above expression, the Section has been made also applicable in cases where the assessee has not at all maintained any books for a particular source of income. The section therefore envisages that if the books of are not maintained, then by virtue of 2nd condition of Section 69/69A, the onus will still be on the assessee to prove the genuineness and source of the investments by some other evidence. For e.g., if an assessee is found to be in possession of investment/ asset/ cash etc. and claims that such assets are out of non-taxable receipt (capital receipts) in kind/ cash and also does not maintain any books of accounts for such source, then the assessee shall still be falling within the sweep of Section 69/69A if the explanation offered by him for such source is unsatisfactory. Therefore, Section 69/69A can still be invoked, once the source is unexplained even if the other condition of not recording in books of accounts are not fulfilled, due to non-maintenance of books of accounts by assessee for such source. **This would mean that conditions of (i) non-recording of entries in accounts and (ii) unsatisfactory explanation about nature & source, are required to be read disjointly and independently.** The two situations are not interdependent and out of the two conditions, only the condition of proving the source is a must in all situation. Therefore, even the two conditions are separated by the word 'and', yet the two conditions are disjoint and the Section 69/69A shall get invoked once the source is not explained satisfactorily, whether or not the other condition of not recording in books of accounts is fulfilled. The condition of proving the source is the primary condition and the recording in

accounts is only an optional/ situational, which is applicable only when accounts are maintained for that source.

4.2 This takes to next question that where assessee records the necessary entries in books of accounts in respect of unrecorded stock/ investment/ cash found during search/ survey, albeit subsequent to date of survey but before the closure of the relevant FY of search/ survey and also fully recognizes the income in relation to such entries in P&L a/c for relevant FY and its disclosure as income in ROI, then whether such incomes get out of the sweep of the nature of deemed incomes under Section 69/69A? The answer needs to be analysed in the context that it is quite natural that if any person is not regularly recording particular transaction/ receipt in books of accounts, he would not have done so even subsequently, had no search or survey or enquiry was carried out by the Department. Once cannot take shelter that particular item remained to be recorded due to absence of accountant or any other reason. Hence, any subsequent recording in accounts after having been detected during search/ survey, would not be akin to recording in books in normal course but only as an attempt to cure the default. Hence, even though the Act does not specify as to at what point of time the entries are required to be recorded in accounts, if any maintained for any source, but, as the event of not recording could be ascertained only when detected by the Department during any search/ survey/ enquires, therefore in this context, the point of time when the non-recording in accounts is to be tested, shall be the point when it was detected initially during survey, and not at any later date when they were recorded in books subsequent to survey. **Hence, recording of any entry in books of accounts after the search/ survey for the period prior to search/ survey would not foreclose/ mitigate the default of non-recording detected earlier during the search/ survey.**

4.3 One may also argue that, it is not possible to record the entries on a real-time basis always and every time, more so when a large number of transactions are happening and neither there is any such law to enforce the time of recording in books of accounts. Therefore, the recording in the books of accounts can always have some genuine time lag between the actual happening of business transactions and recording of relevant entries in the accounts on real- time basis, for multiple reasons. There can be no denial from this situation. But in a genuine and bona fide situation, there would always be availability of basic documents with the assessee at the time of search/ survey as evidence to support the happening of such transactions in the form of bills/ vouchers/ challans/ payment receipts/ bank statement etc. which remained to be entered in books for multiple reasons. If that be so, the updating of the accounts subsequent to survey, to arrive at the correct income would still be permissible, because such entries are backed by necessary evidences duly found during the search/ survey/ enquiries itself. This situation would be entirely different from the situation where there was no supporting evidence was also found in respect of investments/ assets/ transactions and which were also unrecorded in books of accounts as on date of search/ survey. Further, if the accounts are already written/ updated upto a particular date, say 1st July 2019, and during search/ survey/ enquiries were on; for

www.taxguru.in

example on 1st November 2019, it is found that some unexplained receipts of money or transactions of investment in assets happening earlier, say in month of May 2019, are still unrecorded, then even if these entries were to be recorded subsequently, the adjustment entry can be recorded only in the dates of July 2019 based on supporting evidences because once the books of accounts are already written/ updated upto a particular date, any unrecorded transactions from unexplained sources, cannot be recorded in dates preceding the date upto which the accounts were already updated. Therefore, in such situation, mere recording the investments subsequently after search/ survey but without explaining any source, or proved by other evidences about its source (which is the primary condition), would not fulfil the conditions for purposes of getting out of the sweep of Section 69/69A. Therefore, the benefit of recording such entries in books of accounts of any source subsequent to survey would not be available to claim that such income was part of business income only, if the necessary bills/ challans/ debit/ credit notes/ vouchersfor expenses/ receipts, sources of funds being received/ transferred through banking channels, etc. pertaining to such transaction/ stock/ investment/ cash, were not available on date of search/survey. If the recording of transactions/ investment/ receipts from unexplained sources without corroborating evidence subsequent to search/ survey date were to be considered as meeting the requirement of condition under Section 69/69A of being recorded in books of accounts, then there would be no case where Section 69/69A could be applied.

4.4 In the above situation, after subsequent recording in books and offering income representing such unexplained incomes under Section 69/69A to tax in the ROI for the search/ survey Assessment Year would also not meet the conditions of recording in books of accounts and offering the satisfactory explanation with regards to nature and source thereof. The provisions of Section 69/69A therefore, shall still get triggered because the primary requirement of explaining the source ofincome from any particular business/ profession cannot be said to be satisfied. Section 69/69A etc. only create a fiction to deem certain unrecorded assets/ investments as income of the assessee for the financial year. Hence, even if the assessee offers the same suo moto as income in the ROI, it does not take away such income out of category of deemed incomes under Section 69/69A for the financial year in which they are found. Rather, offering such income suo moto in ROI for the financial year in which they are found, without any supporting evidences to support the year of income and the nature of income and also not having recorded such income in books of accounts for the business/ profession maintained if any, itself tantamount to having applied and accepted the provisions of deeming such assets as income of the financial year in which it was found under Section 69/69A. If it were not to be interpreted so, then it was impossible for the assessee too to ascertain as to for which financial year the unrecorded assets pertains and for which financial year the income therein pertained. In the absence of any evidence to the contrary, the assessee gets the jurisdiction to offer the income pertaining to unexplained assets in ROI relevant to the financial year in which such unexplained assets are found, only if he also admits to the application of Section 69/69A

which create a deeming fiction not only to charge the asset as income but also deems such income to be of the FY in which they are found. **Hence, offering such income in ROI suo-moto for any FY in which it is found without any evidence/nexus to the actual of year of earning, such action of assessee would also not foreclose the applicability of Section 69/69A.**

4.5 The Madras HC in ***M/s. SVS Oils Mills vs. The Assistant Commissioner of Income Tax*** in ITA No. 765 of 2018, while dismissing the appeal of the assessee decided the following question of law while confirming the order of ITAT:

'Whether the provisions of Section 69B/69C of the Act would justify the separate addition for the value of the excess stock despite inclusion of such excess stock by posting necessary entries in the stock register and further despite the undisputed reporting of the sales effected in relation thereto in its entirety by the Appellant?

The relevant findings of the Tribunal are quoted below for ready reference:

> *"There is a clear admission by the assessee that the difference in stock as on date of survey was added in its stock register but no corresponding entry was passed in the books of accounts. Stock cannot come in from vacuum. When stock is introduced in the stock register, there has to be a corresponding entry in the financial books of accounts. Either it has to be a purchase or shown as paid out of explained or unexplained source. Once stock to the extent of the surplus found at the date of survey, is included in the stock register, assessee has to give an explanation for the source from which it acquired such stock.*
>
> *...Assessee having not passed any entry in financial books, addition of stock made by it, in its stock register, can only be considered as made out of undisclosed source. The addition in our opinion was rightly done by the lower authorities. Coming to the decision of Ahmedabad Bench of the Tribunal in the case of Chokshi Hiralal Mangnlal (supra), there is a clear finding that excess stock found during the survey was not separated or clearly identified, but, was part of mixed stock which was included in the declared stock, as per books of accounts. Facts here are entirely different. There is no case for the assessee that surplus stock was clearly identified at the time of surveyor entries passed in its cash book, journal or ledger for the value of such stock. In the circumstances, we do not find any reason to interfere with the order of the learned Commissioner of Income Tax (Appeals). Appeal of the assessee stands dismissed."*

The Hon'ble Madras HC, after hearing the submissions of the counsel for assessee and above findings of ITAT, observed as under in para 6 to 11 of its order dated 26/3/2019:

> *"6. Having heard the learned counsel appearing for the Assessee, we are satisfied that no substantial question of law arises in the present case and the finding of facts of all the three Authorities concurrently rendered against the Assessee in the present case cannot be held to be perverse or wrong in any manner. These orders, therefore, deserve*

www.taxguru.in

to be upheld and we do not find any merit in the Appeal of the Assessee.

7. *However, before parting with, we may observe that there is a series of five provisions viz., Section 69-Unexplained investments, Section 69A-Unexplained money, etc., Section 69B-Amount of investments, etc., not fully disclosed in books of account 69C- Unexplained expenditure, etc. and 69D-Amount borrowed or repaid on hundi which have been enacted in the Income Tax Act, 1961 from time to time to bring to tax the undisclosed income either as undisclosed income or the same found during the course of investigation either during the Survey under Section 133A or the search operation under Section 132 of the Act or otherwise, investigation or scrutiny during the Assessment proceedings and thus, the unexplained investment or expenses are brought to tax in the form of undisclosed income by making the additions to the extent of such undisclosed income or expenditure straightaway. There is no justification or question of giving the corresponding deduction to the extent of any purchase or source of incurring such expenditure or unexplained investments.*

8. *In our opinion, Section 69B providing for amounts of investments in Bullion, Jewellery or other valuable articles (including excess Stocks as well) would have been more appropriate Section to be indicated in the orders passed by the Authorities below rather than Section 69C-Unexplained Expenditure. Nonetheless, we are of the clear opinion that mentioning of wrong section would not upset the Additions made by the Assessing Authorities below in the present case. All these 5 provisions enumerated above have been enacted with a view to bring to tax the unexplained debit balances in the Balance Sheet of the Assessee either in the form of Unexplained Investments, Expenses or Stocks, etc., or unexplained Assets, Money, Bullion, Jewellery, etc., and therefore, such unexplained investments and expenses intended to be brought to tax as Undisclosed Income, these provisions are not only clearly worded but also indicated to plug the loopholes and check the menace of black money. Likewise, unexplained credits in the Balance Sheet are also brought to tax under Section 68 of the Act.*

9. *In the light of the above, the contention raised by the learned counsel for the Assessee has essentially emanated from a misconception that the Additions made under Section 69B/69C have to be reduced to some extent by giving leverage to the Assessee to claim some deductions from these Additions as well. If the contention of the learned counsel for the Assessee was to be accepted viz., by allowing the purchases corresponding to the alleged excess stock, the Assessee will have to now record verifiable purchases in his Books of Accounts and for that he will have valid purchase Invoices from genuine and existing Sellers which is not possible. When the excess stocks were found during the Survey, there is no question of allowing the Assessee to record any additional purchases because such purchases had already been recorded in the books of accounts of the Assessee. Therefore, the excess stock, per se, has to be naturally brought to tax as*

www.taxguru.in

'undisclosed income' by itself and there is no question of any corresponding deduction from that in such cases.

10. *In our opinion, the learned Tribunal as well as the Authorities below were justified in bringing to tax the Undisclosed Income under Sections 69B/69C of the Act and such findings of fact do not give rise to any substantial question of law. The order passed by the learned Income Tax Appellate Tribunal, Ahmedabad Bench does not enure to the benefit of the arguments advanced by the learned Senior Counsel as there also the learned Tribunal has rightly held that the value of excess stock of Rs. 58,02,095 should suffer tax and by inclusion of those Stocks in the value of Closing Stock the Assessee has recognised income over and above recorded in its Books of Accounts. Such Additions of the excess Stocks declared by the Assessee during the course of search in the closing stock does not amount to double taxation as contended. Mere remand of the case by the Ahmedabad Bench of Income Tax Appellate Tribunal to the Assessing Authority for verifying the figures, does not lay down any principle as contended by the learned Senior Counsel for the Assessee.*

11. *We do not find any merit in the present Appeal of the Assessee and the same is liable to be dismissed. Accordingly, it is dismissed. No order as to costs.*

The above decision of Madras High Court also supports the view that mere subsequent recording in books of accounts for his business, does not take away such income representing undisclosed assets such as stock/ cash/ money/ bullion etc. out of sweep of Section 69/ 69A/ 69B etc. and they do not ipso facto be treated as part of business income. Recording of such entries to make them as part of business income can be permissible only when the entries subsequently recorded as part of business transactions are based on other collateral evidences already found during search/ survey such as bills/ challans/ debit/ credit notes/ vouchers for expenses/ receipts, funds being received/ transferred through banking channels, etc. even though not recorded in books till the date of survey. Therefore, unless the subsequent recording done in books of accounts maintained for any particular business/ profession and the same is supported by bills/ challans/ debit/ credit notes/ vouchers for expenses/ receipts, funds being received/ transferred through banking channels, etc. available during search/ survey, the linkage of such transactions/ entries to the regular business income does not get established so as to take such transactions/assets to be part of the same business income for which accounts were being maintained. Such income would fall into residual head of income and not as business income.

4.6 It has been held by Gujarat High court in ***Fakir Mohamad Haji Hasan vs. CIT*** 247 ITR 290(Guj) that expression 'save as otherwise provided by this Act' used in Section 14, clearly leaves the scope for deemed income of nature covered under scheme of Section 69, 69A, 69B and 69C being treated separately, because such deemed income is not income from salary, house property, profit and gains of business or profession or capital gains nor the income from other sources. In ***CIT vs. Kerala***

www.taxguru.in

Sponge Ltd 379 ITR 330(Ker), the main question of law raised by the Revenue was whether on the facts and circumstances of the case, since the income determined under Section 68 does not fall under any head in Section 14, it is not such an income beyond Section 70 which deals with set off? **The High Court held that:**

"When the income has been treated as cash credit under Section 68, the said unexplained income could not be treated as business income under any of the heads provided under Section 14 and the question of giving any deduction under provisions which correspond to such heads of income, in which case the question of set off did not arise.

Similarly, the Punjab and Haryana High Court in case of *Kim Pharma Pvt Ltd vs. CIT* 216 Taxman 153 (P&H) held that:

"The **unexplained money disclosed during survey, which was not reflected in books of accounts and no source from where it was derived was declared by the assessee, was assessable as deemed income under Section 69 A and not the business income.**

4.7 Thus the moment any income representing any excess stock/ investment/ cash/ bullion etc. Found during survey/search and not recorded at that point of time in books of accounts nor evidences found during survey justifying the source of such assets, then such assets represent deemed incomes only under Section 69/69A/69B etc and not a regular business income. Accordingly, the provisions of Section 115BBE are attracted irrespective of the fact that the same was subsequently recorded in books maintained for any business being carried on and declared suo moto by assessee as income in the ROI as part of business income. The ITAT Chandigarh in case of *Famina Knit Fab* vs. *ACIT* 176 ITD 246 (Chandigarh Trib.) has also held that as far as the income surrendered and to be assessed under Sections 69, 69A, 69B and 69C of the Act, the same is to be subjected to tax as per the provisions of Section 115BBE of the Act.

* * * * * * * * * *

www.taxguru.in

Application of Section 115BBE to Income Offered in Tax Return in Consequence to Detection/ Admission/Surrender during Search & Seizure or Survey Proceedings

Byomkesh Panda
(IRS: 2004)
Addl. CIT, Navsari (Gujarat)

Byomkesh Panda is an Indian Revenue Service officer of the 2004 Batch. He has done M.Phil in Economics (J.N.U.) and L.L.B. (VNSGU) and has served in the Indian Economic Service for 3 years before joining the IRS. In the Department, he has worked at diverse positions of the Investigation Wing, Central Charges, International Taxation Units, Income Tax Appellate Tribunals, etc. His areas of interest are Taxation of crypto-currencies and Digital Money, BEPS and Taxation of Digital Economy, Taxation of Diamond, Real Estate and Textile Industry, Comparative Tax laws, evolution of Law of Transfer Pricing in India, etc. His interests include research in Sanskrit language, study and practice of Ornithology and Marathon running. Presently he is pursuing Ph.D in the field of Impact of Crypto-currencies and the Central Bank Digital Currency on India's Monetary and Fiscal Scenario.

Executive Summary

At times unaccounted income/unexplained investment are admitted and declared by taxpayers in the course of investigative proceedings like search & seizure action under Section 132 or, survey proceedings under Section 133A. Subsequently, such income is offered in the Income Tax Return as regular business income and tax is paid at normal rates. Though the income would not have been disclosed and offered voluntarily, but for the intrusive actions by the Department. In the Income Tax Return, such income is being merged with regular, accounted income. In the course of Assessment proceedings, question arises whether to accept such income as normal business income, or to mete out a different treatment as envisaged in Section 115BBE of the Income Tax Act, 1961. This Article posits that the answer lies in outcome of further inquiry by the Assessing Officer and the discharge of burden by the taxpayer Assessee.

Keywords: "Unaccounted Income", "Unexplained Investment", "Nature", "Source", "Head of Income", "Section 115BBE", "Deemed Income".

I. Issue

Certain unaccounted income in form of unaccounted cash/unexplained stock/ undisclosed receivables/ undisclosed sales/ undisclosed bank investments etc. has been detected during search/survey and have been "declared" or "Admitted" as business income and has been incorporated in Return of income and taxes have been paid at a normal rate of 15% / 30%.

Whether the Assessing Officer should accept the Income Tax Return of the taxpayer or, apply provisions of Section 115BBE on the impugned income?

www.taxguru.in

(i) At the very outset, it should be borne in mind that the deliberate and systematic conduct of unaccounted business is antithetical to the duties of a law abiding citizen. However, upon being detected and cornered by the Department, if the claim of source being legitimate business is made, even when it would not be entered in the accounts as on the date of search/survey; is nothing but a mischief. In *MakData (P.) Ltd. vs. CIT [2013] 38 taxmann.com 448/358 ITR 593 (SC), the Apex Court has observed that:"…The AO, in our view, shall not be carried away by the plea of the assessee like "voluntary disclosure", "buy peace", "avoid litigation", "amicable settlement", etc. to explain away its conduct…. We are of the view that the surrender of income in this case is not voluntary in the sense that the offer of surrender was made in view of detection made by the AO in the search conducted in the sister concern of the assessee. In that situation, it cannot be said that the surrender of income was voluntary…. It is the statutory duty of the assessee to record all its transactions in the books of account, to explain the source of payments made by it…"* Hence, such surrenders are not voluntary and the explanation regarding the embedded income ought to be considered by the Assessing Officer with a grain of salt. Also no presumption should be held that the declared/ admitted income are from business only – as per ratio of PCIT vs. Khushi Ram & Sons Foods (P.) Ltd., Income Tax Appeal No. 126 of 2015 (O&M).

Question arises whether such incomes included and offered in the return of income, but actually having a past history of suppressed nature can be meted out an equal treatment with fully, voluntarily disclosed income? If such incomes are treated at par with voluntarily disclosed and offered income, then it will be iniquitous to the honest taxpayers who offer income without any concealment or suppression. Issue is whether such income is tainted with certain unexplained attributes or, gets absorbed in regular total income once offered in Tax Return.

II Sections for Charging of Deemed Income

The credits in accounts like receipts, inflows, loans, advances and investments in various assets like stock, bank account, cash etc. must be explained by the Assessee to the satisfaction of the Assessing Officer. Sections 68, 69 and 69A entail onus on Assessee regarding explanation regarding "**nature and source**" **to the satisfaction of the Assessing Officer**. The onus is twofold and cumulative in regards to explanation of:

i. Nature of Income, ***and***

ii. Source of Income

"The words 'and also' are used in a cumulative and conjunctive sense. To read these words as being in the alternative would be to rewrite the language used by Parliament" - CIT vs. Jet Airways (I) Ltd. [2010] 195 Taxman 117/[2011] 331 ITR 236.

Hence, the onus is cumulative as regards to "Nature" as well as "Source" since conjunction "and" has been used.

III. Meaning of the term "Nature"

The first term "nature" has not been defined in the Income Tax Act, 1961. As per Black's Law Dictionary(9th Ed.), "nature. (l4c) 1. A fundamental quality that distinguishes one thing from another; the essence of something…"

Thus, the fundamental quality of a transaction is whether it is a receipt, or a gift or capital gain or salary, etc. Such attribute will come under the aegis of "nature". Therefore, the phrase,

"Nature" means the category of a credit. Nature of a credit can be "Business receipt", "Share Application money/share capital", "Gift", "Advance", "Unaccounted Business receipts", etc.

IV. Meaning of the term "Source" and the Onus on Taxpayer

The term "source" means the person/entity from which the funds emanate and flow to the Assessee under consideration. Guidance can be obtained from the case of *CIT vs. Sadiq Sheikh [2020] 122 taxmann.com 39 (Bombay)*

[Taxpayer's SLP dismissed vide [2021] 124 taxmann.com 202 (SC); in favour of Revenue]:

"…23. The record, in this case, indicates that hardly any explanation as such was offered by the assessees when called upon to explain the transactions leading to the transfer of this huge amount of Rs. 8.49 crores into their bank accounts on 10-3-2007. ***Even the source was not indicated by the assesses*** *but the same was unearthed by the Revenue by probing the bank accounts and the money trail.*

24. The assessees neither cooperated nor were they candid. It is only as the probe deepened, the assessees and their alleged sources began to offer some half-hearted explanations, which, as found by the AO and the Commissioner (Appeals) were far from satisfactory…"

A *prima facie* reading of the above decision brings out that "source" indicates the payer/opposite party of the transaction under examination from whom the sums flow to the Assessee under question. SLP has been dismissed by the Hon'ble Apex Court, hence, the interpretation is final and binding.

V. Anatomy of the Expression "Source" in view of Judicial Ratio

In the legal perspective of Sections 68, 69, 69A of the Income Tax Act, 1961, the term "Source"'as enshrined in those section comprises of a complex of information backed with evidence expected from the subject Assessee; laced with the burden to prove the same to the satisfaction of the Assessing Officer.

In landmark judgment of CIT vs. Bikram Singh [2017] 85 taxmann.com 104/250 Taxman 273/399 ITR 407 (Delhi), it has been held that three conditions i.e. (I)dentity of the creditor, (G)enuineness of the transaction and (C)reditworthiness/capacity of the creditor, had to be fulfilled cumulatively. Thus, the explanation as regards to "Source" is threefold, therefore, onus is called the "'Triple Onus"'.

Thus, the term "Source" as envisaged in the relevant sections above, have inherent evidentiary requirements from the recipient Assessee.

VI. Illustrations of "Nature" and "Source"

Thus, while "Nature" of an item of income is easy to explain. "Source" has to established as per the rule of evidence laid down in the relevant sections. **"Nature" is far removed from "Source" in terms of species.**

The "Nature" of a sum is closely related to the "Head" of Income.

Table 1

Nature	Head	Section
Dividends, Deemed Dividends	Dividends	8
Salary/Perquisites	Salary	15
Rent/Deposits	House Property	22
Accounted Business receipts	Business or Profession	28

Table (Contd.)...

www.taxguru.in

...Table (Contd.)

Gain from sale of Shares, Bonds, Securities	Capital Gains	45
Gain from transfer of Immovable Property	Capital Gains	45
Various other Income like lottery, unrequited considerations, gifts etc.	Income from Other Sources	56
Unaccounted Business receipts	Business or Profession	68
Share Capital/Gift/ Advance/Deposits	Capital Receipts/ Not Income	68
Debtors/Receivables	Business or Profession	68
Undisclosed Bank Account	Business or Profession	69
Excess Stock	Business or Profession	69
Unexplained Business Investments	Business or Profession	69
Unexplained Cash deposited in Bank Account	Any Head possible	69/69A
Excess Cash	Any Head possible	69A
Unexplained investment in Assets like jewellery, crypto-currency, paintings	Any Head possible	69A
Not completely disclosed investment in Assets	Any Head possible	69B
Unexplained Business expenditures	Business or Profession	69C
Unexplained Personal expenditures	Any Head possible	69C

VII. Extent of Onus on Assessee and the Assessing Officer

The judgment of *Rajshree Synthetics Pvt. Ltd. vs. CIT* [2002] 256 ITR 331/[2003] 131 Taxman 391 (Raj.) elaborates the onus of the Assessee in a succinct manner:

"…8. Section 68 gives a statutory recognition to the principle that the cash credits which are not satisfactorily explained, may be assessed as income. This provision empowers the Assessing Officer to make enquiry specifically to be satisfied regarding the cash credit. If he is satisfied that these entries are not genuine, he has every right to add its amounts as income from other sources. This satisfaction of the Assessing Officer is the basis for invocation of powers under section 68 and the satisfaction must be derived from the relevant factors on the basis of proper enquiry. It is well settled that the assessee is required to prove prima facie the transactions, which result in cash credits in his books of account. Such proof includes the proof of identity of his creditor, the capacity of such creditor to advance the money and, lastly, the genuineness of the transaction. These things must be proved prima facie by the assessee and only after the assessee has adduced evidence to establish prima facie the aforesaid onus shifts on the Department. Mere filing of confirmatory letters does not discharge the onus that lies on the assessee. Similarly, mere furnishing of particulars is not enough. In Sreelekha Banerjee vs. CIT [1963] 49 ITR 112 (SC), it is held that when a cash credit entry appears in the assessee's books of account in an accounting year, the assessee has a legal obligation to explain the nature and source of such credit. It is further held in Kale Khan Mohammad Hanif vs. CIT [1963] 50 ITR 1 (SC), that if the assessee offers an explanation about the cash credit, he has to prove his explanation and if the assessee fails to tender the evidence or shirks an enquiry, then the assessing authority is justified in rejecting the explanation and holding that the income is from undisclosed source. Since the Tribunal has remitted the matter to the assessee, we refrain from making any further observations on the controversy, as it may prejudice the case of either of the parties.…"

The decision of the Hon'ble Delhi High Court in *CIT vs. Divine Leasing & Finance Ltd.* [2007] 158 Taxman 440, provides some pointers that

www.taxguru.in

would essentially have to be satisfied by the taxpayer in order to carry a transaction outside the ambit of section 68.

"..16. In this analysis, a distillation of the precedents yields the following propositions of law in the context of section 68 of the Income-tax Act. The assessee has to prima facie prove (1) the identity of the creditor/subscriber; (2) the genuineness of the transaction, namely: whether it has been transmitted through banking or other indisputable channels; (3) the creditworthiness or financial strength of the creditor/subscriber; (4) If relevant details of the address or PAN identity of the creditor/subscriber are furnished to the Department along with copies of the Shareholders Register, Share Application Forms, Share Transfer Register etc. it would constitute acceptable proof or acceptable explanation by the assessee. (5) The Department would not be justified in drawing an adverse inference only because the creditor/subscriber fails or neglects to respond to its notices; (6) the onus would not stand discharged if the creditor/subscriber denies or repudiates the transaction set up by the assessee nor should the Assessing Officer take such repudiation at face value and construe it, without more, against the assessee. (7) The Assessing Officer is duty-bound to investigate the creditworthiness of the creditor/subscriber the genuineness of the transaction and the veracity of the repudiation…"

The Hon'ble Court has also made the Assessing Officer duty-bound to conduct inquiry into the existence, identity, creditworthiness of the creditors.

The strict onus resting on the Assessee has been upheld by a plethora of judicial decisions:

- ✓ *Sumati Dayal vs. CIT [1995] 80 Taxman 89 (SC).*
- ✓ *Navodaya Castle (P.) Ltd. vs. CIT [2015] 56 taxmann.com 18/230 Taxman 268.*
- ✓ *N. Tarika Property Invest. (P.) Ltd. vs. CIT [2014] 51 taxmann.com 387/227 Taxman 373 (SC).*
- ✓ *CIT vs. Empire Builtech (P.) Ltd. [2014] 366 ITR 110 (Delhi).*
- ✓ *CIT. vs. Maithan International [2015] 375 ITR 123/231 Taxman 381/56 taxmann.com 283 (Cal.)*
- ✓ *Subhlakshmi Vanijya (P.) Ltd. vs. CIT [2015] 60 taxmann.com 60/155 ITD 171 (Kol. - Trib.)*
- ✓ *CIT vs. M. GanapathiMudaliar [1964] 53 ITR 623 (SC): Where the assessee has failed to prove satisfactorily the source and nature of the credit entry in his books and it is held that the relevant amount is the income of the assessee, it is not necessary for the department to locate the exact source.*
- ✓ *CIT vs. Devi Prasad Vishwanath[1969] 72ITR194 (SC): It is for the assessee to prove that even if the cash credit represents income it is income from a source which has already been taxed.*

VIII. Burden of Proof

The onus of establishing that the sums are from explained business sources is on the Assessee. The knowledge lies in domain of the Assessee, and the Assessee must establish the same.

The burden rests on the taxpayer to produce evidence with regard to facts – especially those facts which is within his knowledge in the light of Section 106 of the Evidence Act, 1872 - *Burden of proving fact especially within knowledge - When any fact is especially within the knowledge of any person, the burden of proving that fact*

www.taxguru.in

is upon him. Hence, such provision is directly applicable to the first layer of source of the credit/ investment/expenditure. Also that, since the such burden extends to source of source also as the term *"especially"* does not rule out the burden in regards to further layers. Any interpretation of *"Especially"* to mean *"only"* is not as per the spirit of the Evidence Act.

Section 106 of the Evidence Act puts the strict onus in relation to facts which are especially within the knowledge of the assessee which would prima facie be - (i) identity of the creditor; (ii) the capacity/creditworthiness of the creditor to advance the money; and (iii) the genuineness of the transaction.

Thus, the burden to establish that the income is from explained "'source"' and the nature of that income is business income rests squarely on the taxpayer.

IX. Re-characterization of Income offered as "Business Income" into "Deemed Income" upon Rejection of Accounts

Revenue authorities can re-characterize the transaction if it is found to be a sham or bogus transaction.

Section 68 begins with *"any sum is found credited in the books of an assessee"* and the term *"any sum"* is very broad and it includes sums credited to books as "sales" or "loans" or "sundry credits" etc. The term "cash credit" is a broad term pertaining to all sums which have been "credits" – here "credits" used in the accounting sense. The use of the term as intended by the Legislature is "credited" meaning "any receipts" and it should not be restricted to the conversational usage of "credit" which means only loan or goods with payment due or, pending.

Reliance is placed upon the ratio of *J.M.J. Essential Oil Company vs. CIT,* [2018] 100 taxmann.com 181 (Himachal Pradesh) for such a view and action.

"…17. In the instant case, undisputedly, in the relevant year(s) there has been cash sales made across the counter, which was credited in the books of account maintained for the relevant year(s). Further the assessee was asked to furnish information regarding the nature and source thereof, which he did so, but in the opinion of the Assessing Officer was found to be not satisfactory and as such, the said sum was charged to the income of the assessee in the relevant year(s)…"

The SLP in the matter has been dismissed by the Hon'ble Apex Court vide *J.M.J. Essential Oil Companyvs. CIT,*[2020] 113 taxmann.com 463 (SC). Hence, the position of law is settled.

Reliance is also placed upon:

- ✓ *V. GovindarajuluMudaliar vs. CIT, Civil Appeals Nos. 41 to 43 of 1957 D/- 24-9-1958 : (AIR 1959 SC 248)*
- ✓ *Lakhmichand Baijnath vs. CIT, AIR 1959 SC*
- ✓ *Roshan Di Hatti vs. CIT [1977] 2 SCC 378*
- ✓ *SumatiDayal vs. CIT [1995] 80 Taxman 89 (SC)*

However, the **rejection of accounts** invoking Section 145 is a sine qua non before any such re-characterization. The rejection can be made under Sub-section 145(3) on account of "incompleteness" and "incorrectness" if the taxpayer fails to furnish the source, details of payer, details, dates, etc. of the impugned transactions detected during search/survey.

X. Analysis of pre-se. 115BBE Judicial Decisions – Class of "Deemed Income" as "Headless Income"

Fakir Mohmed Haji Hasan vs. CIT [2002] 120 Taxman 11/[2001] 247 ITR 290 (Guj.)

www.taxguru.in

"…6. Under section 4 of the Act, income-tax is to be charged in accordance with the provisions of the Act in respect of the total income of the previous year of every person. As provided by section 5 of the Act, total income of any previous year of a person would, inter alia, include all income from whatever source derived which is received or is deemed to be received by such person, subject to the provisions of the Act. It will be seen from section 69A that where the bullion, jewellery or other valuable article is not recorded in the books of account and ***there is no explanation about the nature and source of its acquisition, or the explanation is not satisfactory,*** *the value thereof may be deemed to be the income of the assessee of the financial year immediately preceding the assessment year in which the assessee is found to be the owner of such bullion, etc.*

6.1 The scheme of sections 69, 69A, 69B and 69C of the Act would show that in cases where the nature and source of investments made by the assessee or the nature and source of acquisition of money, bullion, etc., owned by the assessee or the source of expenditure incurred by the assessee are not explained at all, or not satisfactorily explained, then the value of such investments and money, or value of articles not recorded in the books of account or the unexplained expenditure may be deemed to be the income of such assessee. It follows that the moment a satisfactory explanation is given about such nature and source by the assessee, then the source would stand disclosed and will, therefore, be known and the income would be treated under the appropriate head of income for assessment as per the provisions of the Act. ***However, when these provisions apply because no source is disclosed at all on the basis of which the income can be classified under one of the heads of income under section 14 of the Act, it would not be possible to classify such deemed income under any of these heads including "Income from other sources" which have to be sources known or explained.*** *When the income cannot be so classified under any one of the heads of income under section 14, it follows that the question of giving any deductions under the provisions which correspond to such heads of income will not arise. If it is possible to peg the income under any one of those heads by virtue of a satisfactory explanation being given, then these provisions of sections 69, 69A, 69B and 69C will not apply, in which event the provisions regarding deductions, etc., applicable to the relevant head of income under which such income falls will automatically be attracted.*

6.2 The opening words of section 14 'Save as otherwise provided by this Act' clearly leave scope for 'deemed income' of the nature covered under the scheme of sections 69, 69A, 69B and 69C being treated separately, because such deemed income is not income from salary, house property, profits and gains of business or profession, or capital gains, nor is it income from 'other sources' because the provisions of sections 69, 69A, 69B, and 69C treat unexplained investments, unexplained money, bullion, etc., and unexplained expenditure as deemed income where the nature and source of investment, acquisition or expenditure, as the case may be, have not been explained or satisfactorily explained. Therefore, in these cases, the source not being known, such deemed income will not fall even under the head, 'Income from other sources'. Therefore, the corresponding deductions, which are applicable to the incomes under any of these various heads, will not be attracted in case of deemed incomes which are covered under the provisions of sections 69, 69A, 69B and 69C in view of the scheme of those provisions…."

www.taxguru.in

The Hon'ble Gujarat High Court held that in case of unexplained sources, the income would not be even classifiable as "Income from Other Sources". Similar view has been adopted in the following cases:

CIT vs. Kerala Sponge Iron Ltd. [2017] 79 taxmann.com 350/[2015] 379 ITR 330 (Ker.)

Pr. CIT vs. Khushi Ram & Sons Foods (P.) Ltd., Income Tax Appeal No. 126 of 2015

XI. Whether there can be a Class of "Deemed Income" separate from "Heads of Income"

As opposed to the ratio of above decisions, certain judicial decisions had taken a view that there cannot be a case of any income originating from unexplained "source" which cannot be subsumed into section 14 and the enumerated five "Heads of Income".

The case of *CIT vs. Chensing Ventures* [2007] 291 ITR 258/163 Taxman 175 (Mad.) is the lead case in such judicial thought process:

"…However, the assessee had agreed to offer the sum of Rs. 28.50 lakhs as income from undisclosed source for the assessment year 2002-03. The assessee filed a return of income for the said assessment year on 31-10-2002, admitting a business loss of Rs. 11,95,384 and admitting an income of Rs. 28,50,000 under the head "Income from undisclosed sources".....There was no reason given by the Assessing Officer to deny the set off of the business loss against the income declared under the head "Other sources"....Section 14 has classified the different heads of income and income under each head is separately computed. Income which is computed in accordance with law is one income and it is not a collection if distinct tax levied separately on each head of income and it is not an aggregate of various taxes computed with reference to each of the different sources separately.

The Hon'ble High Court alternated between "head of income" and "source" without the reasoned distinction. Also that, though the contradictory ratio of *Fakir Mohmed Haji Hasan vs. CIT* [2001] 247 ITR 290 (Guj.)was available, the same was not brought to the notice of the Hon'ble Madras High Court while the decision was laid down.

The above decision was followed in *DCIT vs. Radhe Developers India Ltd.* [2010] 329 ITR 1/ [2011] 198 Taxman 58 (Guj.)

"....The earlier decisions of the Apex Court commencing from case of United Commercial Bank Ltd. vs. CIT [1957] 32 ITR 688 (SC) have been considered by the Apex Court and, hence, it is not necessary to repeat the same. Suffice it to state that the Act does not envisage taxing any income under any head not specified in section 14 of the Act. In the circumstances, there is no question of trying to read any conflict in the two judgments of this Court as submitted by the learned Counsel for the Revenue.... The decisions of this Court in the case of Fakir Mohmed Haji Hasan (supra) and Krishna Textiles (supra) are neither relevant nor germane to the issue considering the fact that in none of the decisions the Legislative Scheme emanating from conjoint reading of provisions of sections 14 & 56 of the Act have been considered."

Also case of *CIT vs. Shilpa Dyeing & Printing Mills (P.) Ltd.* [2013] 39 taxmann.com 3/219 Taxman 279 (Guj.) held the same view:

"…Assessing Officer holding a belief that income from unlisted source would not fall under any of the heads of the income, the same has to be taxed separately, the current losses cannot be set off against such income....The AO's only objection is that the said disclosure ought not to be reduced from the income from the business being not part of the business income and the

www.taxguru.in

resultant loss ought not to be adjusted against the said undisclosed income which is to be taxed independently in the hands of the assessee. In our considered opinion, the AO had gone wrong by not considering the provisions of Section 71 of the IT Act.…In our opinion, the statutory provisions contained in Section 71 was applicable in the present case…"

The case of *Bhima Jewellers vs. Pr. CIT* [IT Appeal No. 208 (COCH) of 2018 dated 20-08-2018] as cited in *Vijaya Hospitality and Resorts Ltd. vs. CIT*, [2020] 114 taxmann.com 91 (Kerala) is the latest addition to such viewpoint:

"…4. The Tribunal also relied on a judgment of the Gujarat High Court in *Fakir Mohmed Haji Hasan vs. CIT* [2002] 120 Taxman 11/[2001] 247 ITR 290 in order to arrive at a finding that, the source of unexplained cash credit is not known and hence they cannot be linked to any known source/head of income, including the 'income from other sources'. In order to constitute 'income from other sources', the source, namely the 'other sources', has to be identified. Income from unexplained or unknown source cannot therefore be considered or taxed as 'income from other sources'…"

These cases professed to have drawn sanction from *CIT vs. D.P. Sandu Bros. Chembur P. Ltd.* [2005]273 ITR 1 (SC).

XII. Confounding of Meaning of "Head"/ "Nature" with "Source"

With due respect to the Hon'ble High Courts, it appears that the above class of judicial decisions emerged due to the unavailability of distinction being pointed out between "Head" of income and "Source" of income.

The Income Tax Act, 1961 also envisages a difference between "source" and "head". For instance, Section 70 deals with Set off, or carry forward and set off:

Set off of loss from one source against income from another source under the same head of income.

70. *(1) Save as otherwise provided in this Act, where the net result for any assessment year in respect of any source falling under any head of income, other than "Capital gains", is a loss, the assessee shall be entitled to have the amount of such loss set off against his income from any other source under the same head.*

Hence, "Source" is the origin of funds of an individual transaction and the "Head of Income" is a classification of income as received by the Assessee in question. There is no similarity between a "Source of Income" and "Head of Income". The onus cast under Sections 68, 69, 69A was establishment of "Source of Income", while the judicial decisions directed the "Source of Income" to be read as "Head of Income".

Support is drawn from the Apex Court, in the case of *United Commercial Bank Ltd. vs. CIT* [1957] 32 ITR 688 (SC) whereby it has been observed that:

*"…Every **item** of income, whatever its **source**, would fall under one particular **head** and for the purpose of computing the income for charging of income-tax the particular section dealing with that head will have to be looked at. The various sources of income, profits and gains have been so classified that the items falling under those heads become chargeable under sections 7 to 12 of 1922 Act as they are income of which the source is 'salaries', 'interest on securities', 'property', 'business, profession or vocation', 'other sources' or 'capital gains'…"*

Hence, there is clear distinction between the terms "Item of income", "Source" and "Head of income". If the taxpayer fails to explain the "Source of Income" meaning the person/entity

www.taxguru.in

from whom the funds have been received and failed to establish that the Identity, Genuineness and Capacity of the "Source", then such income is deemed to income of the taxpayer and it would not fall under any of the "Heads of Income" as envisaged in Section 14 of the I.T. Act.

XIII. "Income from Other Sources" as per Section 56 is a Head of Income and not linked to "Source" as within the meaning of Sections 68/69/69A

The decisions based on *ratio of Chensing Ventures (supra)* have treated Section 56 as a "catch all" basket of all income from every kind of sources. However, the conjoint reading of section 14 and section 56 negates such an interpretation.

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.

"Income from Other Sources" is a "Head" of income and it pertains to income of "Every kind" enumerated within section 14 only.

However, Section 14 starts with an exception:

"...Heads of income

14. Save as otherwise provided by this Act,..."

The commencing phrase *"save as otherwise provided"* of Section 14 means an exception. The Hon'ble Apex Court in SLP (Crl.) No. 6563 of 2007, in respect of Code of Criminal Procedure, has held that the opening words which contains- *"save as otherwise provided"* – are in the nature of exception intended to exclude the class of cases mentioned out of operation of the body of Section. Similar interpretation is applicable to the Income Tax Act, 1961.

Hence, the deeming provisions are an exception carved in the Income Tax Act, 1961 and lie beyond the scope of 14. While, Section 56 is limited by its application to Section 14 as it entails a head of income for a kind of income *"if it is not chargeable to income-tax under any of the heads specified in Section 14, items A to E"*.

XIV. Introduction of Section 115BBE and subsequent Amendments

The above controversy regarding the nature and species of "Deemed income" has been laid to rest with introduction of Section 115BBE of the Income-tax Act, 1961 vide Finance Act 2012 which contained special provisions for taxation of cash credits, unexplained money, investments etc., w.e.f. 01.04.2013 and onwards. Section 115 BBE is a Section contained in Chapter XII of the Income Tax Act, 1961 titled **"Determination of the tax in certain special cases"**. This Section laid down in specific terms that income referred to in Section 68 or Section 69 or Section 69A or Section 69B or Section 69C or Section 69D (Referred to as the 'specified sections') are of a different class of income and any deduction related to other heads of income cannot be allowed from such income.

Thereafter, *vide* amendment to the Finance Act of 2016, higher rate of taxation (60% base tax rate) and non-allowance of set off of loss, apart from non-allowance of any deduction has been introduced in the Section 115BBE with effect from 1st of April, 2017–applicable for Assessment Year 2017–18 and onwards.

The explanatory notes to the provisions of the Finance Act, 2016 enumerates the reasons for introduction of the further amendment barring

www.taxguru.in

the set off, with effect from 1.4.2017. It has been stated that—*'Currently, there is uncertainty on the issue of set-off of losses against income referred to in section 115BBE of the Income Tax Act. The matter has been carried to judicial forums and courts in some cases has taken a view that losses shall not be allowed to be set-off against income referred to in section 115BBE.* ***However, the current language of section 115BBE of the Income-Tax Act does not convey the desired intention and as a result the matter is litigated****. In order to avoid unnecessary litigation, the provision of the sub-section (2) of section 115BBE of the Income Tax Act has been amended as to expressly provide that no set off any loss shall be allowable in respect of income under the section 68 or section 69 or section 69A or section 69C or section 69D.'*

XV. Summing Up: There should be no confusion between "Head" and "Source".

In the context of Section 68/69/69A of the I.T. Act: "Source" means the payer, the party – the source from which the sums have emanated. And not merely head.

Thus, the correct interpretation of "Source" is the payer as envisaged by Sections 68/69/69A.

Section 115BBE of Income Tax Act, 1961, *inter alia*, relates to Sections 68/69/69A etc. Therefore, the onus cast under Sections 68/69/69A is required to be discharged by the taxpayer.

The true exposition of "source" will be with the verifiable Identity – ascertainable Genuineness and Creditworthiness of the source entity/person.

Mere furnishing of broad and blanket clarification that the "source" is "Business" or "Profession" etc. is not in consonance with the intention of the Legislature present behind the above-mentioned sections.

XVI. Course of Action for Assessing Officers

Under the above backdrop, if Unexplained Income has been offered in the tax Return at normal rates –

(i) The first step is bringing the relevant income into the ambit of section 115BBE and conducting due inquiry in respect of the "'nature"' and "'source"'.

(ii) There is no presumption of the nature and source being Business. As per ratio of *Pr. CIT vs. Khushi Ram & Sons Foods (P.) Ltd.*, Income Tax Appeal No. 126 of 2015 (O&M)

"…13. It is not necessary that the surrendered amount is from business income. It could be on account of any other transaction legal or otherwise. Merely because an assessee carries on certain business, it does not necessarily follow that the amounts surrendered by him are on account of its business transactions. There is no presumption that absent anything else an amount surrendered by an assessee is his business income. It is for the assessee to establish the source of such surrendered amount…"

(iii) In respect of such income, call for the details of "'source"' – payer, mode of payment etc.

(iv) If the sources are submitted, undertake inquiry through Verification Unit for the identity/ existence of the parties. If necessary, commission may be issued to the Investigation Wing of the relevant jurisdiction.

(v) If the source has been identified, it is probable that the payment would also be unaccounted in hands of the source (As the receipt is unaccounted in hands of the recipient Assessee) then the unexplained income paid by the "source"may be referred to CRU/VRU for necessary action.

(vi) If possible, the Assessing Officer is needed to

www.taxguru.in

inquire into the source of the source since as per *Nemi Chand Kothari vs. CIT* [2004] 136 Taxman 213/264 ITR 254 (Gau.): *"The inquiry under Section 68 need not necessarily be confined by the Assessing Officer to the transactions, which took place between the assessee and his creditor, but that same may be extended to the transactions, which may have taken place between the creditor and his sub-creditor.."*

(vii) If there is failure to establish that the nature as well as source with accounts, identity, capacity, confirmations; the Assessing Officer may reject the accounts as per Sub-section 145(3) being incomplete and incorrect.

(viii) The offered sums can be assessed under Section 68/69/69A, as the case may be.

(ix) The offered sums can be re-characterised as per Sub-section 115BBE(2) of the I.T. Act. There will be no extra addition of income, since the income has been offered as per normal rates of tax. However, for the purpose of computation, the relevant income is to be treated as a separate class of 'Deemed Income' and taxed at appropriate rate as per mandate of Section 115BBE of the I.T. Act.

(x) The most significant aspect is that Section 115BBE cannot be applied mindlessly to detected/ surrendered income unless due inquiries establish that the nature and source are not unexplained fully and satisfactorily. Uninhibited use of the provision which is quite stringent, will lead to creation of judicial precedents against Revenue, which will hamper the normal and judicious interpretation and application of the section.

* * * * * * * * * *

www.taxguru.in

Urban Bad Debts Write-off by Banks: A Ticklish Issue

Dr. Shakir Hussain Shaik
(IRS: 1992)
CIT (AU), Kurnool, AP

Dr. Shakir Hussain Shaik is 1992 batch of IRS officer, currently posted as CIT (Appeals), Kurnool, Andhra Pradesh. During his service, he has worked in various capacities in Assessment, Investigation, Headquarters, Transfer Pricing etc. He was on Deputation from 2010 - 2013, as Chief Executive officer, Central Haj Committee, Bombay and completely stream lined the Haj administration, introduced transparent selection and training of Haj Prilgrims. He has vast experience in the area of Appeals from 2015 to till date.

Executive Summary

A mere provision for bad and doubtful debt(s) is not allowed as a deduction in the computation of taxable profits. In order to promote rural Banking, the Clause 36(1)(viia) was inserted by the Finance Act 1979 (w.e.f 1-4-1980) to provide for a deduction for Provision for Bad and Doubtful Debts (PBDD), in respect of rural provisions only. The clause (viia) was distinct and independent of clause (vii) at that stage and banks were allowed double deduction in respect of rural provisions once at the provision stage under Section (viia) and again at the write-off stage under Section (vii).

The common practice is that the Banks (having both rural and urban branches) claim deduction for PBDD under Section 36(1)(viia) and maintain single provision account under Section 36(1)(viia). However, the Banks debit only the rural bad debts write off and do not debit urban bad debts write off to the provision account. The Banks create an artificial illusion that they are fully complying with the first proviso to Clause 36(1)(vii) and Clause 36(2)(v) before the tax authorities and get away with it.

After the insertion of first proviso to Clause 36(1)(vii) and Clause 36(2)(v) in 1985, the Clause 36(1)(viia) is not distinct and independent of Clause 36(1)(vii) and therefore no separate deduction under each clause.

The deduction allowed for PBDD is only a lump sum figure calculated on the basis of formula specified under Section 36(1)(viia)(a). It is not advances wise/ debtor wise. It could be in fractions as per the formula and the method of computation prescribed under Rule 6ABA. To prevent double deduction, it is absolutely necessary to maintain single provision account in respect of both rural and urban provisions and debit both urban and rural bad debt write-off to the provision account by the banks (especially with both urban and rural branches).

The claim of the banks that the deduction allowed for the PBDD under Clause 36(1)(viia) is entirely for rural provisions is based on old law as existed from 1979 to 1985 only. Much water has flown down the Ganges. The time has come to shake them from the cosy comfort of enjoying such double deductions.

www.taxguru.in

GENERAL INTRODUCTION

The issue of deduction for bad debts write-off is an important issue in the assessments/ appeals of all the public sector and private sector banks having both urban and rural branches. It is common knowledge that urban bad debts write-off constitute a large chunk, while rural bad debts write-off constitute a minuscule portion of the total bad debts write-off by any bank having both rural and urban branches. The banks routinely claimed double deduction of urban bad debts write-off and was also allowed by the Department as the issue is less understood in the Department. Thus, it is observed that many banks take undue advantage of the complex provisions—the first proviso to Sections 36(1)(vii), 36(1)(viia) and 36(2)(v).

1.1 Normally, the banks claim deduction for the provisions for bad and doubtful debts (PBDD) under Section 36(1)(viia)(a).The banks also claim deduction for bad debts write-off under Section 36(1)(vii). To prevent such double deduction, first proviso to Section 36(1)(vii) and 36(2)(v) was introduced by the Finance Act,1985. Accordingly, the assesses claiming deduction under Section 36(1)(viia) are required to maintain one single provision account under Section36(1)(viia). As per the first proviso to Section 36(1)(vii), the deduction for bad debts write-off under Section 36(1)(vii) for the assessees who claim deduction for PBDD under Section 36(1)(viia), shall be limited to the amount by which such bad debts exceeds the credit balance in the provision account under Section 36(1)(viia).

1.2 The common practice is that the banks(having both rural and urban branches) claim deduction for provision for bad and doubtful debts (PBDD) under Section 36(1)(viia) and maintain single provision account under Section 36(1)(viia). However, the banks debit only the rural bad debts write-off to the provision account. The banks create an artificial illusion that they are fully complying with the first proviso to Section 36(1)(vii) and 36(2)(v). Such Banks do not debit urban bad debts write-off under Section 36(1)(vii) to the provision account. The argument of the banks is that the deduction allowed under Section 36(1)(viia) is for rural provisions only, which is totally misconceived as explained in the paragraphs below. In effect, the banks are claiming deduction twice in the case of urban bad debts write-off—once at the provision stage under Section 36(1)(viia) and again at the write-off stage under Section 36(1)(vii) without first debiting the provision account under Section 36(1)(viia).

ILLUSTRATION

To understand the above legal clauses and the issue involved, consider the following example:

2.1 A bank (having both rural and urban branches),during the AY 2013–14:

a. The bank made rural advances of Rs 1500 Cr. The outstanding rural aggregate average advances (AAA) at the end of the year (including earlier year advances of Rs. 3500 Cr) was Rs. 5000 Cr.

b. The income of the bank before claiming deductions under Section 36(1)(viia) and Chapter VI A was Rs. 1000 Crore.

c. The deduction for PBDD under Section 36(1)(viia)(a) allowed to the bank till AY 2012–13 was Rs. 2000 Cr. Thus, the opening credit balance in the provision account under Section 36(1)(viia)(a) was Rs. 2000 Crore.

www.taxguru.in

d. In its books, bank made provision for bad and doubtful debts (PBDD)of Rs. 920 Cr (830 Cr urban + 90 Cr rural) and debited to the Profit & Loss Account.

e. The bank claimed deduction for PBDD under Section 36(1)(viia)(a) of Rs. 575 Cr in the computation.

f. Total bad debts write-off during the year was Rs. 882 Cr (Rs 880 Cr urban + Rs. 2 Cr rural)and claimed deduction under Section 36(1)(vii) of Rs. 880 Crin the computation.

g. The bank's computation of income is as under:

(Rs in Crores)

Net profit as per P&L		1000
Add: provisions for bad debts		920
Less: Deduction under Section 36(1)(viia)(a)	10% of AAA (10% x 5000)+ 7.5% of total income (7.5% x 1000)	575
Less: Deduction under Section 36(1)(vii)	880 Cr (Urban debts)	880
Taxable income		465

2.2 Whether the deduction claimed under Section 36(1)(viia)(a) and under Section 36(1)(vii) is correct?

In the computation of income, the provision of Rs. 920 Cr was added back to the taxable income. The deduction for the PBDD was claimed under Section 36(1)(viia) amounting to Rs. 575 Cr being the amount eligible as per the formula under Section 36(1)(viia)(a).

2.3 Solution:

A. Deduction under Section 36(1)(viia)(a)

Eligible amount of deduction under Section 36(1)(viia)(a) works out as under:

10% of AAA (10% x 5000) = 510

7.5% of total income (7.5%x1000)=75

Total: 575 Cr

The provision for bad and doubtful debts debited to the Profit & Loss Account is Rs. 920 Cr (830 Cr for urban debts + 90 Cr for rural debts). As per 36(1)(viia), the provision in the books of accounts can be in relation to any debts - not necessarily in respect of rural advances. Therefore, the Bank is eligible for deduction of Rs 575 Cr under Section 36(1)(viia)(a).

B. Deduction under Section 36(1)(vii)

In the computation of income, the Bank claimed deduction of Rs 880 Cr for urban bad debts write-off under Section 36(1)(vii). Since, the Bank is claiming deduction under Section 36(1)(viia), it is required to maintain one provision account under Section 36(1)(viia) in view of the 36(2)(v). Further, in view of the first proviso to 36(1)(vii), the deduction for bad debts write-off under Section 36(1)(vii) for the assessees who claim deduction under Section 36(1)(viia), shall be limited to the amount by which such bad debts exceeds the credit balance in the provision account under Section 36(1)(viia). The Bank's provision account under Section 36(1)(viia) for AY 2013–14 was as under:

Provision Account under Section 36(1)(viia) for AY 2013–14

(Rs in Crores)

Rural bad debts written-off under Section 36(1)(vii)	2	Opening balance	
	2000		
		Provision allowed during the year	575
Closing balance	2573		
Total	2575	Total	2575

www.taxguru.in

In view of the first proviso to Section 36(1)(vii), the Bank should have debited both rural and urban bad debts write-off to the provision account first. Only bad debts in excess of the credit balance in the provision account under Section 36(1)(viia) should be allowed as deduction under Section 36(1)(vii). In this case, the bank debited only the rural bad debts write-off (2 Cr) to the provision account under Section 36(1)(viia). The urban bad debts write-off (880 Cr) was not debited to the provision account under Section 36(1)(viia). Since, the bad debt write-off doesn't exceed the credit balance in the provision account, the deduction of Rs. 880 Cr is not allowable.

3. What is the relationship between Clause 36(1)(viia) and Clause 36 (1)(vii)?

In order to understand the critical issue of deduction under Clause 36(1)(viia)(a) and its relationship with Clause 36(1)(vii), it is necessary to understand the background of Clause 36(1)(viia), which is mentioned along with the relevant circulars in the paragraphs below:

3.1 Background of Clause 36(1)(viia)

Any assessee carrying on business is entitled to a deduction under Section 36(1)(vii) of the IT Act, 1961 of the amount of any debt which is written-off as bad debt during the previous year, in the computation of taxable profits subject to certain conditions. However, a mere provision for bad and doubtful debt(s) is not allowed as a deduction in the computation of taxable profits. However, in order to promote rural banking and to assist the scheduled commercial banks in making adequate provisions from their current profits to provide for risks in relation to their rural advances, the Finance Act 1979, w.e.f. 01 April 1980inserted Clause 36(1)(viia) to provide for a deduction, in the computation of taxable profits of all scheduled commercial banks, in respect of provisions made by them for bad and doubtful debt(s) relating to rural advances made. The deduction is limited to a specified percentage of the aggregate average advances made by the rural branches computed in the manner prescribed by the IT Rules, 1962.

3.2 The deduction under Section 36(1)(viia) was initially intended solely for provision made for bad and doubtful debts in respect of rural advances made by rural branches where risk of non-recovery was greater. Initially, when the clause was introduced, it was meant for only Scheduled Banks, which was gradually extended over a period of time to other entities. As the provisions stand today, under Section36(1)(viia), there are four clauses which are applicable to:

- 36(1)(viia)(a): Scheduled & Non-Scheduled and Cooperative banks
- 36(1)(viia)(b): Foreign Banks
- 36(1)(viia)(c): Public Financial institutions etc.
- 36(1)(viia)(d): NBFC

3.3 The Gist of the Amendments to Clause 36(1)(viia)

The gist of amendments and main features are summarized in the following Table 1:

3.4 Double Deduction Allowed for Rural Advances Only - Finance Act 1979

The Clause 36(1)(viia) was first Introduced by the Finance Act, 1979 w.e.f. 01 April1980 and at the time of its insertion, this clause reads as under:

> *'(viia) in respect of **any provision for bad and doubtful debts** made by a scheduled Bank **in relation to the advances made by its rural branches**, an amount not exceeding one and a half per cent of the aggregate average advances made by such branches, computed in the prescribed manner.*

Table 1

Gist of Amendment & Year	Requirement of Provision	Limits of Deduction	Remarks
Finance Act, 1979 (w.e.f.01 April 1980) Any provision for bad and doubtful debts (PBDD)# made in relation to the rural advances	Provision in relation to the rural advances only.	not exceeding 1.5% of AAA*	Applicable to rural branches of scheduled Banks only
Finance Act, 1982 Same as above	Same as above	Same as above	Extended to rural branches of Non-scheduled Banks also
Finance Act, 1985 (w.e.f.01 April 1985) The PBDD had to be created and debited to the P&L a/c	Provision can be in relation to any debt- not necessary to be in relation to rural advances only	not exceeding 2% of AAA OR not exceeding 10% of total income** Whichever is higher	Proviso to Section 36(1)(vii) and 36(2)(v) simultaneously introduced to prevent double deduction
IT (Amendment) Act, 1986 w.e.f 01 April1987. Substituted the present Clause (viia) for the one as substituted by the Finance Act, 1985.	Provision can be in relation to any debt- not necessary to be in relation to rural advances only.	not exceeding 2% of AAA* + not exceeding 5% of total income**	
Finance Act, 2013	Same as above	not exceeding 10% of AAA* + not exceeding 7.5 % of total income**	Explanation 2 was inserted - the account referred to in proviso to Section 36(1)(vii) & 36(2)(v) shall be only one account
Finance Act, 2017	Same as above	not exceeding 10% of AAA* + not exceeding 8.5 % of total income**	not exceeding 8.5 % of total income**

* AAA stands for aggregate average advances of rural branches
** total income (computed before making any deduction under Section 36(1)(viia)&Ch VIA)
# PBDD stands for Provision for Bad and doubtful debts

The CBDT vide its circular no. 258 of 14th June, 1979 clarified that this section is independent of Section 36(1)(vii) and the banks would continue to get full benefit of write-off under Section 36(1)(vii) in addition to the provision for bad and doubtful debts under Section 36(1)(viia). At that stage, the provision was required to be made only in relation to the rural advances. It was a conscious decision to allow double deduction to promote rural banking as explained in the CBDT circular, which is incorporated below:

CBDT Circular No. 258 dated 14.06.1979

'Deduction in respect of provisions made for bad and doubtful debts relating to rural branches of scheduled commercial banks - Sec. 36(1)(viia)

www.taxguru.in

13.1 Under Section 36(1)(vii) of the IT Act, a taxpayer carrying on business or profession is entitled to a deduction, in the computation of the taxable profits, of the amount of any debt which is established to have become bad during the previous year, subject to certain conditions. However, a mere provision for bad and doubtful debts is not allowed as a deduction in the computation of the taxable profits.

13.2 In order to promote rural Banking and assist the scheduled commercial banks in making adequate provisions from their current profits to provide for risks in relation to their rural advances, the Finance Act has inserted a new cl. (viia) in sub-s. (1) of s. 36 of the IT Act to provide for a deduction, the computation of the taxable profits of all scheduled commercial banks, in respect of provisions made by them for bad and doubtful debts relating to advances made by the rural branches. The deduction will be limited to 1-1/2 per cent of the aggregate average advances made by the rural branches computed in the manner to be prescribed by rules in the IT Rules, 1962. For this purpose, a "rural branch" means a branch of a scheduled Bank situated in a place with a population not exceeding 10,000 according to the last preceding census of which the relevant figures have been published before the first day of the previous year. The expression "scheduled Bank" has the same meaning as in the Explanation below s. 11(2)(b) of the IT Act but does not include a co-operative Bank. The expression "scheduled Bank" would, therefore, cover the State Bank of India constituted under the State Bank of India Act, 1955, any subsidiary Bank of the State Bank of India as defined in the State Bank of India (Subsidiary Banks) Act, 1959, a nationalised Bank as specified in Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or any other Bank included in the Second Schedule to the Reserve Bank of India Act, 1934. It may be mentioned that all co-operative banks have been excluded from the purview of this provision in view of the position that under Section 80P(2)(a)(i) of the IT Act, the profits and gains of a co-operative society engaged in the business of Banking or providing credit facilities to its members are completely exempt from income-tax.

13.3 It may be relevant to mention that the provisions of new cl. (viia) of s. 36(1) relating to the deduction on account of provisions for bad and doubtful debts is ***distinct and independent of the provisions of Section 36(1)(vii) relating to allowance of the bad debts.*** *In other words, the scheduled commercial banks would continue to get the full benefit of the write-off of the irrecoverable debts under s. 36(1)(vii) in addition to the benefit of deduction of the provision for bad and doubtful debts under Section 36(1)(viia).*

13.4 This provision will take effect from 1st April, 1980 and will accordingly apply in relation to the asst. yr. 1980–81 and subsequent years.'

In other words, in respect of rural advances, the double deduction was allowed—once at the stage of provision @1.5% of aggregate average advances (AAA) of rural branches and again at the stage of write-off of rural advances under Section 36(1)(vii). The crucial issue which should be kept in mind is that at the stage of first introduction of the clause, the PBDD had to be made only in respect of rural advances and therefore,deduction under Section 36(1)(viia) was also in respect of rural advances.

www.taxguru.in

3.5 Drastic change - No double deduction for any advances

(i) The Finance Act, 1985, w.e.f. 01 April 1985 made following drastic changes:

- The provision was not required to be necessarily in relation to rural advances and it can be in relation to any advances of the bank– rural or urban or both.
- The double deduction in respect of any advances (including rural advances which was allowed as per the Finance Act 1979) was stopped by introducing proviso to Section 36(1)(vii) and 36(2)(v).
- Section 36(2)(v) requires maintenance of one provision account for the deduction allowed under Section 36(1)(viia).
- As per the first proviso to 36(1)(vii), the deduction for bad debts write-off under Section 36(1)(vii) for the assessees who claim deduction for PBDD under Section 36(1)(viia), shall be limited to the amount by which such bad debts exceeds the credit balance in the provision account under Section 36(1)(viia).
- Increased the quantum of deduction to include 2% of AAA or 10% of total income, (whichever is higher).

(ii) The following Clause (viia) was substituted w.e.f. 01 April 1985:

> ***"in respect of any provision for bad and doubtful debts made*** *by a scheduled Bank [not being a Bank approved by the Central Government for the purposes of cl. (viiia) or a Bank incorporated by or under the laws of a country outside India] or a non-scheduled Bank, an amount not exceeding ten per cent of the total income (computed before making any deduction under this clause and Chapter VI-A) or an amount not exceeding two per cent of the aggregate average advances made by the rural branches of such banks, computed in the prescribed manner, whichever is higher."*

(iii)Clause 36(1)(vii) and proviso reads as under:

> *36. (1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28—*
>
> .....
>
> *(vii) subject to the provisions of sub-section (2), the amount of [any bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year]:*
>
> *[**Provided** that in the case of [an assessee] to which clause (viia) applies, the amount of the deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that clause:]*

(iv) Simultaneously, Clause 36(2)(v) was introduced which reads as under:

> *"Sec. 36(2) In making any deduction for a bad debt or part thereof, the following provisions shall apply —*
>
> *(i) to (iv) .....*
>
> *(v) where such debt or part of debt relates to advances made by an assessee to*

www.taxguru.in

which cl. (viia) of sub-s. (1) applies, no such deduction shall be allowed unless the assessee has debited the amount of such debt or part of debt in that previous year to the provision for bad and doubtful debts account made under that clause."

(v) The CBDT in its Circular No. 421 dated 12.06.1985 explained the legislative purpose behind the introduction of proviso to Section 36(1)(vii) and 36(2)(v) which is reproduced below:

The CBDT Circular No. 421 dated 12.06.1985:

"Deduction in respect of provisions made by Banking companies for bad and doubtful debts

17.1 Sec. 36(1)(vii) of the IT Act provides for a deduction in the computation of taxable profits of the amount of any debt or part thereof which is established to have become a bad debt in the previous year. This allowance is subject to the fulfilment of the conditions specified in sub-s. (2) of s. 36.

17.2 Sec. 36(1)(viia) of the IT Act provides for a deduction in respect of any provision for bad and doubtful debts made by a scheduled Bank or a non-scheduled Bank in relation to advances made by its rural branches, of any amount not exceeding 1½ per cent of the aggregate average advances made by such branches.

17.3 Having regard to the increasing social commitments of banks, s. 36(1)(viia) has been amended to provide that in respect of any provision for bad and doubtful debts made by a scheduled Bank [not being a Bank approved by the Central Government for the purposes of s. 36(1)(viia) or a Bank incorporated by or under the laws of a country outside India] or a non-scheduled Bank, an amount not exceeding ten per cent of the total income (computed before making any deduction under the proposed new provision) or two per cent of the aggregate average advances made by rural branches of such banks, whichever is higher, shall be allowed as a deduction in computing the taxable profits.

17.4 Sec. 36(1)(vii) of the Act has also been amended to provide that in the case of a Bank to which s. 36(1)(viia) applies, the amount of bad and doubtful debts shall be debited to the provision for bad and doubtful debts account and that the deduction admissible under s. 36(1)(vii) shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account.

17.5 Sec. 36(2) has been amended by insertion of a new cl. (v) to provide that where a debt or a part of a debt considered bad or doubtful relates to advances made by a Bank to which s. 36(1)(viia) applies, no such deduction shall be allowed unless the Bank has debited the amount of such debt or part of debt in that previous year to the provision for bad and doubtful debt account made under cl. (viia) of s. 36(1)."

(vi) Main purpose of proviso to Section 36(1)(vii) and 36(2)(v):

The double deduction in respect of any advances (including rural advances)was stopped by the insertion of new provisoand clause. The revenue leakage due to double deduction in respect of rural advances was

www.taxguru.in

less pre-1985 and therefore, it was allowed consciously. Post-1985, the provision in the books can be made for urban advances also and thepossible revenue leakage due to double deduction in respect of urban advances would have been much more. Therefore, proviso to Clause (vii) and Clause 36(2)(v) were inserted to stop double deduction mainly in respect of urban advances. However, it was canvassed by the stakeholders that the new insertion was to stop double deduction in respect of rural advances only (which was allowed pre 1985).

3.6 Whether Clause 36(1)(viia) is distinct and independent of 36(1)(vii)?

The banks rely on the CBDT Circular No. 258 dated 14.06.1979 and claim that the Clause 36(1)(viia) is distinct and independent of Section 36(1)(vii) and therefore they are eligible for deduction under both Clauses 36(1)(viia) and 36(1)(vii). The claim of the banks is patently wrong in view of the following:

(i) When the Clause 36(1)(viia) was introduced by the Finance Act 1979 for the first time, it was distinct and independent of Clause 36(1)(vii) which was also clarified in the Circular No. 258 dated 14.06.1979. Therefore, in the case of assesses, who claim deduction for PBDD, the Clause 36(1)(viia) is distinct and independent of Section 36(1)(vii) from 1979to 1985 only.

(ii) The first proviso to 36(1)(vii)and 36(2)(v) were simultaneously introduced by the Finance Act, 1985. Therefore, w.e.f 01.04.1985, in the case of assesses who claim deduction for PBDD under Section. 36(1)(viia), the Clause S.36(1)(viia) is not independent of Section .36(1)(vii).

(iii) Circular No. 258 dated 14.06.1979- Not relevant to the present law.

The amendments made by Finance Act 1985 stopped double deduction – once at the provision stage and again at the write-off stage. This position continues even today. All the banks conveniently fail to take cognizance of this crucial change and continue to harp on the CBDT circular no. 258 dated 14.06.1979 (which was issued in connection with the amendments made by Finance Act, 1979). When the law itself is amended in 1985, there is no reason to rely upon the old circular and old law. At present, the relevant applicable circular is no.421 dated 12.06.1985 (incorporated above) wherein it is clarified in clear terms that no double deduction is allowed. There is not a single circular or instruction of the CBDT after the amendment in 1985, which allows double deduction.

4 Two Limbs of Eligible Deduction

The quantum of eligible deduction underwent periodic changes and it was increased from 1.5% to 10% of AAA (present level) and 10% to 8.5% of total income (present level). The periodic changes are mentioned below:

Finance Act	Limits of deduction under Section 36(1)(viia)(a)
Finance Act, 1979 (w.e.f. 1.4.1980)	Not exceeding 1.5% of AAA*
Finance Act, 1985 (w.e.f 1.4.1985)	Not exceeding 2% of AAA* OR Not exceeding 10% of total income** Whichever is higher

www.taxguru.in

IT (Amendment) Act, 1986 w.e.f01 April1987	not exceeding 2% of AAA* + not exceeding 5% of total income**
Further changes	4% of AAA + 5% of total income
Finance Act, 2013	not exceeding 10% of AAA* + not exceeding 7.5 % of total income**
Finance Act, 2017	not exceeding 10% of AAA* + not exceeding 8.5 % of total income**

* AAA stands for aggregate average advances of rural branches
** total income (computed before making any deduction under Section 36(1)(viia)&Ch VIA)
# PBDD stands for Provision for Bad and doubtful debts

4.1 First limb - 10% of Aggregate average advances (AAA)

As the Clause 36(1)(viia)(a) stand today, the Banks are allowed deduction in respect of the provision made in the books not exceeding 10% of the aggregate average advances made by the rural branches of such Bank computed in the manner prescribed in rule 6ABA. It is noteworthy to mention that amidst all the above periodic changes in clause 36(1)(viia) over a period of time, the rule 6ABA remained unchanged even today since its introduction w.e.f 01.04.1980. Not a comma or word was added/deleted/ substituted in this rule which reads as under:

> ***[Computation of aggregate average advances for the purposes of clause (viia) of sub-section (1) of section 36.***
>
> *6ABA. For the purposes of clause (viia) of sub-section (1) of section 36, the aggregate average advances made by the rural branches of a scheduled Bank shall be computed in the following manner, namely :*
>
> *(a) the amounts of advances made by each rural branch as outstanding at the end of the last day of each month comprised in the previous year shall be aggregated separately ;*
>
> *(b) the sum so arrived at in the case of each such branch shall be divided by the number of months for which the outstanding advances have been taken into account for the purposes of clause(a);*
>
> *(c) the aggregate of the sums so arrived at in respect of each of the rural branches shall be the aggregate average advances made by the rural branches of the scheduled Bank.*
>
> *Explanation : In this rule, "rural branch" and "scheduled Bank" shall have the meanings assigned to them in the Explanation to clause (viia) of sub-section (1) of section 3650.]*

4.2 Second limb - 8.5% of total income

Most of the Scheduled Banks have both rural and urban branches. The second limb to determine the eligible deduction is-8.5% of total income which includes income of both rural and urban branches. However, it is common knowledge that rural branches do not make much profit in view of the very nature of the business activities of rural branches as compared to the urban branches.

5. Is calculation of eligible deduction @ 10% of AAA is an incentive?

The banks claim that Clause 36(1)(viia) is an incentive clause and if it is interpreted that the banks have to adjust both the rural and urban advances write-off against the provision allowed under Section 36(1)(viia), then there is no

incentive. They further claim that even without claiming any deduction under Section.36(1)(viia), the banks can claim deduction under Section 36(1)(vii) in respect of write-off of debts and allowing a deduction slightly ahead of write-off stage is not an incentive perse. Let us examine the claim in the light of the relevant rules and factual position.

5.1 As the Clause 36(1)(viia)(a) stand today, the banks are allowed deduction in respect of the provision made in the books not exceeding 10% of the aggregate average advances made by the rural branches of such bank computed as per Rule 6ABA. The outstanding aggregate average advances are calculated including rural advances made during the year and the rural advances made in the earlier years. This is a huge incentive to promote rural Banking given to the scheduled Banks and other banks which have both rural and urban branches. The following data in respect of a bank clearly illustrates the incentive nature:

in Rs. (Crores)

AY	AAA at the end of year	Incremental advance made during the year	Deduction as per outstanding AAA @ 10%	Deduction as per incremental advance @ 10%	Extra deduction under Section 36(1)(viia)(a) over and above the advances made during the year as incentive
A	B	C	D	E	F= D-E
2011-12	2895	-	-	-	-
2012-13	3593	698	359.3	69.8	289.5
2013-14	5109	1516	510.9	151.6	359.3
2014-15	7373	2264	737.3	226.4	510.9
2015-16	8596	1223	859.6	122.3	737.3

5.2 The above data shows that the rural advances made during the year are very less as compared to the total outstanding balances. However, the deduction is allowed as per the AAA on the basis of outstanding balances at the end of the year which includes earlier years' advances and not on the basis of rural advances made during the year alone. The figures in column D are worked out on the basis of total outstanding AAA and the figures in column E are worked out on the basis of incremental advances made during the year.

5.3 Thus, the extra eligible deduction under Section 36(1)(viia)(a) in "column F" in the above table on the basis of outstanding balances (including earlier years' advances) is nothing but huge incentive for rural Banking.

5.4 It is also quite interesting to note that a Bank with both rural and urban branches is entitled for deduction on the basis of AAA outstanding at the end of the year, even if it has not advanced any fresh rural advances during the year. The only requirement is adequate provision has to be made in the books in relation to any advances—rural or urban or both.

5.5 Apart from that, even if no provision is made in the books in respect of rural advances and no fresh rural advances are made during the year, deduction @ 10% of AAA would still be available (on the basis of outstanding AAA of earlier years), if adequate provision was made in the books for urban advances.

5.6 Further, even if a bank which has both rural and urban branches will get its deduction for provision made in the books under Section 36(1)(viia)(a), even if the total income is NIL/ loss on the basis of 10% of AAA

www.taxguru.in

subject to the provision made in the books of accounts. However, the banks with only urban branches will not get deduction for the provision made, if there is no income.

5.7 The above discussion makes it crystal clear that the calculation of AAA of rural advances (as per Rule 6ABA) and deduction for PBDD in respect of any provisions—rural, urban or both as per the limits of clause 36(1)(viia)(a)-give huge incentive to promote rural Banking.

6. Deduction allowed under Section 36(1)(viia)(a) is not a standard deduction

Let us examine, whether deduction under Section 36(1)(viia)(a) is a standard deduction (without any conditions attached) allowable to all select assesses mentioned in the relevant clauses? The answer is -the deduction allowed under Section 36(1)(viia)(a) is not a standard deduction as in the case of House property income, wherein 30% of annual value is allowed as deduction under Section24 of IT Act without any conditions attached.

6.1 The deduction is subject to the fulfillment of certain conditions under the clause 36(1)*(viia)(a), which is reproduced below:*

(viia) [in respect of any provision for bad and doubtful debts made by—

(a) a scheduled Bank [not being 14[* * *] a Bank incorporated by or under the laws of a country outside India] or a non- scheduled Bank 15[or a co-operative Bank other than a primary agricultural credit society or a primary co-operative agricultural and rural development Bank], an amount 16[not exceeding 16a[eight and one-half per cent]] of the total income (computed before making any deduction under this clause and Chapter VIA) and an amount not exceeding 17[ten] per cent of the aggregate average advances made by the rural branches of such Bank computed in the prescribed manner :

6.2 The deduction under Section 36(1)(viia)(a) is subject to the provision made in the books of accounts in respect of any advances made and subject to the eligible amount as per the formula prescribed under Section 36(1)(viia)(a).

- If no provision made in the books, then no deduction under Section 36(1)(viia)(a) is allowed whatever may be the eligibility.
- If the provision made in the books is less than its eligibility, then the deduction will be allowed only to the extent of provision made in the books.
- If the provision made in the books is more than its eligibility, then the deduction will be restricted to the extent of eligibility.
- After 1985, provision in books is not required to be in relation to only rural advances and it can be in relation to any advances - rural, urban or both.
- Deduction is applicable to only select assesses mentioned.

7. What is the character of the deduction allowed under Section 36(1)(viia)(a)—Is it for rural or urban provisions ?

The banks often quote few lines out of context from decision of the Hon'ble Supreme Court in the case of Catholic Syrian Bank 343 ITR 270 (SC)and submit that in the case of banks with rural branches, the deduction under Clause 36(1)(viia)(a) is allowed for rural debts only.

7.1 In order to appreciate the issue, it is necessary to go through the opening lines of Clause 36(1)(viia)(a) again which are reproduced below:

36. (1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28—

(i) … (vii) …

(viia) [in respect of any provision for bad and doubtful debts made by—

7.2 The deduction allowed under Section 36(1)(viia)(a) is for the provision for the bad and doubtful debts (PBDD) made in the books. Therefore, the character of the deduction allowed - whether for rural or urban provision - obviously depends on the provision made in the books. The simple test to determine whether deduction allowed is for rural or urban provisions is –to see how much provision is made in the books for rural and urban advances.

7.3 Deduction (viia)is only a lump sum figure and not advance specific.

The deduction allowed for PBDD is only a lump sum figure calculated on the basis of formula specified under Section 36(1)(viia)(a). It is not advances wise/ debtor wise/ party wise. It could be in fractions as per the formula and the method of computation prescribed under Rule 6ABA.

7.4 If the provision is made entirely forurban advances, then it can be said that the deduction allowed is only for urban provisions. If the provision is made entirely for rural advances, then it can be said that the deduction allowed is only for rural provisions. If the provision is made for both rural and urban advances, then it can be said that the deduction is allowed for both rural and urban provisions subject to the limits laid down under Section 36(1)(viia)(a).

7.5 In other words, it can't be said that the deduction is allowed only for rural provisions, when the provision is made in the books for both rural and urban advances. Similarly, it can't be said that the deduction is allowed only for urban provisions, when the provision is made in the books for both for rural and urban advances.

7.6 The Hon'ble Supreme Court decision in the case of Catholic Syrian Bank was delivered in the context of the assumption that banks would maintain separate PBDD accounts in respect of rural branches and non-rural branches and therefore it is possible to discern PBDD as one in respect of rural branches and non-rural branches. The Hon'ble Supreme Court in that case never held that the deduction allowed under Section.36(1)(viia)(a) for banks(having both rural and non-rural branches) is in respect of rural provisions only, irrespective of the provision made in the books of accounts. In fact this issue was not there before the Hon'ble Supreme Court.

7.7 The claim that the deduction allowed for the PBDD under Section 36(1)(viia) is for rural provisions is based on old law as existed from 1979 to 1985 only as already discussed in earlier paragraphs. After the amendments by the Finance act 1985, the character of deduction allowed depends on the provision made in the books of accounts. In practice, it is observed that only 5 to 10% of the PBDD in the books is for the rural advances and 90% to 95% of the PBDD is for urban advances. It is utterly baseless to

www.taxguru.in

claim that the deduction allowed is entirely for rural advances Section 36(1)(viia)(a), when the provision made in the books for rural advances is only 5%–10%.

8. If substantial eligible deduction is attributable to First limb (10% of AAA), it doesn't mean deduction allowed is for rural provisions

The eligible amount of deduction is as per the formula- 10% of AAA (first limb) and 8.5% of total income (second limb). It is observed that substantial eligible amount of deduction is attributable to first limb (10% of AAA of rural advances) and the contribution from the second limb is negligible. Based on this, the banks also contend that the deduction under Section 36(1)(viia)(a) allowed to them is for rural provisions only. This is the biggest fallacy in the minds of the banks. Just because, substantial portion of eligible deduction comes from 10% of AAA of rural advances, it is wrong to conclude that the deduction allowed is automatically for rural provisions. As explained above, it depends on the provision made in the books of accounts.

9. Why only one provision account under 36(1)(viia)(a) to prevent double deduction?

The Finance Act 1985, made amendments to stop double deduction in respect of rural advances by introducing proviso to 36(1)(vii) and 36(2)(v). As per 36(2)(v), the assesses claiming deduction under Section 36(1)(viia) are required to maintain only one account for the provision allowed under Section 36(1)(viia) in respect of all advances - rural or urban. The same thing was clarified by Explanation 2 to Section 36(1)(vii),inserted by the Finance Act, 2013.

9.1 The mechanism put in place by the Finance Act 1985 to prevent double deduction is absolutely necessary and the best in view of the following reasons:

(i) The deduction under Section36(1)(viia)(a) is allowed to the extent of provision made in the books of accounts subject to the limits.

(ii) As explained below, in the case of a Bank with either only rural branches or only urban branches, it would be much easier to link the provision made and deduction allowed.

For example R Bank has only rural branches,

- All its advances would be from rural branches
- Provision made in the books also would be in respect of rural advances.
- Eligible for deduction under Section 36(1)(viia)(a) under both limbs:

  @ 10% of AAA and

  @ 8.5% of total income of only rural branches.
- Deduction @ 10% of AAA limb will be available, even if there is no income.
- Since, provision in the books is made in respect of rural advances only, the deduction allowed under Section 36(viia)(a) is also in respect of rural provisions.
- Since the deduction under Section 36(1)(viia)(a) will be allowed only to the extent of provision made in the books of accounts, it would be much easier to link the provision made in the books and deduction allowed.

For example U Bank has only urban branches,

- All its advances would be from urban branches
- Provision made in the books also would be

in respect of urban advances only

- Deduction would be allowed under Section 36(1)(viia)(a) not exceeding @ 8.5% of total income which would be in respect of income of urban branches only.
- If there is no income, then the deduction would be NIL.
- Since the deduction under Section.36(1)(viia)(a) will be allowed only to the extent of provision made in the books of accounts, it would be much easier to link the provision made in the books and deduction allowed.

(iii) Things get much complicated in the case of a Bank which has both rural and Urban branches in view of the discussion below:

For example RU Bank has both rural and urban branches

- Provision can be made in respect of both rural and urban advances in the books.
- RU Bank will be entitled for deduction on account of both limbs:

  o @ 10% of AAA and @ 8.5% of total income.
- The eligible deduction under first limb is 10% of AAA of rural branches.
- The deduction on the basis of second limb will include income of both rural and urban branches. If there is no income, then the calculation would be NIL on second limb.
- Even if the total income is a loss, RU Bank (which has both rural and urban branches) will continue to get its deduction under Section.36(1)(viia)(a),as it is entitled for deduction under the first limb of the eligibility @10% AAA.
- Apart from that even if provision is made in the books in respect of urban advances only and no fresh rural advances are made during the year, eligible deduction @10% of AAA would be available (on the basis of outstanding AAA of earlier years), if adequate provision is made in the books for urban advances.
- However, the deduction under Section.36(1)(viia)(a) will be allowed only to the extent of provision made in the books of accounts. If no provision made in the books, no deduction under Section 36(1)(viia)(a) is allowed whatever may be the eligibility as per formula. If the provision made in the books is less than its eligibility as per the formula under Section.36(1)(viia)(a), then the deduction will be allowed only to the extent of provision made in the books. If the provision made in the books is more than its eligibility, then the deduction will be restricted to the extent of eligibility as per the formula.
- The deduction allowed for PBDD is only a lump sum figure calculated on the basis of formula specified under Section 36(1)(viia)(a). It is not advances wise/ debtor wise / party wise. It could be in fractions as per the formula,the method of computation u/r 6ABA and provision made in the books. It will not be possible to link the provision made in books in respect of rural/ urban advances with the provision allowed under Section. 36(1)(viia)(a) every year.

(iv) As explained above, the complexities in the formula based deduction are much more in the case of banks having both rural and urban branches than a Bank with either only rural or only urban branches. Therefore, the maintenance of one provision account under Section 36(1)(viia) is absolutely necessary in the case of banks having both rural and urban branches.

www.taxguru.in

(v) In view of the inherent complexity involved in the formula based deduction under Section36(1)(viia)(a) and the inability to link the provision made in books in respect of rural/ urban advances with the deduction allowed under Section 36(1)(viia)(a) for PBDD every year, the Finance Act 1985 introduced only one provision allowed account under clause 36(1)(viia) in respect of provision for bad and doubtful debts which shall relate to all types of advances, including advances made by rural branches.

(vi) The same thing was clarified by inserting Explanation 2 to section 36(1)(vii) by the Finance Act, 2013. The Explanation reads as follows:

> "Explanation 2.—*For the removal of doubts, it is hereby clarified that for the purposes of the proviso to clause (vii) of this sub-section and clause (v) of sub-section (2), the account referred to therein shall be only one account in respect of provision for bad and doubtful debts under clause (viia) and such account shall relate to all types of advances, including advances made by rural branches";*

(vii) Explanation 2 to Section 36(1)(vii) was inserted in view of the Hon'ble Supreme Court decision in the case of Catholic Syrian Bank. The Hon'ble Supreme Court decision in the case of Catholic Syrian Bank was delivered in the context of the assumption that banks would maintain separate PBDD accounts in respect of rural branches and non-rural branches and therefore it is possible to discern PBDD as one in respect of rural branches and non-rural branches. The assumption was that when there are two distinct provision accounts, when the write-off takes place, it would be adjusted with the respective provision accounts. Hence, the question of double deduction does not arise.

(viii) There is no basis to say that the explanation is only with prospective effect. There is no amendment in the proviso to Section 36(1)(vii) and 36(2)(v) since its introduction in 1985. In view of the above discussion, the provision account under Section 36(1)(viia) was always only one provision account. The Explanation 2 only reiterated the same.

10. Conclusion

It is observed that many banks are maintaining only one provision allowed account for both rural and urban advances even prior to the insertion of Explanation 2. The only hitch is that they assume that the deduction allowed under clause (viia) is entirely for rural provisions irrespective of the provision made in the books and do not debit the urban bad debt write-off to the provision account grossly violating the proviso to Sections 36(1)(vii) and 36(2)(v). Their claim that the deduction allowed for the PBDD under Section 36(1)(viia) is entirely for rural provisions is based on old lawas existed from 1979 to 1985 only. Much water has flown down the Ganges. The time has come to shake them from the cosy comfort of enjoying such double deductions.

* * * * * * * * * *

Alternative Tax Dispute Resolution via Technological (Faceless) Way

Ashok Kumar Saroha
(IRS: 1990)
Principal CIT (O&MS)

Ashok Kumar Saroha, is an officer belonging to 1990 batch of Indian Revenue Service. He has a wide range of experience in the Income Tax department as well outside the department (on deputation to various departments of the Govt.). Basically, he is a qualified Computer Engineer from IIT. After joining IRS he took keen interest in law and also acquired degree in Law. Also, he has keen interest in using new technology based procedures for transforming the image of the department into that of collecting taxes efficiently and in non-intrusive way as well as delivering quick and efficient tax payer services. Presently he is Principal Commissioner of Income Tax working as ADG(O&MS).

Executive Summary

Income Tax Department is undergoing a paradigm shift in its approach towards taxpayers. The colonial mind-set of treating a taxpayer as an adversary has vacated the seat for a modern and logical approach to treat a taxpayer as an important stakeholder in the tax administration system. However, Income Tax being a complex law, the disputes are bound to arise.

Litigation is a cost on the credibility of a tax administration system as well as an indicator of the robustness and fairness of a system of taxation. While litigation in tax laws is inevitable, such high volume of litigation results in creation of huge amount of tax arrears as uncollectible and irrecoverable demand. Besides, it is a major impediment towards creating an environment of tax certainty for the taxpayers. It also imposes avoidable costs on account of efforts to realize taxes blocked in these appeals.

Negotiation process is not only the most preferred path, it is also the most expedient method to avoid and if necessary, settle any dispute. However, it was not being preferred so far mainly because there cannot be any reliable yardstick to judge whether the discretion has been used in a bona-fide manner and therefore, it would possibly invite unnecessary complaints. Now, with the Department taking various steps to enter into the faceless era, there is hardly scope for such (mis)apprehensions.

Therefore, a faceless system of providing Alternate Tax Dispute Resolution (ATDR) by mediation is proposed. It will be faceless and would be settled on the day of mediation hearing. The Taxpayer can avail this route for settling dispute at two stages. The first stage would be pre-finalization stage of assessment. Idea is to settle dispute at draft assessment order stage. The second stage would be at post-first-appeal stage. It is also proposed that this route should be opened for any number of issues being part of draft assessment order. For this purpose, an amendment would be required in the Section 270AA.

www.taxguru.in

INTRODUCTION

1. The citizen-centric approach of the Income Tax Department is a paradigm shift from the hitherto adversarial approach prevailing since colonial times. Today, the taxpayer is an important stakeholder in the tax administration system. Hence the design of tax administration is coupled with approaches of both firmness and dignity towards the taxpayers. However, Income Tax being a complex law, the prevalence of disputes cannot be obviated. Therefore, Litigation Management is an important part of the tax administration system.

2. The CBDT has always accorded high priority to effectively manage litigation. Various instructions and circulars have been issued from time to time. Special mention is to be made of raising monetary limits for filing appeals before various judicial for a starting from ITAT. Standard Operating Procedure has also been issued on filing of appeals/ SLPs in Supreme Court, High Court and ITAT. Schemes to settle pending disputes such as *Vivad se Vishwas* Scheme of 2020, Direct Tax Dispute Resolution Scheme, 2016 and *Kar Vivad Samadhan* Scheme of 1998 have been launched to reduce tax litigation.

3. The position of pendency of appeals before CIT(A) as per data published in Central Action Plan for FY 2019–20 would give an idea of magnitude of the problem. While the number of new appeals instituted before the CsIT(A) during the year has increase substantially, the disposal of such appeals is marginally lower as compared to preceding year.

3.1 Although there are serious doubts about the reliability of the litigation data maintained by the department for the cases filed before ITAT and higher judicial fora, however, the following data maintained by the Directorate of Income Tax(R&S) clearly goes with the perception that we are a litigating nation.

3.2 The following data is available with the Directorate of Income Tax(R&S) relating to disputed amount for Quarter ending September 2020. This is because data is being provided by CCsIT in Quarterly Progress Report(QPR) only refers to disputed amount and not tax effect.

Table 1

Details	FY 2017–18	FY 2018–19
No. of appeals pending with CsIT (A) as on 1st April	3,28,173	3,21,020
No. of new appeals instituted during the year	1,17,150	1,40,715
No. of appeals disposed of by CsIT (A) during the year	1,23,480	1,20,251
Closing number of appeals	3,21,843	3,41,484
Demand involved in appeals at the end of the year (Rs. crore)	6.38 lakh	5.71 lakh
Demand stayed by ITAT/Courts at the end of the year (Rs. crore)	87,035	1,15,837

Table 2

No. of Appeals by the	Quarter Ending September 2020			Quarter Ending December 2020*		
	ITAT	HC	SC	ITAT	HC	SC
Department	14789	19976	3664	16153	25070	4112
Taxpayer	15480	6334	614	17009	7462	660
Total	30269	26310	4278	33162	32532	4772

*Provisional

Table 3

Appeal by	ITAT		HC		SC	
	Number	Disputed Amount (Rs. Crores)	Number	Disputed Amount (Rs. Crores)	Number	Disputed Amount (Rs. Crores)
Department	14789	957941	19976	3761596	3664	23724
Assessee	15480	792826	6334	2540679	614	930
Total	**30269**	**1750767**	**26310**	**6302275**	**4278**	**24654**

3.3 Litigation is a critical indicator of the judiciousness of a system. While litigation in tax laws is inevitable, overflowing number of cases in litigation are non-productive in as much as they result in huge tax arrears and non-collectible demand. Consequently, besides cost overrun for tax administration, it also creates an aura of uncertainly for taxpayers which is not at all desirable. Sustained efforts have been made and need to be maintained to reduce the number of cases in litigation and minimize the quantum of tax in arrears.

4 Introduction of Alternative Tax Dispute Resolution (ATDR) through negotiations

Trusted negotiation process is not only the most preferred path, it is also the most expedient method to avoid and if necessary, to settle any dispute. The trusted process has now been augmented by technological advancements to accord an opportunity of faceless negotiation.

4.1 International ATDR Best Practices

Though internationally there are prevalent systems of ATDR, nowhere it is faceless. Let us briefly study the practices:

(a) In the **USA**, tax system follows pre-filing agreement program, where the Pre-filing Agreement (PFA) is executed before filing of the return. The programme called Compliance Assurance Process (CAP) is available to large tax payers with complex tax issues. The US tax system also has ADR process during audit (scrutiny) in the form of early referrals to appeals and Fast Track Settlement (FTS) through trained mediator from the IRS Office of Appeals.

(b) In the **UK**, the ADR is a legal process of resolving disputes through a neutral and impartial Her Majesty Revenue & Customs (HRMC) facilitator. This process does not impinge upon the taxpayer's existing review and appeal rights

(c) In **Australia**, the tax office (ATO) publishes Dispute Management Plan (DMP) every year with focus on early engagement and direct negotiation for recovery of unpaid tax liability, and independent review of audit position (assessment).

(d) In **Germany**, the first step in the procedure is militating before the same office making the alleged decision which is to be done within one month from its notification. This office tries to settle the issues in an informal manner by openly discussing the case with the taxpayer. Most disputes ranging from 60%–90%, depending on the office, are disposed of as a result of this discussion. Only when the taxpayer is not satisfied and willing to go to court, is there a formal reasoned decision on the protest, notified to the taxpayer, who

www.taxguru.in

is allowed to go to the court within one month. An action before the court is only possible, in principle, if the taxpayer has first exhausted the out-of-court appeal proceedings. While the case is before the court, it still continues to be under the responsibility of the appeals official, who continues discussions with the taxpayer, often reaching an agreement, under which the taxpayer withdraws the case from the court. In other cases, the judge often convenes a pre-trial meeting, where the appeals officials represent the tax administration. The role of the judge is very active, directing the discussion as a sort of conciliator, trying to get the parties to an agreement. The pre-trial meeting is very informal and speedy (typically scheduled for about 2 hours). Proofs and documents are personally analyzed by the judge. When an agreement is reached, the judge writes a report, and the tax administration makes the agreed decision. When there is no agreement a public trial is convened before the court, which issues a ruling on the case.

(e) In **Italy**, mediation procedure has been introduced for complaints against tax agency decisions with a value upto 20,000 Euros. Controversies without specified value (e.g., denial of registration) are not subject to the mediation phase of the procedure. The goal of the procedure, which is a mix between ADR and traditional protest before the tax administration, is to discharge the judiciary of tax complaints and improve relationships between taxpayers and the tax administration, giving the latter the opportunity to correct mistakes. Mediation in this procedure differs from the mediation provided for, in civil and commercial controversies and is alternative to judicial mediation, which is excluded in these cases. The procedure does not suspend the obligation to pay the tax and is a pre-requisite for judicial appeal. The grounds for the complaint must coincide with the grounds for the judicial appeal and the papers to be filed consist of an administrative protest, explaining the motives (of fact and law) of the complaint, filed before the tax agency's provincial or regional tax directions issuing the protested decision, within 60 days of its communication. This protest can be accompanied by a reasoned proposal for mediation which can include a concrete amount of tax.

4.2 In India, the ADR in the form of conciliatory mechanism exists in Section 89 of the Civil Procedure Code (CPC),Chapter V of New Consumer Protection Act; Section 442 of Companies Act, 2013 read with the Companies (Mediation and Conciliation) Rules, 2016;Section 12A of Commercial Courts Act, 2015;Section 18D of MSMED Act, 2006 and Section 32(g) of the Real Estate (Regulation and Development) Act, 2016. However, in none of the existing ADR mechanism under the above stated Acts, the government is a party which is executing a sovereign function of revenue collection. The proposed ATDR is a major deviation, in this sense. Again, none of the exiting ADR mechanism under the above stated Acts is faceless.

4.3 Existing Mechanism of ATDR under the IT Act, 1961.

i) **DRP:** The Act provides for Dispute Resolution Forum (DRP) at pre-assessment stage for the foreign companies and Associated Enterprises (AE) entities under Section 144C.

ii) **AAR**: There is provision for Authority for Advance Ruling (AAR) under Chapter XIX-B of the Act for adjudicating on taxability of the transactions by or with non-residents. The provisions have limited scope of application to resident taxpayers.

iii) **ITSC:** Income Tax Settlement Commission (ITSC) under Chapter XIX-A of the Act for one-time settlement of tax dues. However, it has limited the scope because this route can be exercised only before assessment is finalized and a taxpayer can take this route only once. Small/marginal tax-payers don't avail the provisions of the Settlement Commission as the tax has to be paid before going to the Settlement Commission.

iv) **Section 270AA**

Any tax-payer can pay tax and interest as per the assessment order and apply for immunity from imposition of penalty under Section 270A and launching appreciation under Section 270C or Section 276CC. However, this route is available, only if the taxes are paid on all issues under dispute.

4.4 It is also observed that the ATDR systems as indicated in Para 4.3 above, have restricted application to large number of taxpayers and litigants. Therefore, suitable amendments would be necessary in the relevant sections, especially, Section 270AA.

5. Pre-assessment (ATDR Stage-I)

i) The AO shall pass a draft assessment order which shall be uploaded on system along with copies of the evidences relied upon to make the additions proposed in the draft assessment order. The draft assessment order along with copies of the relied upon evidences would be served upon the tax-payer via e-mail and would also be available for download on portal.

ii) Within 30 days of the service of draft order, the tax-payer will exercise his choice for pre-assessment ATDR.

iii) In case of tax-payer not choosing the Pre-assessment ATDR route, the AO would pass final assessment order as per the draft before time barring date.

iv) In case of the tax-payer choosing ATDR route, he/she may file his/her objections/ or claims online. Pr. CIT will cause to upload issue-wise comments of the AO and Range Head and upload the missing requisite material, if any, used in the draft assessment.

v) One National Centre will be having a software for replacing identity indicators like Name, PAN and Phone No. etc. After identity indicators have been removed, scheduling of the meetings in virtual environment would be done.

vi) On the day of the meeting, tax-payers, mediators and mediating officials shall be attending in virtual environment. A software shall allocate mediator and mediating officials to a case and the requisite access of the documents would be allowed to the mediating official alongwith comments of the Pr.CIT. Once, the mediating officials are through with their study of draft assessment order, relied upon documents and comments of the Pr.CIT, their leader would give a signal and tax-payer and/or his counsel, mediator and mediating officials would be directed to a particular (virtual) room where guided negotiations(guided by the mediator) would take place.

www.taxguru.in

vii) A case would be mediated within that day itself.

viii) In case mediation is not over in one day, the tax-payer can ask for one more opportunity (which would be final and more than two opportunities would not be afforded). However, a new set of mediator and mediating officials would be allocated afresh just before the starting of the meeting.

6. Powers and Functions of Mediator and Mediating Officials

i) The mediator will not have any power to adjudicate and shall only be a facilitator.

ii) After the mediation process, any or all of the proposed addition, as agreed by both parties shall be recorded/reduced in writing, duly digitally signed by both the parties and uploaded on the system. It shall be transmitted to the AO by the system.

iii) The AO shall pass the final order within 15 days of the receipt of the mediation report, incorporating the settled amount and tax payable thereupon with notice of demand under Section 156, as also the incomes/amounts which were not settled. On agreed items/issues there will not be any appeal admissible before any authority.

iv) In case of non-agreement of any, or all, issue/proposed addition, the tax-payer may follow the normal appeal route.

v) In the Alternate Tax Dispute Resolution (ATDR) process, the role of mediating official will be to present the side of the revenue in an efficient and professional way and to ensure that all relevant facts are considered and dispute is resolved on the date of the meeting, so as to avoid protracted litigation.

7. Post-First-Appeal ATDR in Respect of Cases Pending before SC/HC/ITAT

i) The mechanism of ATDR at this stage would be similar to pre-assessment ATDR with the only modification being that rank of mediators would be higher.

ii) Where an appeal is admitted and pending before ITAT/HC/SC, and the tax-payer is willing to settle the dispute to avoid protracted litigation, he may approach the Principal CIT online, seeking mediation anytime before the final date of hearing.

iii) Pr.CIT shall apply for leave of ITAT/HC/SC for mediation of the dispute in a time bound manner, cause to upload copies of the relevant assessment/appeal orders, copies of the evidences replied upon in any of the orders and issue-wise comments of the AO, Range Head and Pr.CIT.

iv) Afterwards, the role of the National Centre for replacing identity indicators would start and after identity indicators have been removed, scheduling of the meetings in virtual environment would be done like pre-assessment stage ATDR.

8. General

i) Directorate of Income Tax (L&R) or any other Directorate as the CBDT may decide, may be responsible for forming related policies, including qualification and procedure to appoint mediators. This Directorate may also decide policy to assign level of mediating officials/team of mediating officials for a particular class of cases.

ii) The application for mediation shall be decided within 3 months of applications in pre-assessment stage and within 3 months of Leave of ITAT/HC/SC in Appellate stage.

iii) After completion of mediation/ agreement or no agreement, the ITAT/ HC/SC shall be informed accordingly for withdrawal of appeal or continuation of appeal, within 30 days.

iv) In case of an issue agreed/settled through ATDR, tax amount involved shall not be liable for interest under Section 234A/234B/234C and under Section 220(2). No penalty shall be leviable. Also, the taxpayer shall be immune from prosecution under the Income-tax Act, 1961, for that year.

v) The principle of Res Judicata shall not apply to the issues settled through ATDR with respect to the amounts/issues settled in respect of the assessee or any other tax-payer for any Assessment Year in respect of any claim before AO/CIT(A) or any court of law.

vi) The dispute settled shall not be construed to be an act of interpretation of law, and or acceptance of taxpayer's/Revenue stand or claim in legal terms, and shall not becited/admissible in any court of law as legal viewpoint/position of the Department, in any other case.

vii) The application and/or settlement before the mediator shall be liable to be rejected or annulled, if during the course of the proceeding, or later on, it is detected/found that the tax-payer has misrepresented/concealed any material facts which were in his knowledge/ possession, with mala fide intention.

viii) The period of payment of full amount of tax on settled issue shall be 30 days from the agreement. In case of non-payment, the agreement shall be null and void, and part of tax paid if any, shall not be refunded to the tax-payer, under any circumstances.

ix) Cases involving fraud or having serious violation of other laws like Prevention of Money Laundering Act, Foreign Exchange Regulation Act and other Acts(to be prescribed by the CBDT) will be outside the scope of ATDR.

x) Any determination of income and/or payment of tax under ATDR process, will not be having any bearing on violation of any other laws, and will not be cited as evidence for defence before any court of law.

9. It is recommended that legislative provisions are introduced in line with Section 442 of the Companies Act, 2013 for the creation of Mediation Panel, in the IT Act, 1961. The suggested procedure and eligibilities may be brought through the notification of relevant rules.

ACKNOWLEDGMENTS

Reference is made with gratitude to the following Reports/Material:

i. Central Action Plan for FY 2019–20,

ii. Report of Committee to Examine Litigation Management(Part-I): March, 2019, and

iii. Report of Direct Tax Litigation Data Committee: 31st May 2021

* * * * * * * * * *

www.taxguru.in

Convergence of the Wings of International Taxation & Transfer Pricing

Anantharaman N.V. Iyer
(IRS: 2007)
Addl. CIT (Admn.),
O/o Pr. CCIT-Kanpur

Anantharaman N.V. Iyer has done masters in commerce from Bombay University and LLB from Delhi University. He has worked in different charges including 2 years as Jt. CIT (International Taxation) Range-Noida with jurisdiction over entire State of Uttar Pradesh.

Executive Summary

The article analyses functions of International Taxation and Transfer Pricing wings and highlights their complementarities & common applicability of concepts like Arm's Length Pricing.

It suggests a working convergence between the two wings with the object of correct determination of India's taxing rights on the income of a foreign enterprise that is earned out of business connection or for services rendered in India. Need for such a convergence and an integrated approach, is emphasized by analysing ratio-decidendi of Hon'ble Apex Court judgments.

It also suggests strategy for the said convergence in the present set-up i.e. within the existing frame-work.

I. INTRODUCTION

'Integration' is the current buzzword in management, be it private corporates or government corporations. The old school of thought hovering around concepts like 'division of labour', 'specialisation' etc. aimed at improving quantity and quality of output, though effective in the shortrun, but in the longrun these have been responsible for ushering in Silo-Bin Culture and Turf-War within an organisation, which at times even threaten the very existence of the organisation itself.

II. FUNCTIONS OF INTERNATIONAL TAXATION & TRANSFER PRICING WINGS

a. International Taxation Wing

Department's International Taxation Wing is responsible for assessment and taxation of income of non-residents which

www.taxguru.in

accrue or arise in India, as provided for, under the Income-Tax Act, 1961 subject to DTAA (Double Taxation Avoidance Agreement) with the country where such non-resident is a resident for tax purpose

In line with the above function, it is also entrusted with the work relating to verification of Form 15CA/ 15CB, for verifying whether correct TDS have been deducted from foreign remittance and in case of failure initiate action under Section 201(1)/201(1A) for collecting amount of TDS from the deductor, levy penalty under Section 271-C/271-I, etc. Besides, this wing is also responsible for the work of processing and verification of applications under Sections 195/197 (Certificate for lower or NIL rate of TDS), under Section 230 (Tax clearance certificate to those who wish to leave the country), as a measure of Tax Payer Service.

i) Why (International Taxation)?

Conventionally, taxation is based on the residential status of assessee i.e. the country where assessee is residing gets the right to levy tax on the global income of the assessee, which is referred to as **Residence Rule of Taxation**. India also adopts such a policy in its tax laws.

With proliferation of MNEs (Multinational Enterprises) and globalisation policies of major governments including that of India, there was an urgent need felt for recognising the taxing rights of the countries where the income is actually generated and this gave birth to Source Rule of Taxation, which has been largely accepted by the world over, including multi-lateral bodies like OECD (Organisation for Economic Co-operation and Development, with 38 countries as members and 5 countries including India as key partners).

Justification for Source Rule of Taxation

Taxing right of host country is well-grounded on the fact that its government is providing the MNEs, infrastructure like roads/ports/power etc., a commercially viable atmosphere both socially and legally (facility to register the MNEs intellectual property rights for its exclusive use, legal remedy through host country's courts in case of violation, etc.) and most importantly market from where the MNEs actually derive their income. Besides, it is in the MNEs' interest also to have a continued economic presence in the host country for a sustained and steady source of income.

ii) How (International Taxation)?

Sections 5 and 9 of Income Tax Act, 1961 lay the foundation for International Taxation by providing for taxing the income of non-residents in India.

DTAA(Double Taxation Avoidance Agreement) is the result of negotiation between two sovereign countries (tax jurisdictions) with a common aim of avoiding double taxation, i.e., to subject the same income to taxation in both the countries. This is for giving fillip to commercial cooperation and development of international trade and commerce. Recognition of taxing rights of each country based on assessee's residential status and source of the income, is at the base of such negotiation

www.taxguru.in

culminating in to DTAA, which also provides for cooperation in the form of exchange of information, assistance in recovery of outstanding tax, etc.

Section 90 of the Act provides a legal basis for such DTAAs and for giving credit for taxes paid in one country, in the other country. It also gives primacy to DTAA provisions over the domestic tax laws.

The Act also provides for special provisions for computing business income of non-residents for being subject to tax in India in some specific business, rate of tax, etc. as under:

Section **44 B**	:	for shipping business
Section **44BB**	:	for business relating to exploration/ exploitation of mineral oils
Section **44BBA**	:	for business of aircraft operation
Section **44BBB**	:	for civil construction and certain turnkey power projects
Section **44C**	:	for allowing head office expenses
Sections **44D & 44DA**	:	for royalty income
Section **115A**	:	provides for the rate of taxation in case of royalty and FTS

But the above are subject to the provisions in the DTAA with the relevant country where the assessee is a 'Resident'.

Section 163 of the Act provides for Representative Assessee on behalf of Non-Residents and Section 161 stipulates liability of such Representative Assessees.

Section 195 of the Act provides for TDS (Withholding Tax) on payments to Non-Residents which is chargeable to tax in India. It, along with Section 197, provides for issue of certificate for Lower/ NIL rate of TDS on foreign remittances. Besides, this Section along with Rule 37BBprovides the basis for submission of Form 15CA/CB at the time of outward foreign remittance.

Rule 10 of the Income Tax Rules, 1962 provides modality for determining the income of Non-Residents (mainly MNEs with presence in multiple countries) and is commonly referred to as Rules for Allocation of Income to the Non-Resident or its PE in India for the purpose of taxation.

Status of Rules for Allocation

This Rule, especially in case of business income of a Non-Resident or its PE (Permanent Establishment in India),is subjective, especially where separate accounts are not maintained for the operations in India giving rise to income accruing/arising or deemed to accrue/ arise in India and this aspect has been widely litigated.

Different Methods of Profit Allocation

Authorised OECD Approach provides for two-step approach for arriving at profits attributable to a PE which were:

Step 1: Functional and factual analysis of PE based on FAR analysis

Step 2: Comparability analysis for determining ALP of PEs transactions based on FAR analysis.

FAR analysis is recommended in TP

www.taxguru.in

guidelines and is a study of **Functions** performed, Assets employed and **Risks** assumed, by the PE. Thus, **OECD approach for profit allocation is ALP based TP Rules**.

A popular alternative to the above method of profit allocation is the **'Formulary Apportionment'**, under which method, profits are allocated according to objective metrics of activity such as sales, employees and fixed assets. This method is used by Canada and USA and even European Union for allocating taxing rights among different states/member countries. US Supreme Court case of *Barclays Bank PLC vs. Franchise Tax Board* has observed that this method,also known as the unitary apportionment method, has at least three major advantages over separate accounting system when applied to multi-jurisdictional businesses, which are:

i) It captures added wealth and value resulting from economic inter-dependencies of multi-states and MNEs through their functional integration,

ii) Centralization of management, and

iii) Economies of scale.

On this Rule of Allocation of Profit, we have determination of Indian Courts like the case of *Rolls Royce PLC vs. DIT* [ITA 493/494/496/498/584/648/650 of 2008] wherein Delhi High Court (Judgment dated 30-08-2011) have directed following allocation/attribution of income in relation to the activities conducted in India:

- On Manufacturing activity : 50% of the global profit
- On R&D activities : 15% of the global profit
- On Marketing activities : 35% of the global profit

OECD's approach based on FAR-linked Transfer Pricing method, grossly overlooks demand-side factors such as market, country dynamics, sales volume and efforts, customers' willingness and ability to pay premium which contribute to income generation. This is because in this approach, income is considered as product of the factors of production which is usually located in the jurisdiction from where the goods/services originate and this is usually different from the country where the market is located, thus totally ignoring functions relating to the market.

Supply *vs.* Demand side Approach w.r.t. Rules of Allocation

Business profits are contributed by both demand and supply of goods and therefore, it is very much justified to grant the taxation rights to both the jurisdictions. Accordingly, where the economy of both tax regions in a tax treaty contribute to the business profits, there exists sufficient economic justification for profits to be allotted to both the tax regions, in a manner that avoids double taxation.

Generally, there are three possible approaches for profit attribution:

i. Supply side approach i.e. allocating profit to tax-jurisdiction where factors of production are deployed from;

ii. Demand side approach i.e. allocating profit to tax jurisdiction where consumer is located;and

iii. Mixed or balanced approach.

www.taxguru.in

While the supply side approach favours the developed countries, the demand side approach is extremely relevant for developing countries since the market/ user base is in such countries, where there is demand that is the prime contributor to the income stream of the Non-Resident/ MNEs.

Even global experts have extended their support to demand side approach. As OECD approach is not favoured by India, there is a need for more clarity in this regard. Adoption of diverse yard-stick while invoking Rule 10 causes further confusion. Thus, lack of a universal rule of allocation leads to uncertainty among stakeholders and consequential protracted litigation. Need of the hour is to have a consistent and universal rule of profit allocation to the PE.

Following are some of the approaches, with advantages and disadvantages:

Global formulary approach, in theory, is best suited. But lack of global data may pose a significant challenge in the implementation stage.

Apportionment method allocates income to PE based on three factors, i.e., sales, employee and assets. 'Fractional apportionment' method does not require consolidation of profits of the non-resident. Hence, it is more suited for allocation of income to the PE by multiplying India-specific profits by a fraction based on equal weights assigned to each of the three factors.

b. Transfer Pricing Wing

Transfer Pricing Wing of the department is mainly entrusted with the task of determining the Arm's Length Price (ALP) of international transactions between an assessee who is resident in India and its Associate Enterprise which is either a non-resident or its PE (Permanent Establishment) in India.

Cases are referred to this Wing by the officers of Domestic Taxation Wing for making a TP Audit of a resident assessee and by officers of international taxation wing for doing a TP Audit of Non-Resident's PE in India. Such reference to TP Wing under Section 92CA of the Act, is with the prior approval of respective PCIT or CIT and the transactions as reported by assessee in Form 3CEB Report and those which has otherwise come to the knowledge of Assessing Officer.

Thereafter, TP Wing determines the ALP of the international transactions (both that was referred and that which has come to light during proceedings before TPO) and recommend TP Adjustments to be made in determining the taxable income of the resident AE or the Non-Resident's PE in India.

i) Transfer Pricing: Why?

Minimisation of taxes, based on the difference in the marginal rate of taxation, adopted by countries where Multi-National Enterprises (MNEs) are operating, is one of the primary goals of such MNEs. For this they resort to shifting of profits from high tax rate countries to low or no tax rate countries. One such strategy is arbitrary pricing of transactions between related parties i.e. AEs (Associate Enterprises) which are under the control

of same management like subsidiary companies or group companies. To counter such practices, countries from where the profits are being shifted, adopt tighter TP Regulations. A classic example is the case of Glaxo Smithkline, where US-IRS served notice for additional taxes to the tune of USD 2.7 billion for the period 1989-1996 on the issue of allocation of taxes between USA andother countries, based on valuation of a certain drug especially w.r.t. R&D expenses incurred in UK and marketing expenses.

Cross-border Transfer Pricing influences, distribution of MNEs' profits across countries in which it has business presence. National government is an important stake-holder, as provider of infrastructure and commercially viable atmosphere like registration of patents/ designs/trademarks for exclusive use of it by the owner, provision of various licences, etc. and above all, providing a market from where MNEs are deriving its profits. Further, it also ensures fair distribution of wealth at a global level. The other important stake-holders are shareholders of MNEs whose interest will be adversely affected by penalty or double taxation on account of Transfer Pricing disputes with the taxauthorities of the host country.

When tax authority of host country makes a TP Adjustment, ideally speaking its converse effect should be made in the taxable profits of that MNE in its residence country. But when this is not done, then there is double taxation on such corrected/adjusted part of the profit. To avoid such pitfalls, most MNEs are adopting same set of Transfer Price Indices for tax compliance purposes.

ii) Transfer Pricing: How?

In taxation and accounting, Transfer Pricing refers to the rules and methods for pricing transactions within and between enterprises under common ownership or control. Because of the potential for cross-border controlled transactions to distort taxable income, tax authorities in many countries can adjust intra-group transfer prices that differ from what would have been charged by unrelated enterprises dealing at arm's length. This is called as **Arm's Length Principle (ALP)**, which is recommended by OECD and World Bank. Countries with transfer pricing legislation generally follow OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations with modifications as per its domestic needs.

Where adopted, transfer pricing rules allow tax authorities to adjust prices for most cross-border intra-group transactions, including transfers of tangible or intangible property, services, and loans. For example, a tax authority may increase a company's taxable income by reducing the price of goods purchased from an affiliated foreign manufacturer or raising the royalty the company must charge its foreign subsidiaries for the use of a proprietary technology or brand name. These adjustments are generally calculated using one or more methods specified in the OECD guidelines, subject to judicial review/other dispute resolution mechanisms.

www.taxguru.in

Transfer Pricing effectively refers to a set of substantive and administrative regulatory requirement imposed by a government on certain taxpayers. However, aggressive intra-group pricing, especially for debt and intangibles, has played a major role in corporate tax avoidance and it was one of the issues identified when OECD released **Base Erosion & Profit Shifting(BEPS)** Action Plan in 2013. The final BEPS reports called for country-by-country reporting and stricter rules for transfers of risk and intangibles but recommended continued adherence to the ALP.

Over sixty governments have adopted transfer pricing rules, which in almost all cases (with the exceptions of Brazil and Kazakhstan) are based on the Arm's Length Principle. The rules of nearly all countries permit related parties to set prices in any manner, but permit the tax authorities to adjust those prices (for purposes of computing tax liability) where the prices charged are outside an arm's length range. Most governments permit adjustments of prices charged between related parties, by the tax authority, even where there is no intent to avoid or evade tax. The rules generally require that market level, functions, risks, and terms of sale of unrelated party transactions or activities be reasonably comparable to such items with respect to the related party transactions or profitability being tested.

Adjustment of prices is generally made by adjusting taxable income of all involved related parties within the jurisdiction, as well as adjusting any withholding or other taxes imposed on parties outside the jurisdiction. Such adjustments are generally made after filing of tax returns.

Most systems allow use of transfer pricing multiple methods, where such methods are appropriate and are supported by reliable data, to test related party prices. Among the commonly used methods are CUP (comparable uncontrolled prices), other transactional based methods like cost-plus/resale price/mark-up or profitability based methods like CPM (Comparable Profit Method), TNMM (Transactional Net Margin Method) or Profit Split Method. Many systems differentiate methods of testing goods from those for services or use of property due to inherent differences in business aspects of such broad types of transactions. Some systems provide mechanisms for sharing or allocation of costs of acquiring assets (including intangible assets) among related parties in a manner designed to reduce tax controversy.

In addition, most systems recognize that an arm's length price may not be a particular price point but rather a range of prices. Some systems provide measures for evaluating, whether a price within such range is considered at arm's length, such as the interquartile range used in US regulations. Significant deviation among points in the range may indicate lack of reliability of data. Reliability is generally considered to be improved by use of multiple year data.

Transfer pricing adjustments have been a feature of many tax systems since the 1930s. USA led the development of detailed, comprehensive transfer

www.taxguru.in

pricing guidelines with a White Paper in 1988 and proposals in 1990–1992, which ultimately became regulations in 1994. In 1995,the OECD issued its Transfer Pricing Guidelines which it expanded in 1996 and 2010. The two sets of guidelines are broadly similar and contain certain principles followed by many countries. The OECD guidelines have been formally adopted by many European Union countries, with little or no modification.

Comparability

Most rules provide for standards when unrelated party prices, transactions, profitability or other items are considered sufficiently comparable in testing related party items. Such standards typically require that data used in comparisons be reliable and that the means used to compare produce a reliable result. The US and OECD rules require that reliable adjustments must be made for all differences(if any) between related party items and purported comparables, that could materially affect the condition being examined.

Among the factors that must be considered in determining comparability are:

- Nature of the property or services provided between the parties,
- Functional analysis of the transactions and parties,
- Comparison of contractual terms (whether written, verbal, or implied from conduct of the parties),and
- Comparison of significant economic conditions that could affect prices, including the effects of different market levels and geographic markets.

Functions and Risks

Buyers and sellers may perform different functions related to the exchange and undertake different risks. For example, a seller of a machine may or may not provide a warranty. The price will be affected by this difference.

Functions and risks impacting prices are:

- Product development
- Manufacturing and assembly
- Marketing and advertising
- Transportation and warehousing
- Credit & Collection risk
- Product obsolescence risk
- Market and entrepreneurial risks
- Financial and currency risks
- Company- or industry-specific items

Market Level, Economic Conditions and Geography

Goods, services, or property may be provided to different levels of buyers or users: producer to wholesaler, wholesaler to wholesaler, wholesaler to retailer, or for ultimate consumption. Market conditions, and thus prices, vary greatly at these levels. In addition, prices may vary greatly between different economies or geographies. Buyers or sellers may have different market shares that allow them to achieve volume discounts or exert sufficient pressure on the other party to lower prices. Where prices are to

www.taxguru.in

be compared, the putative comparable must be at the same market level, within the same or similar economic and geographic environments, and under the same or similar conditions.

Testing of Prices

Tax authorities generally examine prices actually charged between related parties to determine whether adjustments are appropriate. Such examination is by comparison (testing) of such prices to comparable prices charged among unrelated parties.

Such testing may occur on examination of tax returns by the tax authority or taxpayers may be required to conduct such testing themselves in advance of filing tax returns and submit report of such study/ test, in a prescribed form. Such testing requires a determination of, how the testing must be conducted, referred to as a transfer pricing method.

Best Method Rule

OECD and US systems, however, provide that the method used to test the appropriateness of related party prices should be amethod that produces the most reliable measure of arm's length results, known as a 'Best Method' rule. Even India follows such a rule. Factors to be considered include comparability of tested and independent items, reliability of available data and assumptions under the method, and validation of the results of the method by other methods.

For the sake of brevity, different methods for testing Prices like CUP (Comparable Uncontrolled Price) method, other transactional methods like cost-plus/resale price/mark-up and profitability based methods like Comparable Profit Method of US Model and TNMM (Transactional Net Margin Method) of OECD model or Profit Split Method are not discussed at length.

CPM and TNMM have a practical advantage in ease of implementation. Both methods rely on micro-economic analysis of data rather than specific transactions. However, care has to be taken to ensure that tested party is that party with the most easily compared functions and risks. Comparing the tested party's results to those of comparable parties may require adjustments to results of the tested party or the comparable for such items as levels of inventory or receivables. Further, what indication of profitability should be used also needs to be settled i.e. net profit on the transaction, return on assets employed, or some other measure.

Intangible Property Issues

The value added by use of intangibles may be represented in prices of goods or services, or by payment of fees (royalties) for use of the intangible property. Licensing of intangibles, thus, presents difficulties in identifying comparable items for testing. However, where the same property is licensed to independent parties, such license may provide comparable transactional prices.

Services

Enterprises may engage, related or unrelated parties, to provide services they need. Where the required services are available within a multinational group, there may be significant advantages to the enterprise as a whole, when a member

of the group performs those services. Two issues exist with respect to charges between related parties for services: (i) whether services were actually performed which warrant payment, and (ii) the price charged for such services.

The inquiry may focus on whether services were actually performed and who has derived benefit therefrom. In this regard, some differentiate stewardship services from other services. The former are those, that an investor incur for its benefit in managing its investments and these cannot be charged to the investee company. Where services were not performed, or where the related party bearing the charge derives no direct benefit, tax authorities may disallow the charge altogether.

Where the services were performed/ provided, benefit for related party bearing a charge for such services, tax rules also permit adjustment to the price charged. Rules for testing prices of services may differ somewhat from rules for testing prices charged for goods due to the inherent differences between provision of services and sale of goods. OECD Guidelines provide that the provisions relating to goods should be applied with minor modifications and additional considerations. In the US, a different set of price testing methods is provided for services. In both cases, standards of comparability and other matters apply to both goods and services.

III. Need for convergence between the wings of International Tax and Transfer Pricing

Complementarity of these two wings viz. International Taxation (IT)and Transfer Pricing (TP) of the Department, have long been recognised and therefore for affording convergence of synergies thereof, these two wings are placed under the administrative control of Pr. CCIT/CCIT (International Taxation) across India. Besides, in many places like Gujarat these two wings are under a single Commissioner.

Further, from the discussion at para II (a) (ii) and II (b) (ii) above, titled 'How (International Taxation)' and 'How (TP-Transfer Pricing)', it is evident that concept of Arm's Length Principles is common to both i.e. Testing of Prices w.r.t. intra-group transactions for allocation of profit to PE for taxing purpose (more popularly known as Allocation Rule) and adjustment of prices charged between related parties (more popularly known as TP Adjustment). As the ALP of intra-group transactions of MNEs is usually determined or checked by the TP Wing and Assessment function in respect of MNEs is undertaken by IT Wing, convergence between these two wings, is not only logical but is in fact a necessity.

Also, ratio-decidendi from the judgments of Hon'ble Supreme Court in the following cases underscores the need for a close coordination between these two wings of the department, by highlighting their complementarity or commonality:

DIT vs. Morgan Stanley & Co. Inc. [CA Nos. 2914/ 2007; Order dt. 09.07.2007] also reported in (2007) 292 ITR 416; 162 Taxman 165 (SC)

> *32. The object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. Under Article 7(2) not*

www.taxguru.in

all profits of MSCo would be taxable in India but only those which have economic nexus with PE in India. A foreign enterprise is liable to be taxed in India on so much of its business profit as is attributable to the PE in India. The quantum of taxable income is to be determined in accordance with the provisions of I.T. Act. All provisions of I.T. Act are applicable, including provisions relating to depreciation, investment losses, deductible expenses, carryforward and set-off losses etc. However, deviations are made by DTAA in cases of royalty, interest etc. Such deviations are also made under the I.T. Act (for example: Sections 44BB, 44BBA etc.). Under the impugned ruling delivered by the AAR, ***remuneration to MSAS was justified by a transfer pricing analysis and, therefore, no further income could be attributed to the PE(MSAS). In other words, the said ruling equates an arm's length analysis (ALA) with attribution of profits. It holds that once a transfer pricing analysis is undertaken; there is no further need to attribute profits to a PE. The impugned ruling is correct in principle insofar as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE. The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered. Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case. Lastly, it may be added that taxing corporates on the basis of the concept of Economic Nexus is an important feature of Attributable Profits (profits attributable to the PE). situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered. Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case.*** *Lastly, it may be added that taxing corporates on the basis of the concept of Economic Nexus is an important feature of Attributable Profits (profits attributable to the PE).*

(emphasis supplied

ADIT vs. E-Funds IT Solution Inc. [CA Nos. 6082 to 6085, 6087 to 6097, 6099, 6100 to 6104/2015 ; 2962/2016 & 16958/2017; Order dt. 24.10.2017] also reported in (2017) 86 taxmann.com 240 (SC)

"22..... Shri Ganesh is correct in stating that ***as the arm's length principle has been satisfied in the present case, no further profits would be attributable even if there exists a PE in India.*** *This was specifically held*

www.taxguru.in

in Morgan Stanley (supra) as follows:"

(emphasis supplied)

Honda Motor Co. Ltd, Japan vs. ADIT [CA Nos. 2834 to 2840/2018; Order dated 14.03.2018]

> *"In the judgment of this Court dated 24th October, 2017 in* ***Assistant Director of Income Tax-I, New Delhi v. M/s. E-Funds IT Solutions Inc.*** *Civil Appeal No. 6082 of 2015 and connected matter, it has been held that once arm's length principle has been satisfied, there can be no further profit attributable to a person even if it has a permanent establishment in India.*
>
> *Since the impugned notice for the reassessment is based only on the allegation that the appellant(s) has permanent establishment in India, the notice cannot be sustained once arm's length price procedure has been followed.*
>
> *Accordingly, the impugned order(s) is set aside and the appeals areallowed."*

(emphasis supplied)

Prior to the above Apex Court Order, the assessee's writ petition was dismissed by Hon'ble Allahabad High Court, by observing as under:

On the aspect of attribution to the PE in India

> *"****Once the Assessing Officer is satisfied that a permanent establishment of the petitioner exists in India and business is being conducted from this permanent establishment, the attribution of profits is a necessary consequence.*** *The order of TPO will not come in the way for the reason that the TPO's order is in relation to the transactions between a subsidiary company and the petitioner. The situation becomes different when the subsidiary company also works as a permanent establishment of the petitioner. Once a permanent establishment is established, the petitioner becomes liable to be taxed in India on so much of its business profits as is attributable to the permanent establishment in India. The order of the TPO is in relation with the subsidiary company and not in relation with the permanent establishment of the petitioner. The transfer pricing analysis is to be undertaken between the petitioner and its permanent establishment which has not taken place as yet.* ***Once a transfer pricing analysis is done, the computation of income arising from international transaction has to be done keeping in mind the principle of arm's length price. Once this is done, there is no further need to attribute profits to a permanent establishment. However, where the transfer pricing analysis does not take into account all the risk taking functions of the enterprise and it does not adequately reflect the function performed and the risk assumed by the petitioner, the situation would be different and, in such a situation, there would be a need to attribute profits to the permanent establishment for those functions/risk that have not been considered.*** *This is precisely what was considered in* ***Morgan Stanley's case (supra)*** *wherein the Supreme Court held:*
>
> *"As regards attribution of further profits to the PE of MSCo where the transaction between the two are held to be at arm's length, we hold that the ruling is correct in principle provided that an associated enterprise (that also constitutes a P.E.) is reimbursed on arm's length basis taking*

www.taxguru.in

into account all the risk- taking functions of the multinational enterprise. In such a case nothing further would be left to attribute to the P.E. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a case, there would be need to attribute profits to the P.E. for those functions/risks that have not been considered. The entire exercise ultimately is to ascertain whether the service charges payable or paid to the service provided (MSAS in this case) fully represent the value of the profit attributable to his service."

Further, we find that the survey was made much after the order of the TPO, which survey and documents so impounded revealed the existence of a permanent establishment of the petitioner and its business operations in India through its permanent establishment without disclosing its taxable income……"

Thus, the department's success in Allahabad High Court was on account of the argument that survey action established the fact of existence of assessee's PE in India and TP Audit completed as on date of reopening of assessment in the assessee's case was that of the subsidiary HCIL and not of Assessee's PE (Permanent Establishment).

International Taxation Wing while referring the case to TPO after survey action informed the fact about the survey establishing the existence of assessee's PE in India.

However, the TPO Order(which is a one-page order stating that the transactions are at Arm's Length Price) even after such later reference, neither make any TP Adjustments nor discusses the evidences gathered during the survey action w.r.t. to the functions performed in India by the said PE (Functions performed by the expatriate employees under the direction and control of the Non-Resident Company) by a thorough examination of the FAR Analysis Report submitted during the TP Proceedings or the services rendered by the said PE w.r.t. sales effected by the assessee in the Indian market, like sharing of market survey report conducted in India by the said PE with the foreign company, which is a major deciding factor w.r.t. the production plan of the foreign company.

Now a days,a new aspect is seen in TPO's Order in the form of a remark that assessee's transactions with its AE are under examination by TPOs of such entities. Here, it is surprising that when any transaction is tested for pricing, it will be seen both with reference to giver and receiver. Although statutory orders may be passed by jurisdictional officer, but findings cannot be divergent, more so when there is no scheme for reopening of TP Proceedings.

IV. Strategy for Convergence

There can be two modes of convergence of International Taxation Wing and Transfer Pricing Wing and these are:

a) Case-specific Convergence:

Officers of International Taxation Wing must inform their counterpart in Transfer Pricing Wing, about all actions initiated against a particular assessee like survey action along with evidences collected thereof for enabling TPO to subject such evidences to an empirical analysis/study for determining income attributable to operations in India, for the purpose

www.taxguru.in

of taxation, based on the functions performed in India by the MNE's PE in India and whether such functions have been considered while deciding the pricing of the transactions between the MNE and its PE or AEs in India.

b) General Convergence:

There can be joint conferences chaired by Pr. CCIT/ CCIT (IT), in which officers at the level of Joint Commissioners and above from both wings i.e. IT and TP can meet at regular intervals, say twice in a year, for general brainstorming on latest trends and techniques.

Besides, the Pr. CCIT/ CCIT (IT) can also call for a conference besides the regular ones, for discussing any specific developments like adverse orders of Court/ AAR or changes in the law or any international events etc. with discretion to decide on the participants on the lines of meeting between Officers of Investigation Wing and Central Charges during the course of assessment of search cases.

V. Conclusion

MNEs looking forward for tax certainty and to minimise avoidable litigation, explain and clearly document how their transfer pricing policy is respecting the fiscal rules of both the host and source country. According to the OECD Guidelines, a functional analysis of their business and activities is provided, describing in detail the functions undertaken, the assets used and the risks incurred by the different divisions involved in the transaction.

Since national governments tend to implement the OECD Guidelines in their own way, different enunciations or clarification are laid down which need to be respected and complied. Detailed information regarding transactions carried out by independent entities may not be easy to obtain and the availability of useful information varies from country-to-country. Main sources of information are government publications, commercial databases, documentation provided by industry associations, etc.

The suggested convergence between International Taxation and Transfer Pricing wings of the department, will pave the way for an integrated approach in determining the profit to be allocated to the MNEs' PE or subsidiary in India, on scientific principles with less scope for controversy and litigation, thereby safeguarding India's taxing rights on the income attributable to the said MNEs for the services actually rendered in India, whether directly or through its PE or AE.

* * * * * * * * * *

www.taxguru.in

Demystifying Global Minimum Tax

Bidisha Chintey
ACIT, ReAC-AU(5), Mumbai

Bidisha Chintey is an Assistant Commissioner of Income Tax currently posted in the Assessment Unit in the Regional e- Assessment Center, Mumbai. She has done her MBA from IIM Bangalore and has worked in RBI, Hindustan Unilever and Bharti Airtel before joining the IRS.

Executive Summary

Multinational companies today operate in a highly global, digitalized environment. Countries eager to attract FDI provide an incentive to multinationals to shift their profits there by lowering their corporate tax rates. This in turn has led to a "30 year-old corporate tax race to the bottom". The OECD had initiated discussion on a Global Minimum Tax rate through release of its Pillar II Blueprint in October 2020. However, the idea of a Global Minimum Tax has recently gained traction at the recently concluded meeting of the G7 nations in June, where the idea of a 15% global minimum tax was mooted.

In June 2021, the G7—an informal group of rich countries that comprises of the USA, the UK, Japan, France, Italy, Germany and the European Union reached a landmark accord on a 'Global Minimum Tax'. This global minimum tax has been the result of intense negotiations, particularly between the USA and the EU. The consensus reached by these nations during the recent G7 meeting in June has been hailed by Treasury Secretary Janet L. Yellen as a landmark deal that will bring to an end a '30-year race to the bottom on corporate tax rates'' The Global Minimum Tax purports to put a floor on effective tax rates applied to global earnings of multinational companies, thus reigning in on BEPS practices that are widely prevalent.

The proposal for a global minimum tax was also mooted in the USA Budget for the year 2022. In October 2020, the OECD released a series of documents in relation to its ongoing project 'Addressing the Tax Challenges of Digitalization of the Economy'. These documents included two blueprints. Under Blueprint 2, a global minimum tax was proposed to address BEPS issues.

THE NEED FOR A GLOBAL MINIMUM TAX

Organizations today are turning increasingly global with operations and markets spread across countries. Traditionally, the decision for locating a subsidiary in a particular geography was

governed by the factors of production available at that location. However, the footloose nature of many industries today has made the Corporate Income Tax rate the key criteria for such decision. This, in turn, has spurned competition amongst nations to attract FDI. Nations compete against each other by undercutting tax rates, thus giving rise to a 'corporate tax race to the bottom'. Consequently, countries which otherwise would have taxing rights over these companies lose out on potential revenues that could have been used to support investment decisions. According to estimates, a whopping $245 billion is lost each year due to global corporate tax abuse. (Tax Justice Network, 2020).

Today, the epi-center of business has shifted from the brick-and-mortar store to the digital space. For companies, their most valued assets are no longer machines and equipment, rather intangibles such as patents, software, IPRs etc. The fluid nature of intangible assets has made it possible to migrate the incomes arising from such assets to low tax jurisdictions.

While discussion on international tax reforms has been going on since the past few years, the pandemic seems to have accelerated the need for reaching a consensus amongst economies.

The pandemic has seen substantial fiscal support by governments across the globe, resulting in glaring fiscal holes in their national budgets. The national debt levels are expected to remain elevated in the near term, nudging governments to reinvigorate their efforts on reforming the global tax system.

UNDERSTANDING THE GLOBAL MINIMUM TAX

The existing international taxation rules are more favorable to resident countries, while the source countries enjoy limited rights to tax corporate profits of organization. The proposal by G7 aims to reallocate taxation rights between jurisdictions. Under the new proposal, source countries will have the right to tax 20% of profits above a margin of 10%.

Under the second part of the proposal, a minimum 15% tax would be applied on the global income of multinational companies. The successful implementation of the second part hinges on each country passing effective legislation that a company headquartered in that country pay minimum 15% tax in each of the countries in which it operates. Companies paying lesser than 15% in a particular country will make up for the deficit amount in their home countries. Thus, the implementation of a minimum 15% tax rate in each country can reduce the incentive for a company to shift its profits to a low tax jurisdiction.

WHO ARE THE STAKEHOLDERS?

USA: The Biden administration has proposed a Global Minimum Tax of 15% in its Budget for the Financial Year 2022. In order to fund its infrastructure proposals, the USA is keen on raising the minimum corporate tax from 21% to 28%. Moreover, the USA also plans to raise the GILTI rate from its present rate of 10.5% to 21%. Reaching a consensus on global minimum tax will discourage American firms from shifting their profits overseas, thus partly offsetting any negative impact from the increase on corporate tax rates. If countries succeed in reaching a consensus on global minimum tax, it would also replace the patchwork of digital tax services that US companies are subjected to in the EU.

EU: Major multi-national companies like Amazon, Google, Facebook have been under the spotlight in the EU for earning billions of dollars in terms of revenues in these countries,

www.taxguru.in

and yet paying very little by way of corporate taxes. According to EU estimates, companies with digital business models pay less than half the tax rate of businesses with traditional business models, with an effective average tax rate of 9.5% compared to 23.2%. (Anon., 2018). In turn European countries have stepped up efforts to tax at least part of the profits of such companies through introduction of various digital tax services. However, the digital service taxes have been deemed as discriminatory in nature as they mostly target US tech companies.

OECD: The OECD has been at the forefront of addressing BEPS challenges and had come out with 15 Action points for its BEPS Project in 2013. The Action Plan 1 had focussed on tax challenges arising from Digitalization. In October 2020, OECD had also released two blueprints for addressing tax challenges of the Digitalization of the Economy. The Pillar Two Blueprint recommended development of a minimum global tax rule.

Large Multinationals: The global minimum tax will mostly impact the digital services industry. Source countries will be able to tax profits only beyond a margin of 10%, thus limiting the scope of this provision, as very few industries apart from digital service industry earn margins beyond 10%. Negotiations are already underway for the exclusion of industries that may cross the threshold of 10% margins.

For digital companies, although implementation of a global minimum tax may result in higher taxes, they stand to benefit from the uncertainty over the patchwork of digital services taxes in the European countries.

IMPACT

According to a report by EU Tax Observatory, a 25% minimum global tax would increase corporate income tax revenues in the European Union by about €170 billion in 2021. (Barake, et al., 2021).

According to OECD, agreement on Pillar Two Blueprint can result in global tax revenues gains of $42-$70 billion, representing nearly 1.7% to 2.8% of global Corporate Income Tax revenues. (Anon., 2020).

As far as companies impacted by the proposal are concerned, only the largest 100 companies in terms of market capitalization with profit margins above 10% are expected to be impacted by the G7 proposal. The OECD GloBE rules prescribe a revenue threshold of €750 mn. (Anon., 2020).

India stands to gain by implementation of a Global Minimum Tax. According to UK-based Tax Justice Network, India suffers an annual loss of $10.1 billion from global tax abuse. (Anon., 2020). In international taxation the balance of power has been tilted in favour of developed countries as most of the flow of goods, services and technology have been from the developed to the developing countries. Taxation rights of source countries like India have been limited as most of the taxation rights have been allocated to resident countries.

LIKELY CONSEQUENCES OF IMPLEMENTING A GLOBAL MINIMUM TAX

While a global minimum tax will put a backstop to profit shifting to lower tax jurisdictions, it is also likely to increase the compliance cost for companies. Business investment decisions may be impacted by increased tax burden.

Currently, nations compete against each other for attracting foreign investment in their countries. Attractive corporate tax rates are increasingly being used as a tool for attracting FDI, especially tax havens, which may otherwise have few other resources. Implementation of a global minimum tax may reduce foreign investment in these countries, thus impacting their revenues.

www.taxguru.in

CHALLENGES

The successful implementation of a global minimum tax would depend on each participating country passing legislation to that effect. The USA has been a key stakeholder in the negotiations concerning global minimum tax. However, the USA may face resistance at home from its lawmakers who may view the deal as ceding ground to foreign countries to tax US tech companies.

Currently, the agreements reached in the G7 meet in June 2021 has limited representation of only a few wealthy Western countries. Successful roll out of such agreement is contingent on a broader group of 135 countries of the Inclusive Framework accepting such proposals.

Another thorny issue could be reaching a consensus on the actual rate for the minimum global tax. While the USA has advocated a 15% minimum tax rate, France wants the rate to be as high as 21%. On the other hand, Ireland has interests in keeping the rate as low as 12.5%. Thanks to its low corporate tax rate, until now Ireland had been attracting billions worth of investments every year from companies such as Facebook, Google and Microsoft. However, a minimum global tax would negatively impact Ireland. The revenue loss of implementing a global minimum tax has been estimated at €0.8 bn to €2 bn by the Irish Fiscal Advisory Council. (Anon., 2020).

The deal may also face resistance from China. In recent years, China has increasingly faced criticism from Western countries for human rights abuses and it is unlikely to accept a Western backed solution without being offered a seat at the decision table. Changes in global tax policy can have implications for Hong Kong and Macau. Globally, Hong Kong ranks seventh amongst "jurisdictions most complicit in helping multinational corporations underpay corporate income tax." (Anon., n.d.).

CONCLUSION

The Global Minimum Tax could be a game changer in not only arresting BEPS, but also in ensuring greater equity as far as allocation rights of taxation are concerned. However, successful implementation of a global minimum tax is contingent on all countries reaching a consensus and passing legislation in their home countries to that effect. The interests of all shareholders have to be borne in mind, while at the same time governments have to demonstrate immense political will in their home countries.

REFERENCES

[1] Anon., 2018. COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN, Brussels: European Commission.

[2] Anon., 2020. Fiscal Assessment Report-Sustaining the Economy through Covid-19, s.l.: Irish Fiscal Advisory Council.

[3] Anon., 2020. Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS, Paris: OECD.

[4] Anon., 2020. The State of Tax Justice 2020: Tax Justice in the Time of Covid-19, s.l.: Tax Justice Network.

[5] Anon., n.d. Corporate Tax Heaven Index-2021 Results, s.l.: Tax Justice Network.

[6] Barake, M., Neef, T., Chouc, P. E. & Zucman, G., 2021. Collecting the Tax Deficit of Multinational Companies: Simulations for the European Union, s.l.: EU Tax Observatory.

[7] Tax Justice Network, 2020. The State of Tax Justice 2020: Tax Justice in the Time of Covid-19, s.l.: s.n.

* * * * * * * * * *

www.taxguru.in

The PE's Bloodline

Subhash Jangala
(IRS: 2011)
JDIT

The author is an IRS Officer of the 2011 batch. He is presently posted as Joint Director (OSD) Publicity in the Directorate General of Administration and Taxpayer Services. He was earlier a tax diplomat posted in the Foreign Tax and Tax Research Division of the Central Board of Direct Taxes during which he had represented India in the Commonwealth Association of Tax Administrators, in the Inter American Centre for Tax Administrations and the OECD. He has a wide experience in negotiation of Double Taxation Avoidance Agreements, Mutual Agreement Procedure, Implementation of BEPS Actions and working with multilateral organisations. Prior to this he was posted as DDIT(Investigation) in Mangalore and was involved in the planning and execution of several high-profile searches in Karnataka, Goa and New Delhi. He is an engineer by education and is a regular columnist in mainstream newspapers on topics of international and national relevances.

Executive Summary

Permanent Establishment is one of the most important concepts of international tax law today. As the world treads into a new era where the concept of a PE is undergoing tremendous changes, it is necessary to understand the foundational principles of a Permanent Establishment.

In this article, the history of the Permanent Establishment is charted out starting from the World Wars and the birth of OECD. The PE is a concept much older than several countries itself.

By understanding the genesis and the history of a PE, we will be in a much better position to appreciate the evolution and the future course that the concept is now taking.

INTRODUCTION

One of the cornerstones of civilization is taxation. In order to classify a body of archaeological findings as a distinct civilization/era/epoch, scientists have customarily applied a set of attributes which are significantly different to the just preceding civilization. In addition to a distinct language, a binding religion and original infrastructure, there has always been a system of government that was founded on a formal, standardized system of taxation. Evidence of taxation systems are spread across time, space and different mediums of communication of the different ages.

Long before the *Arthashastra* and *Manusmriti*, which describe complex systems of taxation of those times, earlier references to forms of taxation can be dated back to the *Rig Veda* where taxes were made in the style of sacrificial gifts offered to the emperor of the world. This reference continued through the *Mahabharata*, the Mauryan period and later, every period evolving and advancing the complexity and preciseness of the science.

One characteristic feature of these systems always remained the same. The entities that were subject to taxation were, invariably immobile. In essence, they were geographically coupled with a certain village, district or state. Income generating activity was predominantly local. Systems of communication and modes of transportation were still securely bound to 'human' speeds. Subsistence economies were self-sufficient and self-fulfilling in nature. The Multinational Corporation (MNC) was still an unknown commodity of the distant future.

As technology disengaged the speeds of communication, travel and banking from 'human' speeds through scientific breakthroughs, ideas, people and investments crossed borders. While a significant chunk of revenue generating activity continued to retain its geographical locality, cross-border businesses grew exponentially, linked to the exponential fall in the cost of communication, travel and banking. Globalization brought international markets to monetize these skills. Consequently, the MNC was born.

The nature of MNCs allowed them to exploit the profitable arbitrage opportunities that multi-country operations offered. Income generating activity had truly crossed the boundaries that sovereign states had set for their respective tax administrations. Shifting/instituting economic activity overseas is considered much more straightforward and uncomplicated than instituting taxation on the same economic activity.

One of the, if not the most, fundamental and original question that grips the entire narrative around taxation of MNCs is, what kind and extent of activity of an MNC in a jurisdiction justifies its taxation in that jurisdiction. This question takes us to the very central philosophical concepts of why sovereign states tax MNCs at all in the first place. What are those 'goods' and 'services' that sovereign states provide which as an after-effect produce sustained demand for the goods and services that MNCs supply? What should be the price for the 'goods' and 'services' and who exploits these 'goods' and 'services' and to what extent? Quite understandably, the questions are complex. Countries have not been able to arrive at any specific guideline that applies to all situations and that allocates taxing rights to jurisdictions in a mutually agreeable manner. The number of variables involved perhaps precludes any permanent multilateral solution in this respect.

The concept of Permanent Establishment was introduced into international tax jurisprudence precisely to cater to this quandary. While it has permeated deeply and entrenched invariably into all international tax treaties, the definitions, exclusions and the variations of the concept of PE have evolved over time. The sole objective of all involved, however, remains to condense the inordinately complex topic into straightforward, uncomplicated formulae.

The objective of this article is to provide a treatise on the birth and evolution of a PE, both from an academic and from a practitioner's perspective.

ORIGINS OF THE CONCEPT OF PERMANENT ESTABLISHMENT

The First World War was one of the deadliest conflicts in history. The Allied Powers and the Central Powers mobilized colossal amounts of resources in material, men and women. The offensives carried on for more than 4 years, until the signing of the Treaty of Versailles in June 1919. The Treaty of Versailles itself was an outcome of the Paris Peace Conference which opened in January 1919. While it is

www.taxguru.in

widely accepted that the central objective of the Conference was the apportionment of the overseas colonies of Germany amongst the Allies, Part 1 of the Treaty of Versailles created the Covenant of the League of Nations. The Covenant put into effect an Assembly, a Council and a Permanent Secretariat of the League. 27 sovereign powers became the original Members of the League including India as a part of the British Empire. The United States of America, France, Italy, Japan and the British Empire were designated the Principal Allied and Associated Powers and were the only countries represented in the all-powerful Council of the League.

The trickle down of the enormous government spending during the war years contributed to accelerated economic growth during the period of the war. Soon after, North America, Germany and the United Kingdom were hit by waves of economic recession which led to substantial declines in the volumes of business activity. Consequently, during the second session of the Council of the League in February 1920, it was resolved that:

> *The League of Nations shall convene an International Conference with a view to studying the financial crisis and looking for the means of remedying and of mitigating the dangerous consequences arising from it.*

Accordingly, an International Financial Conference was convened in Belgium in September 1920. During the course of the Conference, each country that was represented made an exposition on the financial situation of the country. Most of the European nations were saddled with enormous amounts of internal and external debts in their balance sheets. This was in addition to severely depreciated currencies and stifling inflation. Almost invariably, the introduction of fresh forms of taxes, mostly direct taxes, was resorted to bridge the fiscal gap.

In order to address the concerns of the struggling international financial system, the Conference unanimously adopted resolutions pertaining to public finance, currency and exchange, international trade and taxation. It was resolved that progress shall be made towards:

> *An international understanding which, while ensuring the due payment by everyone of his full share of taxation, would avoid imposition of double taxation which is at present an obstacle on the placing of investments abroad.*

This question of double taxation was referred to the Financial Committee of the League of Nations which subsequently entrusted the theoretical study of double taxation to four economists who submitted their report, 3 year later, in 1923. The question of tax evasion was added later to the study and consequently, a group of fiscal administrators from various countries was assigned the task of studying the twin-problems from an administrative point of view.

At this point, it is important to note that since the last century, double taxation has been given a higher pedestal over tax evasion. It is quite logical since the push for laws usually came from businesses that were being taxed twice. Prevention of tax evasion was only a reactionary outcome. It was not the original cause of action. The arrangement continues to this date in respect of most areas of regulation.

The experts submitted their resolutions to the Financial Committee of the League in 1925. The report, titled, 'The Double Taxation and Tax Evasion Document' of February 1925 referred to existing bilateral treaties between pre-World War 1 European states and notes specifically, the treaty between the Austro-Hungarian Empire and Prussia of 1899.

This treaty, widely regarded as the first international double taxation treaty, introduced the concept of *stehendes gewerbe*, or a fixed place of business. The report, after duly considering existing conventions, legal jurisprudence and comments from stakeholders including the chambers of international commerce, resolved in respect of multinational enterprises thus;

> *If the enterprise has its head office in one of the States and in another has a branch, an agency, an establishment, a stable commercial or industrial organisation, or a permanent representative, each one of the contracting States shall tax that portion of the net income produced in its own territory.*

THE DRAFT OF 1927

The report of 1925 adopted resolutions pertaining to, among others, methods for the avoidance of double taxation, residence, assistance in the collection of taxes and exchange of information. The report suggested the creation of a Committee for the Preparation of Preliminary Draft Conventions on the basis of the resolutions in the report. Accordingly, a Committee of Technical Experts on Double Taxation and Tax Evasion was constituted, comprising of senior tax officials of Members of the League. The Committee eventually drafted, in 1927, four draft conventions pertaining to the subjects of:(a) prevention of double taxation, (b) prevention of double taxation in the matter of succession duties, (c) administrative assistance in matters of taxation, and (d) judicial assistance in the collection of taxes.

The Draft Bilateral Convention for the Prevention of Double Taxation, brought along with it, the concept of Permanent Establishment (PE) on to the world stage for the first time. Article 5 of the Convention, which incidentally, under the latest UN and OECD Model Conventions, also deals with Permanent Establishment clarified the basis on which income of businesses from states other than that in which they are domiciled shall be taxed,

Article 5

- *Income from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or profession possess permanent establishments.*
- *The real centre of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots shall be regarded as permanent establishments. The fact that an undertaking has business dealing with a foreign country through a bonafide agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country.*
- *Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory.*
- *In the absence of accounts showing this income separately and in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rule for apportionment.*

The 1927 draft instituted the source basis of taxing business income. The country of source was defined on the twin-criteria of:(a)

www.taxguru.in

presence of persons controlling the undertaking in the country; and (b) the controlling persons possessing a PE. While the draft put forth an exclusive definition for what constituted a PE, limiting them to real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices and depots, it didn't deem it necessary to define 'control'. A loose, negative definition of 'control' appeared in the commentary wherein it is clarified that the usage of the PEs by the traders themselves, permanent representatives or partners/ attorneys would not be material in deciding the permanence of the establishments, i.e. 'control' wouldn't be proscribed to the traders themselves and was bestowed upon agents of the traders.

The draft introduced the first exception to the creation of a PE in the form of independent agents. It was clarified later in the commentary that only agents which are legally and economically independent with a remuneration which is not *below what would be regarded as normal remuneration* would be 'independent'.

The draft also instituted the system of apportioning of income according to the source and a Mutual Agreement Procedure (MAP) to arrive at the proper apportionment. It was clarified in the commentary that in the absence of a provision for MAP, a strict interpretation of the factors of apportionment in the text of the Article would be necessary. The commentary, as an indication/suggestion, and on the basis of practices of countries, described what the factors of apportionment of income would entail,

1. Amount of capital involved
2. Number of workers
3. Wages paid
4. Receipts
5. Nature of activity, i.e. Manufacturing/ Merchandizing(Marketing/Sales)

In summary, the outline of the 1927 Permanent Establishment looked like this,

The 1927 draft, in total, comprised 9 pages, including the Commentary to the Draft

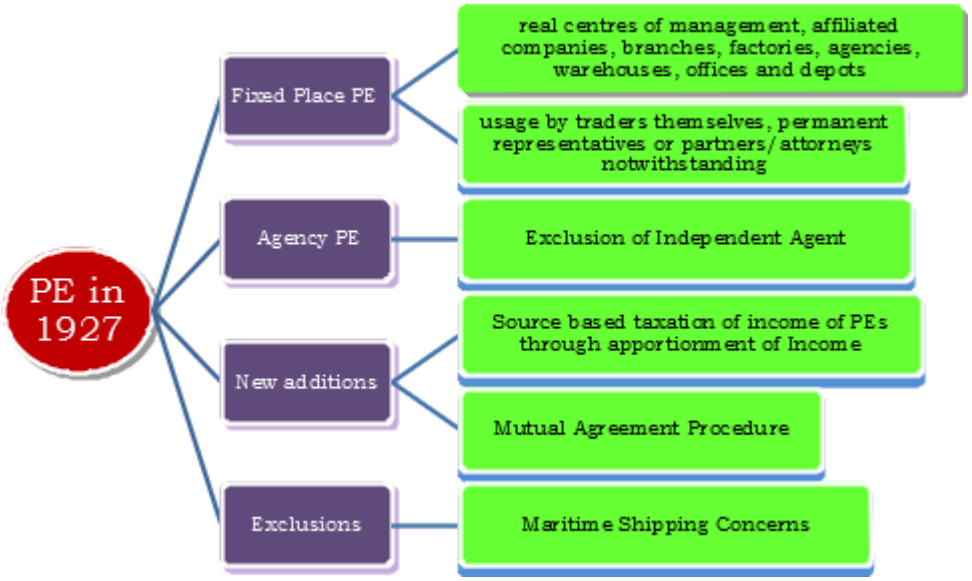


Figure 1: The outline of the 1927 Permanent Establishment

Convention. In comparison, the 2019 Model Double Tax Convention of the OECD comprises about 650 pages in a font size that can strain the eyes.

THE REPORT OF 1929

Subsequently, the work on the draft conventions was taken over by the Fiscal Committee of the League. In October 1929, the Fiscal Committee submitted its first report to the Council. In this report, it was observed that a universally acceptable definition of the term 'PE' would greatly facilitate the application of the draft conventions and the rules therein. After a review of the existing definitions of PE in the various conventions already signed, a fundamental principle was arrived at, for the presumption in favour of the existence of a PE,

When a foreign enterprise regularly has business relations in another country through an

agent established there, who is authorised to act on its behalf, it shall be deemed to have a

permanent establishment in that country.

Founded on this fundamental principle, the report brought out the five situations under which a PE may be presumed to exist,

1. the agent carries out his activities in a premises at his disposal by the enterprise;
2. the premises where the agent carries out his activities are designated by outward signs as being an establishment of the enterprise itself;
3. the agent is habitually in possession, for the purposes of sale, of a stock of goods belonging to the enterprise;
4. the agent, having a business headquarters in the country, is a duly accredited agent who habitually enters into contracts on behalf of the enterprise for which he works;
5. The agent is an employee who habitually transacts commercial business on behalf of the enterprise in return for remuneration.

Quite understandably, the definition of a 'PE', evolved organically through 1929. Whereas the 1927 draft focused on elaborating on what could be called, the present day 'fixed place of business PE', the 1929 report expanded on the concept of what we call today, the 'agency PE'. One may appreciate the endurance of the concepts in:(a) and (d) above which have survived for a century, still appearing almost intact in the latest OECD and UN Models, more than three-quarters of a century later.

While expanding on the definition of 'agents comprising a PE', the report also excluded explicitly, travelling salesmen, casual brokers and independent commission agents, the latter concept continuing to this day. The Report attached importance in delineating the characteristic features of an independent agent which would make it fall outside the ambit of the PE. The report identified the following features:

1. The Independent Agent acts in his own name and not in the name of the party
2. The responsibility towards the goods sold by the Agent lies with the Agent
3. The Agent keeps no permanent stock on behalf of any one seller.

The Report, in no equivocal terms noted the urgency and the pressing need to secure a precise definition of a PE, until which time, it would be nigh impossible to conclude a multilateral convention on avoidance of double taxation.

www.taxguru.in

These reports were followed by the Report of 1930 which introduced minor changes and the Report of 1931 which introduced, for the first time in the modern history, a multilateral instrument which was expected to be ratified by a group of nations. The multilateral instrument contained options which could be chosen by the countries depending on their preferences in respect of fixing the nexus. The 1931 report was also ground-breaking in the sense that, for the first time, workable methods for the avoidance of double taxation were introduced.

THE MEXICO AND LONDON DRAFTS

In June 1939, the Fiscal Committee of the League suggested that a revision should be undertaken of the model bilateral conventions on tax matters which had been prepared in 19281. Two drafts finally emerged from the meetings of the Fiscal Committee in 1943 and 1946 held in Mexico and London respectively. Whereas, there were differences between the Mexico and London drafts on various issues, in respect of the definition of PE, both the drafts concurred with each other.

An important point to note at this juncture is that for the first time in the evolution of international tax law, the necessity to improve the drafts prepared by the League of Nations from the perspective of developing countries was acknowledged. The Foreword to the Mexico Draft reads thus,

> *"The Committee thinks that the work done both in Mexico and in London could be usefully reviewed and developed by a balanced group of tax administrators and experts from both capital-importing and capital exporting countries and from economically-advanced and less advanced countries, when the League work on international tax problems is taken over by the United Nations."*[2]

The expression 'balanced group of tax administrators' clearly indicated a perceived imbalance in the existing composition of experts commanding the orientation of the drafts.

The Mexico Draft consisted of 30 pages including the commentary. It was also a norm that the commentary to the Draft was a part of the main document while the draft itself was attached as an Annexure, a complete turnaround from the present-day custom of the commentary being relegated to an Annex.

It would be safe to presume that the text of the Convention was seen as a synthesis and a consequence of the detailed investigation and reasoning in the Commentary as against the present day's approach of the commentary being only a supplementary clarification of what has already been very clearly stated in the text of the Convention. The precedence to commentary over the synthesized text of the convention may be inappropriate from a practical application point of view to administrators implementing the Convention. However, from a policy perspective, in the present day, the commentary merits distinct application and a scrutiny independent of the text of the convention.

The Mexico Draft is significant for one other reason. It was amongst the first drafts to recognize the weakness of the concept of a PE. Almost three-quarters of a century later, we are faced with a similar predicament. In the commentary to Article IV, the Mexico draft states,

> *"…if an enterprise were to be taxable on its profits in a foreign country only if it had a permanent establishment in that country, some countries would lose revenue. Moreover, certain forms of fiscal evasion might be encouraged. Indeed, some enterprises might seek to avoid taxation in a country by carrying out their business in that*

country without maintaining a permanent establishment therein or by concealing the existence of such an establishment."

In order to circumvent the complexity being brought about by the concept of a PE, the Mexico draft proposed that any activities of an enterprise which are not of an occasional/ isolated nature in a country could make that enterprise liable for tax in that country. While the alternative proposal started with an honest and legitimate concern, the recourse taken was equally, if not more ambiguous.

The Mexico proposal for re-characterization of the concept of PE was considered in the London meeting. Several reasons were put forward to revert to the PE concept. It was stated that the PE Concept has already entrenched itself deeply into international tax law by virtue of its widespread prevalence in treaties that have already been signed. A much more important reason was the observation that PEs by themselves would not lead to evasion of taxes since the income would be taxed in either the country of fiscal domicile or the country of source and the tax liability of the enterprise would be all the same. While this line of argument may have been appropriate for a pre-globalized, homogenous set of countries with similar tax rates and relatively congruous economic conditions, it would definitely be archaic in the times of transfer pricing, preferential regimes, tax havens and letterbox companies.

PE was defined in the Protocol of the Mexico and London Draft. The definition in the Mexico Draft3, for the first time, opened up the definition of the Fixed Place PE for interpretation by including the category, 'and other fixed place of business having a productive character'. This additional category and the use of the word 'and', in effect, made the twin condition of the place of business being fixed and the nature of the activity being productive necessary conditions for the creation of a PE. This seems to be an outcome of the proposal to do away with the principle of a PE altogether.

For the first time, a construction PE has been defined and categorized as a separate category of a PE. The clarification that the presence of a subsidiary company in the source state, by itself, does not create a PE in the source state also appeared for the first time in the Mexico Draft.

THE OEEC AND OECD

After the conclusion of World War II, the Organisation for European Economic Cooperation (OEEC) was founded to administer the Marshall Plan for the Reconstruction and Modernization of Europe. After the conclusion of the Plan, the focus of OEEC shifted to economic issues pertaining to the European Union. Consequently, the Organisation for Economic Cooperation and Development (OECD) was conceived as a compelling successor to the Organisation for European Economic Cooperation with a wider, global economic agenda focussed on policy and development. The 20 founding members, all developed countries of Europe and North America signed a Convention to create OECD which superseded the OEEC in 1961.

The OEEC, in 1956 set up a Fiscal Committee. One of the agenda items was to submit a draft Convention for the Avoidance of Double Taxation. Several reports were submitted by the Fiscal Committee to the OEEC between 1958 and 1961 containing proposals for the various articles to be included in the draft Convention. Subsequent to 1961, the Fiscal Committee submitted further reports to the successor organization, OECD and in 1963 a Draft Double

www.taxguru.in

Taxation Convention on Income and Capital was submitted.

The Fiscal Committee, in its first meeting in 1956, elected its officers and adopted its program of work, the first point of which was the study of,'The Concept of the Permanent Establishment'. A two-member party christened Working Party I comprising Germany and the United Kingdom was set up by the Fiscal Committee to study the PE Issue and submit a report in respect of draft Article to be included in the Convention. Six meetings were held during 1956–1958 to discuss the concept of the PE and a draft PE Article was finally proposed.4

It would be very difficult for a recently initiated student in International Treaty Law, to identify the differences between the 1958 Draft and the 2017 OECD Model Tax Convention (OECD MTC) at first glance. It can be said that the modern structure of the Article on PE was forged during these meetings. The second meeting of Working Party I acknowledged the structural definition to the Article in a general definition, then a list of examples and finally a list of exceptions5. The overall structure continues to this day.

THE FUTURE

The PE, as a concept is being questioned vigorously and we are at the cusp of history being written. The digital age has forced international organizations and national tax administrations to re-imagine their treatment of a PE both legally and administratively. India leads the charge in balancing the scales in favour of developing countries, as we have seen in the early adoption of the concepts like the Significant Economic Presence and Equalization Levy and the even more recent passage of the 'Bansal Proposal' by the United Nations. History is being written at this very moment in the evolution of the concept of a PE. While it has not outlived its utility, the PE is undergoing a complete transformation, in the interest of equity and fairness in the corridors of international taxation.

REFERENCES

[1] League of Nations, Fiscal Committee London and Mexico Model Tax Conventions: Commentary and Text, Nov. 1946, C 88 M 88 1946 II A.

[2] League of Nations, Fiscal Committee London and Mexico Model Tax Conventions Commentary and Text, Nov. 1946, C 88 M 88 1946 II A at p–6.

[3] Appendix 1 – Definition of PE as per the Mexico Draft of 1943 - C.88.M.88.1946. II.A, November 1946

[4] Annex – Draft Article in the Concept of Permanent Establishment, 31st January 1958, Fiscal Committee of the OEEC.

[5] Ibid.

* * * * * * * * * *

46 Significant Direct Tax Issues before the Supreme Court

Reena Sinha Puri
(IRS: 1987)
Earlier DGIT (L&R),
Now CCIT(OSD), Delhi

Reena Sinha Puri, officer of 1987 batch of Indian Revenue Service, has varied experience in tax policy and administration, including areas of personnel, training, vigilance, investigation, adjudication of appeals and advocacy. She has also worked with the Department of Taxes, Government of Botswana. Prior to working as DGIT, Legal & Research, she worked as Financial Adviser in the Ministry of Coal, Mines and Corporate Affairs and served as Government nominee Director on the Board of Coal India Limited, Northern Coal Fields, Hindustan Zinc Limited and Bharat Aluminum Company. She holds a Bachelor and Masters degree in Political Science from Punjab University; Bachelors in Law from Delhi University and Masters in Public Policy from LKY School of Public Policy, National University of Singapore

Executive Summary

The Directorate of Legal & Research is entrusted with the responsibility of processing and filing Revenue Special Leave Petition (SLP) in the Apex Court. As an endeavor to manage tax litigation better, a detailed exercise was conducted in the beginning of 2021, to identify cases with identical issues amongst the 2853 pending Revenue SLPs having disputed tax of Rs 1.27 Lakh Crores.

The outcome was identification of 46 lead cases. These cases represent 80% of the disputed tax and 30% of the total Revenue SLPs pending in the Apex Court as on 01.01.2021.

The adjudication by the Supreme Court of these 46 SLPs will have enormous cascading effect in settling large numbers of tax disputes and disputed taxes pending on 46 issues in various High Courts, Income Tax Appellate Tribunals and Commissioner of Income-Tax- Appeals. Further, with clear interpretation of the provisions of the Income Tax Act by the Apex Court, potential tax disputes at the level of assessing officers will stand eliminated. Finally, the all round certainty in tax administration will not only alleviate litigation but also enable in ushering an improved environment for tax compliance.

The Directorate of Legal & Research is entrusted with the responsibility of processing and filing Revenue Special Leave Petition(SLP) in the Apex Court. As an endeavour to manage tax litigation better, a detailed exercise was conducted in the beginning of 2021, to identify cases with identical issues amongst the 2853 pending Revenue SLPs having disputed tax of Rs 1.27 Lakh Crores.

The outcome was identification of 46lead cases (42 Revenue SLP and 4 Assessee SLP) with913 tagged cases (777 Revenue SLP and 136 Assessee SLP), involving disputed tax of Rs 1.01 Lakh Crores. These cases represent 80% of the disputed tax and 30% of the total Revenue SLPs pending in the Apex Court as on 01.01.2021.

www.taxguru.in

The adjudication by the Supreme Court of these 46 SLPs will have enormous cascading effect in settling large numbers of tax disputes and disputed taxes pending on 46 issues in various High Courts, Income Tax Appellate Tribunals and Commissioner of Income-Tax-Appeals. Further, with clear interpretation of the provisions of the Income Tax Act by the Apex Court, potential tax disputes at the level of assessing officers will stand eliminated. Finally, the all-round certainty in tax administration will not only alleviate litigation but also enable in ushering an improved environment for tax compliance.

The 46 issues, along with the Section of the Income Tax Act, quantum of tax dispute, numbers of cases involved and the lead case, are as follows:

1.	Section 92CA, Rule 10B, 92C	**Whether inclusion or exclusion of comparables / other transfer pricing adjustment is a question of fact and no Substantial Question of Law is involved?**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		589.17	83	Hewlett Packard (India) Global Soft P Ltd
2.	Section 234B, 234C	**Liability to pay interest under Section234B when Income Tax has not been deducted at source.**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		119.71	42	Mitsubishi Corporation
3.	Section 5(2) and 9(1)(i), Rule 10	**Whether the assessee company, a tax resident of Netherlands, is having a Permanent Establishment (PE) in India and what proportion of income, arising from its operations in India, is taxable in India under Section 5(2) read with Section 9(1)(i) of the Income Tax Act?**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		615.70	58	Galileo Nederland BV
4.	Section 153A/153C	**Validity of assessment order passed under Section153A or under Section153C of the Income-tax Act without reference to any incriminating material found during the search.**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		732.06	36	Divine Infracon Pvt. Limited
5.	Section 9(1)(vi)	**i. Whether payment made to non-resident suppliers for purchase of standard software is 'Royalty' within the meaning of Article 12 of DTAA entered into by India with USA/ UK read with Section 9(1)(vi) of the Income Tax Act?** **ii Whether the license of right to use a copyrighted article tantamount to right to use a copyright in the Article?**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		492.1	107	Engineering Analysis Centre of Excellence Private Limited (*Lead case is SLP filed by assessee)

<table>
<tr><td>6.</td><td>Section 254(2A)</td><td colspan="3">i. Constitutional validity of third proviso to Section 254(2A) of the Income Tax Act.
ii. Whether the Tribunal has power to grant stay of demand beyond 365 days provided that the delay is not attributable to the assessee?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>0</td><td>42</td><td>Pepsi Foods Ltd.</td></tr>
<tr><td>7.</td><td>Section 153A, 1532A and 254</td><td colspan="3">Whether the limitation for passing order under Section153A / 254, pursuant to the remand by the ITAT under Section 254, begins from the point of time from which the Departmental Representative (in ITAT) receives the copy of the decision or from the point of time when the order is received by concerned (jurisdictional) CIT?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>34494.90</td><td>14</td><td>Virendra Jain</td></tr>
<tr><td>8.</td><td>Section 9(i)(vi) / 9(1)(vii)</td><td colspan="3">i. Whether amount received by assessee from its non-resident customer for providing transponder facility is taxable where the satellite was not stationed over Indian airspace?
ii. Whether amount paid to assessee by its non-resident customer is royalty under Section 9(1)(vi) or fees for Technical Services under Section 9(1)(vii) of the Income Tax Act?
iii. Whether assessee is to allow expenditure relatable to India only while computing income chargeable to tax in India?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>258.57</td><td>9</td><td>Asia Satellite Telecommunication Co Ltd.</td></tr>
<tr><td>9.</td><td>Section 158BC</td><td colspan="3">If there is disclosure by the assessee in its regular return of income, whether any assessment can be made in respect of such transactions in a block assessment as undisclosed income as a result of search undertaken?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>2609.05</td><td>5</td><td>Slocum Investment (P) Ltd.</td></tr>
<tr><td>10.</td><td>Section 28</td><td colspan="3">i. Whether subsidy on rural electrification, whether received or not, would be treated as ‘taxable income’ of the assessee?
ii. Whether the claim of interest relatable to earlier years is in allowable deduction?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>891.74</td><td>4</td><td>U.P. State Electricity Board, Lucknow</td></tr>
<tr><td>11.</td><td>Section 10(20)</td><td colspan="3">Whether assessee is a ‘Local Authority’ as contemplated under Section 10(20) of the Income Tax Act and, therefore, its income is exempt from tax?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>264.28</td><td>4</td><td>Jaipur Development Authority</td></tr>
</table>

www.taxguru.in

<table>
<tr><td>12.</td><td>Section 9(1)</td><td colspan="3">i. Whether contract could be segregated into offshore and onshore activities and attribution of assessee's activities outside India to its PE.
ii. Whether the assessee had Permanent Establishment in India under Article 5(2)(h) of India - UAE DTAA?
iii. Whether the sub-contractor was a depended agent PE under Article 5(4) of DTAA?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>320.72</td><td>5</td><td>National Petroleum Const Company</td></tr>
<tr><td>13.</td><td>Section 80IA</td><td colspan="3">i. Whether tax liability is part of the tariff charged for the sale of electricity and is not independent of the tariff charge?
ii. Whether relief in respect of all units have to be taken into account for the purpose of computation of deduction under Section80IA?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>40.19</td><td>4</td><td>Neyveli Lignite Corporation</td></tr>
<tr><td>14.</td><td>Section 269SS</td><td colspan="3">Whether Residuary Non-Banking Financial Company (RNBC) are excluded from complying with the provisions of Section 269SS of Income Tax Act provided reasonable cause exists?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>3622.54</td><td>23</td><td>Sahara India Financial Corporation Ltd.</td></tr>
<tr><td>15.</td><td>Section 37</td><td colspan="3">i. Allowability of Privilege fees paid by the assessee to the State Government as an item of expenditure.
ii. Competence of State Legislature to amend the Excise Act in manner pre-judicial to the Central Legislation</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>855.09</td><td>4</td><td>Karnataka State Beverages Corp Ltd.</td></tr>
<tr><td>16.</td><td>Section 254(1)</td><td colspan="3">Whether ITAT has jurisdiction to hold the 'Regulations' framed by Insurance Regulatory and Development Authority of India to be inconsistent with the provisions of the Insurance Act, 1938?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>571.36</td><td>22</td><td>Cholamandalam MS Gen Insurance Co. Ltd</td></tr>
<tr><td>17.</td><td>Section 147/148</td><td colspan="3">Quashing of assessment reopened under Section 147 of the Income Tax Act on the basis of incriminating findings in the Justice Shah Commission Report.</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>0</td><td>51</td><td>Venture Real Estate</td></tr>
</table>

<table>
<tr><td>18.</td><td>Section 32 and 115JB</td><td colspan="3">i. Allowability of depreciation @ 60% on UPS.
ii. Applicability of provisions of Section115JB of the Income Tax Act to the insurance companies.
iii. Liability to deduct tax at source on payment of commission to other insurance companies on the receipt of re-insurance premium</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>1424.47</td><td>21</td><td>Royal Sundaram Alliance Insurance Co Ltd.</td></tr>
<tr><td>19.</td><td>Section 92C and 92CA</td><td colspan="3">Benchmarking of advertising, marketing and sales promotion expenses (AMP) Expenses incurred by the assessee for the benefit of Associated Enterprises (AEs) for creating marketing intangibles and brand name of AE.</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>99.70</td><td>3</td><td>Sony Mobile Communications India P Ltd.</td></tr>
<tr><td>20.</td><td>Section 92C and 92CA</td><td colspan="3">i. Taxability of advertising, marketing and sales promotion expenses (AMP) Expenses incurred for the benefit of AEs for creating marketing intangibles and brand name of AE.
ii. Taxability of inventories written off without any supporting evidence.
iii. Taxability of payment made on account of Intra Group Services, i.e, payment of service fees to AEs.</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>778.31</td><td>45</td><td>Canon India Pvt. Ltd.
(*Lead case is SLP filed by assessee)</td></tr>
<tr><td>21.</td><td>Section 10 and 44</td><td colspan="3">i. Whether benefits of Section 10 of the Income Tax Act are available to insurance companies in view of the non-obstante clause at the start of Section 44 of the Act?
ii. Whether the AO can use the valuations made by the Actuary to make adjustments to the taxable income?
iii. Whether the surplus in the shareholders accounts to be taxed as ‘income from other sources’?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>1917.35</td><td>16</td><td>ICICI Prudential Life Insurance Co. Ltd.</td></tr>
<tr><td>22.</td><td>Section 10 and 44</td><td colspan="3">i. Whether benefits of Section 10 of the Income Tax Act are available to insurance companies in view of the non-obstante clause at the start of Section 44 of the Act?
ii. Whether the AO can use the valuations made by the Actuary to make adjustments to the taxable income?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>12348.90</td><td>4</td><td>Life Insurance Corporation of India</td></tr>
</table>

www.taxguru.in

<table>
<tr><td>23.</td><td>Section 263</td><td colspan="3">Direction of CIT under Section 263 to disallow the surrender value of holiday membership' expenditure as a contingent liability- as expenditure not accrued are allowable on payment basis even though the advances have been recognized as income.</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>600.83</td><td>7</td><td>Pancard Clubs Ltd.</td></tr>
<tr><td>24.</td><td>RBI Master Circular dated 02.09.2013 and CBTD Circular No 665</td><td colspan="3">i. Whether assessee bank is eligible for the benefit of depreciation on the entire investment portfolio based on 'lower of cost or market value' as such benefit is available only on securities 'Held for Trading' and the assessee had no security in this category?
ii. Disallowance under Section14A of Income Tax Act?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>651.71</td><td>16</td><td>Kotak Mahindra Bank Ltd.
(*Lead case is SLP filed by assessee)</td></tr>
<tr><td>25.</td><td>Section 37(1) and 80-IA</td><td colspan="3">i. Whether expenditure incurred for replacement of meters is an allowable expenditure?
ii. Whether Head Office expenses allocated to various units are allowable for computing deduction under Section 80IA?
iii. Whether market price of power generated is to be adopted under Section80IA as the price of power purchased?
iv. Whether deduction under Section 80IA is allowable to the extent of gross total income and not to the extent of business income only?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>1433.34</td><td>7</td><td>Reliance Infrastructure Ltd.</td></tr>
<tr><td>26.</td><td>Section 153C</td><td colspan="3">Whether Section153C of the Act, as amended w.e.f. 01.06.2015 (addition of words 'pertain or pertains to any information contained therein would be applicable to the case where search is conducted prior to that date.</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>86.96</td><td>119</td><td>Fortune Gilts Pvt. Ltd.</td></tr>
<tr><td>27.</td><td>Section 32 and 72</td><td colspan="3">Whether unabsorbed depreciation, pertaining to assessment years prior to 1997-98, can be carried forward beyond the period of 8 assessment years as mentioned in sub-Section 2(iii)(b) of Section 32, as amended by Finance Act, 1996 w.e.f 01.04.1997?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>91.60</td><td>8</td><td>Petrofils Co-operative Ltd.</td></tr>
<tr><td>28.</td><td>Section 9(1)(vi)</td><td colspan="3">Whether the service charges received by the assessee from various TV Channels on account of providing facility of broadcasting their programmes through the transponders located in the satellite would not amount to royalty as defined in Explanation 2 to Section 9(1)(vi) of the Act and taxed in India?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>579.83</td><td>17</td><td>Shin Satellite Public Co. Ltd.
(Thaicom Public Company Ltd.)</td></tr>
</table>

<table>
<tr><td>29.</td><td>Section 92C and 92CA, Rule 10B</td><td colspan="3">i. Whether inclusion or exclusion of comparables / other transfer pricing adjustment is a question of fact and no Substantial Question of Law is involved?
ii. Whether payment of royalty by the assessee to its Associated Enterprises is an International Transaction under Section92CA?
iii. Whether High Court is justified in directing the TPO to compute the ALP of the International Transactions at the enterprise level?<table><tr><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr><tr><td>268.80</td><td>11</td><td>Toyota Kirloskar Motors (P) Ltd.</td></tr></table></td></tr>
<tr><td>30.</td><td>Section 115JB and 32</td><td colspan="3">i. Treatment of provision for obsolescence and provision of gratuity while computing profit under Section115JB.
ii. Treatment of depreciation on acquired aircraft on hire purchase.<table><tr><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr><tr><td>386.70</td><td>4</td><td>Jet Airways (India) Ltd.</td></tr></table></td></tr>
<tr><td>31</td><td>Section 2(47) and 263</td><td colspan="3">i. Quashing of order under Section 263 of the Income Tax Act.
ii. Whether pledging of shares amounts to transfer of such shares under Section 2(47) of the Act and the fair market value of the shares so pledged is the consideration for such alleged transfer?
iii. Whether amount received on account of Indefeasible Right of Connectivity Fees, accrued in the instant assessment year, is to be treated as the income of the current assessment year although license fees was received for the period of 20 years?<table><tr><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr><tr><td>2404.57</td><td>2</td><td>Reliance Communications & Infrastructure Ltd.</td></tr></table></td></tr>
<tr><td>32.</td><td>Section 143(1) and 143(2)</td><td colspan="3">Whether CBDT Instruction No 1 of 2015 dated 13.01.2015, prohibiting the processing of return under Section 143(1), when a notice under Section 143(2) has been issues, is unsustainable in law?<table><tr><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr><tr><td>760.98</td><td>3</td><td>Tata Teleservices Ltd.</td></tr></table></td></tr>
<tr><td>33.</td><td>Section10(23C)(iv) and 11</td><td colspan="3">i. Whether coaching classes conducted by the assessee is a business activity and not a charitable activity and hence, in violation of the provisions of Income Tax Act?
ii. Whether overseas expenditure incurred by the assessee without the permission of CBDT is a deductible expenditure?<table><tr><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr><tr><td>57.71</td><td>13</td><td>The Institute of Chartered Accountants of India</td></tr></table></td></tr>
</table>

www.taxguru.in

<table>
<tr><td>34.</td><td>Section 43B</td><td colspan="3">i. Whether custom duty paid on import of inputs and custom duty included in closing stock can be disallowed under Section43B of the Income Tax Act?
ii. Whether sales tax subsidy received by the assessee is a revenue receipt?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>727.78</td><td>14</td><td>Maruti Suzuki India Ltd.
(Formerly Known As Maruti Udyog Ltd.)</td></tr>
<tr><td>35.</td><td>Section 37(1) and 35ABB</td><td colspan="3">Whether variable license fees payable under New Telecom Policy, 1999 is an allowable revenue expenditure under Section 37(1) of the Income Tax Act?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>1162.81</td><td>26</td><td>Bharti Hexacom Limited</td></tr>
<tr><td>36.</td><td>Section 44 and 10(23AAB)</td><td colspan="3">i. Whether provision for reserve for solvency margin, made under directions of IRDA, is an allowable deduction?
ii. Whether ‘Jeevan Suraksha Fund’, a pension fund of the assessee and income thereof are exempt under Section 10(23AAB) of the Act?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>14493.72</td><td>10</td><td>Life Insurance Corporation of India Ltd.</td></tr>
<tr><td>37.</td><td>Section 80IC and 263</td><td colspan="3">i. Quashing of order passed under Section 263 of the Income Tax Act.
ii. Examination of claim of the assessee for deduction under Section80IC of the Income Tax Act.</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>1012.84</td><td>4</td><td>Oil India Limited</td></tr>
<tr><td>38.</td><td>Section 263</td><td colspan="3">i. Assumption of jurisdiction under Section 263 by the CIT.
ii. Taxability of outside India revenues earned by the assessee under the various contracts which were composite in nature involving inside India and outside India activity for performance of contract in India</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>250.97</td><td>5</td><td>Hyundai Heavy Industries Ltd.</td></tr>
<tr><td>39.</td><td>Section 37</td><td colspan="3">Whether broken period interest paid by banks against the securities purchased is a revenue expenditure or capital expenditure?</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>1500.67</td><td>10</td><td>The Bank of Rajasthan Ltd.
(*Lead case is SLP filed by assessee)</td></tr>
<tr><td>40.</td><td>Article 3(2) and 14(5) of DTAA between India and France</td><td colspan="3">Interpretation of double taxation avoidance agreement between India and France and in particular the scope and width of Article 14(5) read with Article 3(2) which determines the core question of the scope of expression ‘alienation’ or ‘participation’ for the purpose of deciding the jurisdiction of the country to tax the transaction.</td></tr>
<tr><td></td><td></td><td>Tax implication (Rs in Crores)</td><td>Number of cases</td><td>Lead Case</td></tr>
<tr><td></td><td></td><td>1971.86</td><td>3</td><td>Sanofi Pasteur Holding SA</td></tr>
</table>

41.	Section 2(47), 2(14) and 92B	**Whether assignment of option rights in favour of AEs amounts to transfer as per Explanation 2 to Section 2(47) in view of amendments in Sections 2(47), 2(14) and 92B?**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		3738.48	1	Vodafone India Services
42.	Section 11, 12 and 2(15)	**Whether the assessee, whose activities are in the nature of trade, commerce and business, is eligible to claim exemption under Section 11 and 12, though its receipts are above the threshold limit as provided in proviso to Section 2(15) of the Act?**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		4391.24	49	Gujarat Industrial Development Authority
43.	Section 11,12,13 and 2(15)	**Whether assessee was eligible for benefit of Section 11 and 12, when assessee was not carrying out any charitable activity and instead carrying out activity in nature of business, covered by the proviso to Section 2(15)?**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		182	24	Gujarat Cricket Association
44.	Section 50B and 80IA(4)	**Short term capital gain on slump sale and deduction under Section80IA.**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		646.90	2	Gujarat Fluoro Chemicals Ltd
45.	Section 163	**Whether the High Court was justified in setting aside the show cause notice issued under Section 163 without appreciating that the underlying asset was situated in India?**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		354	1	Wapcos
46.	Section 90(1)(a) and10A	**Whether assessee is entitled for rebate/ refund for tax paid in a foreign country under Section 90(1)(a) in relation to income eligible for exemption under Section10A?**		
		Tax implication (Rs in Crores)	Number of cases	Lead Case
		207	1	Wipro
TOTAL TAX EFFECT		**101009.18**	**959**	

Out of the abovementioned cases, the Apex Court has disposed 2 cases. In case of Engineering Analysis Centre of Excellence P Ltd (serial number 5), assessee's SLP was allowed. Revenue SLP in the case of Pepsi Foods Ltd (serial number 6) was dismissed.

* * * * * * * * * *

www.taxguru.in

New Regime of Penalty under Section 270A

Satendra Kumar Dixit
Income Tax Officer
(Assessment Unit),
ReFAC, Haldwani (Uttrakhand)

Satendra Kumar Dixit has worked as Inspector in Central Excise and Customs, in Surat (Gujarat) for two years before joining the department as Income Tax Inspector in 2011 in UP (East) region. He has rendered services to the department, at various places but mostly in assessments charges. He has part of Assessment Unit as ITO from inception of Faceless assessment Scheme.

Executive Summary

An attempt has been made here to introduce legal provision of New Regime of Penalty under Section 270A, in less legal way, i.e., with less complexity and with practical examples. It is a small tour for taxman in three chambers. This tour begins with first chamber where he decides that under-reporting has happened, in second chamber he analyzes the under-reporting to decide quantum of penalty and his tour ends in third chamber with calculation of under- reported income and quantum of penalty to be imposed.

1. Finance Act, 2016 presented the whole package of penalty under Section 270A with twelve sub-sections w.e.f., AY 2017–18 Earlier there used to be two charges: (a) Concealment of particulars of Income, and/ or (b) Furnishing of inaccurate particulars of Income. We are, as Department, well aware that the Revenue lost cases on mere technical grounds such as satisfaction not recorded, satisfaction recorded but had no specific charge, irrelevant portion of charge was not struck-off etc. Hence, we (Revenue) lost cases, which otherwise deserved imposition of penalty on merits.
2. New Section 270A streamlined the old provisions and created only one charge i.e. under-reporting of Income, but quantum with two fixed percentage based on gravity of violations. For violations of lesser gravity, the tax-payer was provided with option of immunity under Section 270AA. This immunity is for tax-payer who believes in Pay Tax,Karo Relax.

.

Use of word 'MAY'

The question as to whether a statute is mandatory or directory would depend upon the statutory scheme. it is now well known that use of the expression 'shall' or 'may' by itself is not decisive. the court, while construing a staute must consider all relevant factors including the purpose and object the statute seeks to achieve [*Ashoklanka* vs. *Rishi Dixit*, AIR 2005 SC 2821 at P. 2834]"

Table 1: Salient Feature of 270A

NEW WORD	• New word coined in place of two charges which were used erstwhile.
	• This new word is UNDER-REPORTED INCOME.
EMPHASIS	• For initiation of penalty, there must be under-reporting as per Section 270A(2).
	• This under-reported income will start from income determined under Section 143(1)(a) to income asseseed OR reassessed.
GRAVITY	• 50% of tax on under-reported income for under-reporting simplicter(Sub-section 7), and
	• 200% of tax on under-reported income if it is in consequence to misreporting in 6 conditions given in Section 270A(9) {Sub-section 8}
	• No Misreporting possible without under-reporting

CHAMBER-ONE

Concept of URI

Ordinary tax-payer might ask from taxmen, hey man! You are collecting taxes on any thinkable income on earth, over waters and in air above it but still you impose huge penalties. The answer of taxman would be,

'Deartax-payer! There are brave-heart people, who having taxable income; either do not return their Income at all or do not return correct income. Therefore, Department wants to discourage them by penalizing and it is part of every law. Earlier, it was done through Section 271(1)(c) and now it will be done through Section 270A.'

WHAT?

1. In this new penalty provision, the basic premise is **URI-The Surgical Strike**, though it is name of movie but here URI is referred as under-reporting of income for taxmen.

   Let's understand this. There was a movie having title of *URI-The Surgical Strike*, the most popular dialogue of the flick was: How is the JOSH? It depicted bravery of our soldiers. I got goosebumps while watching the movie. I always remember the name of the movie because of one more reason. The reason is the word ***URI (Under-Reporting of Income)*** –it may be called surgical strike of taxman on tax evaders under Section 270A, whenever they find under-reporting of income.

2. No one needs to apply mind to understand as to when URI happens. One need to understand only the bottom-line, which is "Whenever variation happens between assessed incomes of two consecutive orders, the URI happens."

Following are the cases where URI happens and taxmen need to initiate penalty under Section 270A (1):

- Some brave-heart assessee don't care about filing of ROI.
- Now the question is, Is it possible to make summary assessment under Section 143(1)(a) by CPC in such case? Obviously, no. Hence, either the case will be reopened under Section 148 or there will be best judgment assessment under Section 144, (except preventive actions).
- In such situation, whatever income is determined in regular assessment, it shall be URI for person having no slab rate. But for person having slab rate URI will happen only if it is more than MANT

www.taxguru.in

(Maximum Amount Not chargeable to Tax). Because, for slab rate person, if URI does not exceed MANT, it is not possible to determine tax payable and result is no URI.

- But one may ask, if in case of reopening assessee filed ROI and returned certain income, then? In this case NO benefit of returned income in ITR filed against notice under Section 148 is permissible and it will be considered same as 'no ROI case'.
- Some brave-hearts file ROI but does not return correct income.
- Everybody knows that the person who has taxable income needs to file valid ROI not WhatsApp message/mail or letter to the Department watermarked with roses. Because the CPC cannot make summary assessment on such messages or letter. It is only possible if CPC has valid ROI. Further, the CPC might do certain Prima Facie Adjustments (PFA) in Income returned, or expenditure claimed (if found necessary) and finally intimates the tax-payer by an order under Section 143(1)(a).
- When this case goes to regular assessment, there may be three possible situations:

A. Return income accepted, or income enhanced, or loss reduced, in PFA by the CPC [by default the order under Section143(1)(a) is final in regular assessment]-***No URI and No penalty.***

B. Return income enhanced in regular assessment/reassessment: The difference of income between order passed in regular assessment/subsequent assessment and income determined under Section 143(1)(a)/ or preceding order. ***Yes URI and Yes Penalty.***

C. Since income includes loss, hence, 'A curious case of loss' wants different treatment.

If returned income is of loss, and this loss was accepted or reduced or additions were of such nature that Loss got converted into positive income during regular assessment. Then,the whole variation is considered as URI and it is treated as total Income for quantifying penalty(discussed in third chamber). See the example below.

RESULT	**NO URI UPTO 143(1)**		**Variation from last order is Rs. 35,00,000 and same is URI**	**Variation from last order is Rs. 25,00,000 and same is URI**
CHANGES	(50,00,000)	(45,00,000)	(10,00,000)	15,00,000
EVENTS	ROI FILED	143(1)	143(3)	147

NOTE: As per Section 270A(10)(b), it is inferred that, in case of slab rate person if the variation of loss exceeds MANT, only then URI will happen. Because variation in loss is to be treated as total income. If whole variation in income is not more than MANT, then tax payable cannot be determined. Therefore, variation of loss should be atleast one rupee more than MANT to make URI happen.

3. In case of person who pays taxes based on Book Profit as per Section 115JB or Adjusted Total Income as per Section 115JC. The URI has been explained in Chamber Three.

Closing Of Chamber One

Before closing Chamber One, AO needs to initiate penalty in assessment order. Initiation of penalty in Assessment Order itself is one of most crucial work. Every taxman must acknowledge the importance; that work of initiation of penalty is not secondary to work of assessment. In the backdrop of judicial precedence, it is necessary to specify charge in clear terms in assessment order. But here comes the bouncer,'satisfaction vis-a-vis mentioning of charge'in next gen penalty.

Looking to new provisions, particularly, Section 270A(2), there is only one charge, i.e. Under-reporting of Income. Further, the two quantum of penalty is only off-shoot of under-reporting of income, based on nature of under-reporting. Hence, satisfaction is not required separately regarding URI Simpliciter and URI in consequence of Misreporting.(Grey Area: Needs more deliberations, looking to judicial precedence).

CHAMBER TWO

Analysing of Violations Causing URI in Chamber One

Till now, it is clear that, as to when taxmen need to start the machine of penalty, is very important. Therefore, in this part we are going to discuss various circumstances, which help in deciding quantum of penalty.

In assessment, taxmen search every nook and corner of books of accounts, and other possible information about a tax-payer. Consequently, different kinds of additions/disallowances take place, which causes under-reporting. After the implementation of 'Faceless Assessment' and 'Faceless Penalty', the pain of proceedings are to be borne separately by AU(Assessment Units) and PU (Penalty Units). Hence, it is attempted to draw contour here to know and decide three types of URI.

A. The instances of additions and disallowances which cause Under-reporting of Income (URI), but are placed in exclusions clause of Sub-section 6 and there's no need to impose penalty, which includes penalty of 271AAB. This penalty is imposed separately.

B. The Instances of additions and disallowances which causes under-reporting of income due to misreporting, fall in Sub-section 9 and attracts higher quantum of penalty i.e. 200% of tax payable on under reported income(Sub-section 8).

C. The third part is residual additions and disallowances which causes under-reporting of income, but quantum is just 50% of tax payable on under-reported income (Sub-section 7), unlike misreporting, the violations which warrants lower quantum of penalty. Furthermore, the tax-payers covered in this part are also eligible of immunity under Section 270AA.

Now I will take you to the three divisions briefly as the matter is subjective and prone to observations and finding on fact-to-fact basis.

Readers might think:

"This doesn't seem chamber, it is separate jungle." Dear readers, there is innate enmity between evaders and taxmen. Evaders device new methods and hence legislature devices laws to fill the loopholes. And final outcome is complexity and jungle, but I will let you in for jungle safari.

www.taxguru.in

1. Exclusion Clause of 270A(6)-URI Yes-Penalty No

- This section will be loved by tax-payer if any URI happens for above reason. But taxmen understand very well that this is just eyewash and hardly anything will be covered in this. Because, if we look closely all the three clauses namely (a),(b) and (c) have SOME common aspect; which are complete disclosure of all material facts, complete and correct Books of accounts (Wherever required) to the satisfaction of AO.

  More precisely, we can say, it is just upgraded version of Prima Facie Adjustment (PFA), which is done by CPC. These are PFA, which are to be done by the AO during regular assessment. Hence, it is just prank of Section 270A, but I swear in the name of Almighty that the tax-payers will fight to come in shelter of this sub-section in URI happened.

2. The Cases of Misreporting of Income

This is the dreadful sub-section for tax evaders, where no sane taxpayer would want to go. Here, Act did not provide for immunity of Section 270AA instead threatened with killer quantum of 200% of tax payable on under-reported income. And a small child knows that there is no reasonable cause to evade taxes Section 273B). How can it be? Isn't it?

As mentioned below, I am giving very light discussion, but if it becomes intellectual type, please pardon me as it is not my intention. Here, the cache is:

"that these points are wide enough to cover every misadventure of evaders' tax planning. So dear tax evaders, just

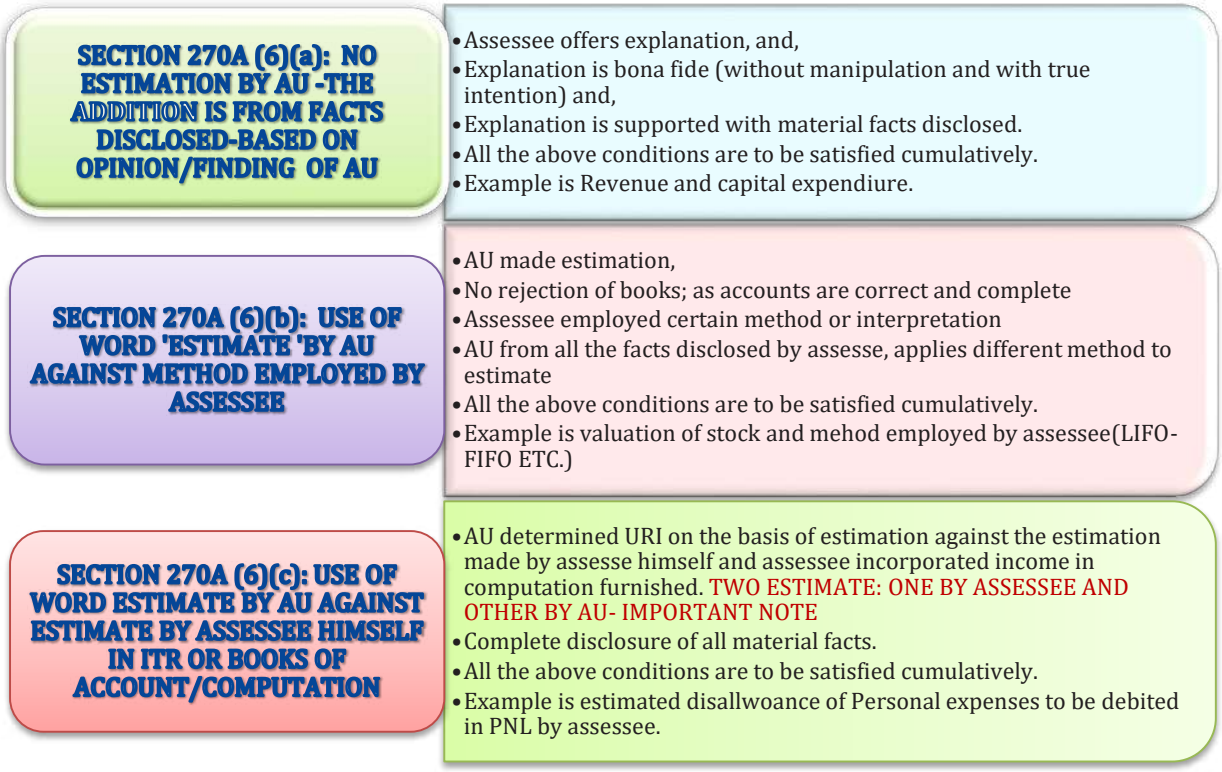


Fig. 1: Exclusion Clause of 270A(6)-URI Yes-Penalty No

www.taxguru.in

beware of and don't perform these six actions in tax matters!"

(a) **Misrepresentation or Suppression of Facts**

If the AO finds in given facts of case, that tax-payer misrepresented and suppressed facts, intentionally to reduce his/her tax liability which might seem within four corners of provisions of Act; or any other action such as machination shifting of liability of tax on persons who are in lower bracket of tax, colouring of transaction for tax avoidance purpose etc. In such instances the tax-payer will be in soup. (Remember No immunity and 200% tax on URI)

(b) F*ailure to Record Investments in the Books of Account*

(c) *Claim of Expenditure not Substantiated by Any Evidence;*

Normally, for this clause, there is already provisions of Section 69 and Section 69C. Hence, till now it can be said that whatever is not covered in Section 69 and 69C for any reason, would be covered here. [Please calculate effective tax including penalty in Section 270A of 200% and Section 271AAC, which is already high BP case.)

(d) Recording of Any False Entry in the Books of Account;

There has been introduced new penalty of Section 271AAD. The cases prior to this amendment are surely covered in this but facts of each and every case would tell as to what can more fall under this clause.

(e) Failure to Record Any Receipt in Books of Account having a Bearing on Total Income;

If we see language of this clause, it is not failure to record income INSTEAD it is failure to record receipt. Further, this failure should have bearing on total Income. This sentence is fun part, because if receipt has no bearing on total income (exempt income), then there would be no URI and NO penalty of Section 270A? Is it so? I am thinking of agricultural income. Let's think about various other examples. It is food for thought.

(f) Failure to Report Any International Transaction or Any Transaction Deemed to be an International Transaction or any Specified Domestic Transaction, to which the Provisions of Chapter X Apply.

This Clause (f), the last and sixth clause deals with specific transactions mentioned in Chapter X of the Act.

3. Residual under-reporting

Whatever URI is not covered by misreporting or does not fall in exclusion clause, it is under-reporting simpliciter. Most of the cases will be covered here. The quantum of penalty for this under-reporting is given in Section 270A(7). Though I am placing it under residual under-reporting, or, say under-reporting simpliciter, but participation in proceedings by taxpayers and respect of statutory provisions, might melt the heart of AU to place the addition under this category. Hence, again, dear tax-payers be cautious in assessment proceedings.

- In my opinion every under-reporting, where degree of disclosure, or where it is established that deliberate effort by tax-payer, has been made to avoid or reduce tax liability; such under-reporting is URI in consequence of

www.taxguru.in

misreporting. It must be considered a case for higher quantum of penalty. But there must not be use of this quantum indiscriminately in every case.

- Other than above-mentioned circumstances, if a tax-payer agrees to additions and disallowance at the stage of Show Cause Notice with Draft Assessment Order stage, it might be fit case for under-reporting residual or simpliciter. Here the tax-payer has an option to pay taxes and file application for immunity and does not prefer litigation. Hence, this under-reporting is a platform of immunity under Section 270AA, which will result in reduction of litigation in the Department.

Conclusion: No concealment type of thing in new regime. It is more mechanical way and only depends on upward variation in income or loss during any proceedings with respect to preceding order. Here, AO has no liberty to quantify penalty between the given range, as was the case in earlier in old regime. Here, the quantum is pre-decided either 50% or 200% of URI.

CHAMBER THREE AND FINAL

Calculation/Computation Under Reported Income and Quantum of Penalty

1. After theory, we need to go to lab and quantify penalty. The above diagram gives steps and flow to reach final quantum of penalty as per facts of case. In this part, I will start from easiest calculation; then, we will go to tricky and disputed ones. Mostly, I have covered disputed calculations, because simple calculation will be done on finger-tips. Just follow the very special concept and newer terminology here, and surely you will find all arithmetic as butter.

2. Taking examples, rather quoting provisions will surely help to understand the nitty gritty of computation of tax payable on under reported income. After determining rates given in Sections 270A(7) and 270A(8) on the basis of analysis of case in Chamber Two, we need to find URI and Tax payable on URI. Based on this tax payable we can find quantum of penalty in particular case.

3. **The Basic Formula and some concepts**

- From this formula, one thing is very clear that in case of NO ROI, assessed income in regular assessment shall become URI directly. We have already discussed that in case of persons covered with slab

{Assesed income in regular assessment/subsequent assessment}	
MINUS	
{Assessed income as per intimation under Section 143(1)(a)/Assessed Income of preceding order}	
Formula **Steps**	
THREE STEPS	MANT-Maximum Amount Not chargeable to Tax (required for person having slab rate of TAX)
STEP-1	Finding of URI [UNDER SECTION 270A(3)]
STEP-2	Finding of TAPURI (Tax payable on URI) [UNDER SECTION 270A(10)]
STEP-3	Computing 50% or 200% on TAPURI [WORK IS DONE]

rate, the URI is possible only when the assessed income in regular assessment is more than MANT.

- The curious case of Loss, is not covered by this formula, because in Loss cases the whole variation becomes URI and considered as total Income for TAPURI.

IDEAL EXAMPLE: M/s SKD is a firm and following particulars are available. From this we need to calculate quantum of penalty under Section 270A:

- There is no under-reporting of Income for increase in income as determined under Section 143(1)(a), though it is more than Income returned by firm.
- The first URI resulted in assessment under Section 143(3), here three steps will be completed.
- Ist Step-Calculation of URI = [75,00,000-60,00,000], thus URI is Rs. 15,00,000
- IInd Step Calculation of TAPURIRs. 4,68,000= {30% of 75,00,000+HEC 4%}-{30% of 60,00,000+HEC 4%}
- IIIrd Step-Calculation of quantum of penalty.

Under Reporting Simpliciter	50% of Rs. 4,68,000
Under Reporting Consequent to Misreporting	200% of Rs. 4,68,000

4. The above example is an ideal example to understand the broad outline to compute under-reported Income and Tax Payable to decide quantum of penalty. But, in practical word, the assessed income may have different additions and disallowances, including additions of Section 271AAC. Hence, method given under Section 270A(3) for under-reported income and method given under Section 270A(10) for calculation of tax payable, changes as per different cases based on status of assessee, nature of additions and circumstances where no ROI is filed by the person having tax liability at slab rates.

NOTE: Tax payble is calculated on Net Taxable Income. Hence, while calculating tax payable care must be taken regarding clubbing, set-off and deductions with applicable cess and surcharge.

4.1 Concept of MANT in case first time assessment where no ROI filed by person having slab rate applicable:

- Suppose an individual assessee who is below the age of 60 years does not file ROI. His case gets reopened and order is passed under Section 147 read with Section144 of the Act, on Income of Rs. 6,20,000
- We all know whatever the assessed income, the above assessee is eligible for basic exemption limit or say MANT amount.
- URI is Rs.3,70,000(6,20,000-2,50,000)
- TAPURI is [Tax on 3,70,000+2,50,000]

	Particulars of Total Income (A.Y. 2019-20)	Rs.
1	As per Return of Income furnished under Section 139(1)	50,00,000
2	Income determined under Section 143(1)(a)	60,00,000
3	Income assessed under Section 143(3)	75,00,000
4	Reassessed under Section 147	95,00,000

www.taxguru.in

- Quantum of penalty will be either 50% or 200% on TAPURI.
- But if this case had been of Firm, then the URI would have been Rs. 6,20,000and TAPURI will be [Tax on 6,20,000], which is flat rate of 30%+cess and surcharge.

NOTE: Simply MANT has been adjusted to find URI and while calculating tax payable the same is added back. Finally, tax payable is on assessed income only, as there is no preceding order in this case.

4.2 'The curious case of loss' returned by assessee:

In previous discussion, we understood concept of loss, where loss is reduced or converted to positive Income; the whole variation is considered as URI. Further, in second step of TAPURI, the under-reported income is considered to be total income of assessee and accordingly the tax payable on TAPURI is computed to decide quantum of penalty.

4.3 More Practical Examples

First let's take an example with two different additions with different rate of penalty.

Particulars of Total Income of Firm (AY 2017–18)		**Rs.**	This difference between 1 & 2 is not URI for PFA reason. But difference between 2&3 of Rs. 13,00,000 is URI
1	As per Return of Income furnished under Section 139(1)	10,00,000	
2	Income determined under Section 143(1)(a)	12,00,000	
3	Income assessed under Section 143(3)		
	(i) Disallowance of Rs.8,00,000 Under reporting simpliciter	8,00,000	
	(ii) Addition of Rs.5,00,000 in 37(Misreporting)	5,00,000	
		25,00,000	

This example involves two URI, hence two calculation.

A. For Under Reporting simpliciter:
   - URI is Rs. 8,00,000[20,00,000-12,00,000]
   - TAPURI is [Tax payable on Rs. 20,00,000-Tax payable on Rs.12,00,000]
   - Penalty is 50% of TAPURI.

B. For under-reporting in consequence to Misreporting:

C. URI is Rs. 5,00,000[17,00,000-1200000]

D. TAPURI is [Tax payable on Rs. 17,00,000-Tax payable on Rs.12,00,000]

E. Penalty is 200% of TAPURI.

4.4 More example

Particulars of Total Income of Individual (A.Y. 2017-18)		**Rs.**
1	As per Return of Income furnished under Section 139(1)	NO ROI
2	Income determined under Section 143(1)(a)	NO INTIMATION
3	Income assessed under Section 147 read with Section143(3)	
	(i) Disallowance of Rs.8,00,000, 8% of business turnover	8,00,000
	(ii) Addition of Rs.5,00,000 Cash credit under Section 68	5,00,000
		13,00,000

Here, the example has been modified. In this case, assessee is individual and did not file ROI. Later, the case reopened under Section 148 and assessment was completed under Section 147 at income of Rs. 13,00,000. This assessed

www.taxguru.in

income has addition under Section 68 which attracts penalty under Section 271AAC. Hence, only one computation will be done.

This example involves one URI, hence only one calculation.

For Under-reporting in consequence to Misreporting:

- URI is Rs. 5,50,000[8,00,000-2,50,000]
- TAPURI is Tax payable on Rs. 8,00,000(5,50,000+2,50,000) Section 270A(10)(a)
- The penalty for Misreporting is 200% of TAPURI.

4.5 One More example

Particulars of Total Income of Individual (A.Y. 2017-18)		Rs.
1	As per Return of Income furnished under Section 139(1)	NO ROI
2	Income determined under Section 143(1)(a)	NO INTIMATION
3	Income assessed under Section 147 read with Section143(3)	
	(i) Disallowance of Rs.8,00,0008% of business turnover	2,00,000
	(ii) Addition of Rs.5,00,000 Cash credit under Section 68	5,00,000
		7,00,000

- For Under Reporting in consequence to Misreporting:
  - URI is Rs. -50,000[2,00,000-2,50,000]
  - No penalty under Section 270A as per Section 270A(2)(b)

4.6 Last and final computation, example of corporate assessee.

Income Normal provisions in Rs.		Income Normal provisions in Rs.	Book Profit
1	As per Return of Income furnished under Section 139(1)	10,00,000	2 Cr.
2	Income determined under Section 143(1)(a)	12,00,000	2Cr.
3	Income assessed under Section 143(3)	25,00,000	2Cr.
	(i) Addition of Rs.8,00,000 URI SIMPLICITER		
	(ii) Addition of Rs.5,00,000 URI SIMPLICITER		

- One can refer formula given in proviso to Sub-section 3(ii) of Section 270A, here I am giving example. But important to note than in above example, assessee company is liable to pay tax as per provisions of Section 115JB, at the stage of regular assessment and also after addition of Rs. 13,00,000to normal income.
- Calculation of URI = Rs. 13 lakh [Result of (A-B)+(C-D)]
- A-B comes to 25-12=13 lakh
- C-D comes to 2Cr-2Cr=0,
- TAP-URI =Tax on [Rs. 25,00,000-Tax on Rs. 12,00,000]
- Quantum of penalty is 50% of TAPURI.

CHAMBER THREE

Step to Exit

Before exit, don't forget principal of natural justice (PONJ) during penalty proceedings.

www.taxguru.in

Please see the beautiful and comprehensible definition of PONJ, which is given as under for benefit of all:

"Natural justice is a pervasive facet of secular law, where a spiritual touch enlivens legislation, administration and adjudication to make fairness a creed of life. The principles of natural justice or fundamental principles of procedure for administrative action are neither fixed nor prescribed in any code. Natural justice has meant many things to many writers, lawyers and system of law. It has many colour and shades and many forms and shapes."

1. Though I did not understood the meaning, hence leaving it to the intellectuals, but what I know that, "PONJ simply means giving ample opportunity to be heard to the assessee in any proceeding under the Act. Same is applicable to penalty proceedings. The 'ample' may be normally two notices, but it may depend on the size of heart also. However, sufficient opportunities must be given to the tax-payer to enable him to present his side.

2. Some taxmen might work with having different SWAG altogether. They pass order in too brief to be speaking order(intelligent ones). They write like, 'I have given opportunity vide so and so notices, assesee furnished his reply and I am not convinced, hence assesee is directed to pay penalty of Rs. ….." This way of deciding fate of penalty, attracts litigation and nothing else. It is just reminder, please speak in order as to why you are not convinced or satisfied. What assessee had said in reply that you got irked so much? Please avoid such things and speak in your order to make it speaking order.

Thus, we closed all chambers after completing the whole package of new regime of penalty. It has been attempted to give computations which involves risk factor in interpretation. In introduction of this write-up, I have stated in advance that the whole provisions were written considering that only additions/ disallowances are going to woo penalty of 270A. Here, I request the readers to visit the provisions under Section 270A(3) and 270A(10) and recheck computation and satisfy themselves.

CONCLUSION

There are more examples and issues that can be discussed, but it would be too early to discuss other aspects of the newly born provisions. The initiation and imposition of penalties are yet to be interpreted and tested on anvil of fundamentals of jurisprudence by honourable courts. The contents are purely my own interpretation of provision of Act. But no provision has been quoted verbatim to avoid boredom and forced reading. Some liberty of language also has been taken to smoothen the spirit of law. But, it is always advisable to refer Bare Acts, whenever any confusion arises.

* * * * * * * * *

Approval under Section 153D does not mean that Search Assessment Proceedings were jointly done by the AO and the Range Head

Ramesh Chander
(IRS: 1990)
CIT (Judicial), Delhi

Ramesh Chander, is an IRS officer of 1990 batch and is currently posted as Commissioner of Income-Tax (Authority for Advanced Rulings), Delhi. He had worked extensively in the field of International Taxes, Transfer Pricing, Alternate Dispute Resolution and other direct taxation fields. The views expressed in this article are his personal.

Executive Summary

While according approval u/s 153D of the Act, the Range Head gets inseparably involved in making assessment or that he is equally responsible with the Assessing Officer for every thing what he does or he does not do in the process of making assessment in search cases would be conceptually flawed and legally absurd especially because such a proposition would firstly be against the very purpose with which this section was brought on the statute book; secondly because by way of such an interpretation provisions of section 144A etc. would be found to be becoming redundant; also such a view would be clearly travelling beyond the intention expressed in the CBDT Instructions associating the Range Head in search assessment; and finally such a view if accepted would be found to be destroying the very independence of the Assessing Officer in performing the *quasi judicial* functions while undertaking assessment.

INTRODUCTION

Section 153D of the Income Tax Act (for short 'the ITA') mandates that no order of assessment or re-assessment under Section 153A or 153C of it in cases subjected to search under Section 132 of the Income Tax Act can be passed by an Assessing Officer without the prior approval of the Joint/Additional Commissioner i.e. the Range Head (hereafter for convenience also referred to as Range Head). In other words, Law provides that unless there is approval of the Range Head, the assessment order so passed by the Assessing Officer (for short hereinafter also referred to as 'AO') cannot take legal effect, i.e., it cannot become enforceable.

www.taxguru.in

2. Controversy

At times controversies do arise about the scope of approval given by the Range Head under Section 153D of the Income Tax Act, 1961.Generally, there is tendency on the part of the assessees to assail the very assessments framed by the AO by raising specious plea that the approval given by the Range Head like ***'assessment proposed is hereby accorded approval'*** etc. is mechanical and does not show application of mind and hence it is 'no approval'. Likewise, there is tendency on the part of the AOs also to argue that since the assessment order passed by the AO is duly approved by the Range Head to their every decision to make some addition or not to make some addition, Range Head too becomes a party and hence, for any deficiencies like under-assessment etc. noticed subsequently in the assessment so framed, Range Head too shares the joint responsibility.

3. Analysis

3.1 Before proceeding further in the context of the issue in hand, it will be relevant to bear in mind the fundamental principles of interpretation. One of the cardinal principles of interpretation is that while interpreting some Clause or Sub-clause of a Section in the Act effort should be made to ensure that the interpretation sought to be advanced is such that it should neither result even indirectly in the evasion (of statute) nor should it result in making some provision itself redundant or otiose.So, while interpreting the scope of Section 153D of the Act effort should be made to give an interpretation whereby neither the scheme of the Income Tax Act gets compromised nor should it make other sections—of the Act, which confer independence to the quasi-judicial decision-making of the AO,—meaningless or compromised.

3.2 With these preliminary remarks that law as contained under Section 153D of the Income Tax Act does not at all provide any specific form in which Range Head needs to couch his approval, it will be relevant to appreciate that entire scheme of the Income Tax Act is such that no one (including the Range Head) is required to interfere in the quasi-judicial independence of the AO except in a limited way as provided specifically under the law like invoking by the AO or by the Assessee or by the Range Head on his own of the jurisdiction/power as vested under Section144A of the Act.

3.3.1 Let us have a look at the relevant bare provisions of Section 153D which read as under:

> ***"Prior approval necessary for assessment in cases of search or requisition.***
>
> *153D. No order of assessment or reassessment shall be passed by an Assessing Officer below the rank of Joint Commissioner in respect of each assessment year referred to in clause (b) of sub-section (1) of section 153A or the assessment year referred to in clause (b) of sub-section (1) of section 153B, except with the prior approval of the Joint Commissioner:*
>
> *Provided that nothing contained in this section shall apply where the assessment or reassessment order, as the case may be, is required to be passed by the Assessing Officer with the prior approval of the Principal Commissioner or Commissioner under sub-section (12) of section 144BA."*

Careful perusal would show that the Law as contained under Section 153D does not at all prescribe the manner in which approval is required to be given by the Range Head. As a matter of fact neither under the Law nor even under the Rules framed there is any prescription qua the approval of the Range Head to be conveyed. Bare law just provides that AO, before he fastens the assessee with any additional tax liability, must obtain specific approval of the Range Head.

3.3.2 With the above preliminary discussion, it will now to relevant to advert to two critical issues which normally, but unfortunately, crop up which are:

(i) Can approval be assailed on the grounds like, 'that it was mechanical'?

(ii) Does the approval given mean that it was, in effect, a joint assessment?

These two oft raised controversies are discussed in the paragraphs that follow now.

3.4 Can approval be assailed on the grounds like 'that it was mechanical'?

3.4.1 When law simply requires **'order of assessment or reassessment…. to be passed only with the prior approval of the Joint Commissioner'** the satisfaction to be gathered by the courts would be confined only to ascertain whether on records there exists approval or not and nothing more. In the garb of applying the law approval given cannot be further dissected. One cannot read something into the Law or the Procedure which is not expressly provided. To undertake any exercise to further probe into the 'approval' given unconditionally (simpliciter) already available on records would be nothing but travelling beyond the law. Peeping further into the 'approval' would be impermissible; especially, when according of approval instead of being a quasi-judicial action on the part of the Range Head is purely an administrative act to be performed in law that is why there is no requirement on the part of the Range Head of affording any pre-decisional opportunity to the taxpayers.

3.4.2 In the light of this, one should remember that just because some benches of the Tribunal have interpreted scope of Section 153D in a particular way and have unfortunately been, instead of being guided by the law, swayed by the taxpayers to question the approvals on specious grounds inter alia like ***'in one approval letter there cannot be approval for more than year' or 'Range Head did not consider the search material or appraisal report while giving approval etc.' or 'the approval should show application of mind' or 'approval given is no approval because it is given in a cryptic manner' or 'approval is given the very same day when the file was put up for approval and hence is without application of mind' or 'approval is given for multiple years by way of one common approval letter which is not permissible' or that 'approval was not in the manner thought to be proper by the***

www.taxguru.in

Tribunal', etc., fundamental point that 'approval' given by the Range Head and found to be available on records cannot further be probed. Accordingly, one cannot allow oneself to be misled by such highly incomprehensible decisions so as to compromise with the express intention of the law. No one, including the judiciary,can in the garb of interpretation of law, interpret law as contained under Section 153D in a way which might tantamount to legislating or prescribing some procedure. It is felt that instead of getting misdirected by these highly questionable decisions and accepting them better option would be to file appeal or writ in the appropriate High Court or the Supreme Court to get such illogical and travelling beyond the Law decisions quashed.

3.5 Does the approval given mean that it was in effect a joint assessment?

3.5.1 As already mentioned scheme of the Income Tax Act is such that Assessing Officer, who is a *quasi-judicial* authority is mandated to work absolutely in an independent manner without getting coerced or influenced externally. Except when the provisions of Section 144A empowering the Range Head to legally interfere with the assessment proceedings are set in motion, one cannot be oblivious of the fact that the Range Head while supervising AO's assessment work purely performs administrative or supervisory role or authority. That is, while supervising the functioning of the AO Range Head does not act in *quasi-judicial* capacity. Concept of supervision of AO's assessment work is entirely different from the concept of administrative supervision. It is precisely why Supreme Court in *State of Bihar & Anrvs. JAC Saldanha & Ors [(1980) 1 SCC 554 dt.30-11-1979][DPB 3,12]* in para 16 has held that in the case of quasi-judicial authority concept of supervision/superintendence so as to direct him to do something is not attracted. Qua this principle, the CBDT also in its letter dated 07-11-2014 explaining and making reference of Inst. 6/2009, clarify that the purpose of issuing directions under Section 144A ,or of approving assessments under Section 153D by the Range Head, is confined to ensure fairness and to avoid infructuous additions, and not beyond.

3.5.2 It needs to be appreciated that Section 153D of the I.T. Act providing for ***'prior approval of the joint/Addl. Commissioner for assessment in cases of search'*** was inserted only w.e.f. 01-06-2007.Concept of statutory approval was introduced in the Act pursuant to the Director Generals of Income Tax (Inv.) & Chief Commissioners of Income Tax (Central) Conference held at Jaipur in October, 2006 where it was suggested that assessments in search cases by the AOs in the rank of ITO, ACIT/DCIT should be made only with the prior approval of the Jt./Addl. CIT. Even the background note as placed by the Board in its proposal for justifying the introduction of the concept of approval will show that the purpose to be achieved by providing for the concept of approval under Section 153D was

"...Therefore, to ensure a just and fair assessment in search cases, it is desirable that the order is approved by the supervisory officer."

3.5.3 This apart, it will be relevant to appreciate that approval mandated under Section 153D is quite similar to the approvals as required to be given under Section 274 where Law requires the AOs to obtain prior approval of the Range Head where the penalty imposable exceeds the specified limit of Rs. 20,000 (Rs. 10,000 where the AO is of the rank of ITO). There the mandate, as is known to all, for the Range Head, is to find out whether in the facts and circumstances of the case penalty as proposed by the AO, is just or otherwise. Prior approval of the AO's proposal to levy penalty is mandated just to ensure fairness and justness so that unnecessary harassment to the taxpayer is avoided. Similarly, while giving approval under Section 153D of the Act to the assessment proposed by the AO Range Head is mandated to see whether in the facts and circumstances of the case the additions/disallowances as proposed by the AO are called for. Concept of prior approval, as discussed later in this Article, is nothing but just a speed-breaker provided by the law to control the arbitrariness and unfairness on AO' part in proposing some addition or disallowance.

3.6 As already indicated, even the CBDT letter 07-11-2014 and Ins. No.6/2009 echo loudly that the intention behind associating Range Head was limited only to the extent of ensuring fairness and avoiding high-pitched additions and not beyond. Keeping in view this rationale and keeping intact AO's *quasi-judicial* independence, the Board's Letter dated 22-12-2006, which lays down detailed procedural compliances to be made by the Assessing Officer and also the Range Head, too limited the association of the Range Head, whoonly to the extent of procedural compliances in respect of centralization of cases, identification of cases for the purpose of issuance of notices under Section 153A, 153C, 148 etc., and not beyond.

3.7 At this juncture, it will be relevant to note that purpose of the Board in issuing Instruction dated 22-12-2006 was even otherwise also just ***" ...to frame general guidelines which would enable Assessing Officers to enhance the quality of assessments.."***. Under these guidelines, which are fundamentally for the guidance and compliance of the Assessing Officer, supervision by the Range Head is on limited aspects as explained below:

- AO & Range Head to jointly scrutinize AR & seized material to prepare Examination Note in respect of notices required to be issued under Sections 153A/153C/148 of the Act to the persons to whom the seized material pertains and for the cases to be centralized. (para 1.3)
- Assessment to be taken up group wise and Action Note be sent to the CIT through Range Head to enable proper supervision by him. (para 1.6)
- AO to record proper satisfaction before issue of 153C/148 Notice & the Range Head to ensure proper action in this regard. (para 1.8)

www.taxguru.in

- AO to prepare questionnaire. If considered necessary directions under Section 144A should be given by the Range Head. (para 2.2)
- AO to analyse reply furnished by assesse including the disagreements with findings recorded in Appraisal Report. (para 2.3)
- AO to bring, conclusions recorded in Appraisal Report which he differs, to the knowledge of Range Head. (para 2.9)
- After receipt of replies on questionnaire and gathering further evidence, instructions may be given by Range Head under Section 144A on own motion or on a reference by AO. (para 2.10)
- Final Show Cause Notice be prepared by the AO in consultation with Range Head. (para 3.2)

3.8. Thus, even within the meaning of this Instruction dated 22-12-2006 the association of the Range Head with the search and seizure assessment is limited to the extent of ensuring procedural compliances and to see that assessment is just and fair and not beyond. Had the intention of the Board been to associate Range Head at each and every stage of assessment thus making the assessment proceedings virtually of the nature of 'joint assessment' by the AO and the Range Head, there would not have been mention or directive to the Range Head to invoke jurisdiction under Section 144A of the Income Tax Act.In short, never ever the intention of the Law or the Board was to associate Range Head so as to interfere in the quasi-judicial independence of the Assessing Officer.

4. Summation

Seen, thus, interpretation to say that by necessary implication while according approval under Section 153D of the Act, the Range Head gets inseparably involved in making assessment or that he is equally responsible with the Assessing Officer for every thing what he does or he does not do in the process of making assessment in search cases would be conceptually flawed and legally absurd especially because such a proposition would firstly be against the very purpose with which this Section was brought on the statute book; secondly because by way of such an interpretation provisions of Section 144A etc. would be found to be becoming redundant; thirdly, such a view would be clearly travelling beyond the intention expressed in the CBDT Instructions associating the Range Head in search assessment; and finally such a view if accepted would be found to be destroying the very independence of the Assessing Officer in performing the quasi-judicial functions while undertaking assessment.

* * * * * * * * * *

www.taxguru.in

Evolution of Search Assessments

Satender Singh Rana
(IRS: 1994)
CIT (Appeal)-23

Satender Singh Rana is an Indian Revenue Service (IRS) officer of 1994 Batch and is currently posted as Commissioner of Income Tax (Appeals)-23, New Delhi. He has extensive experience in the field of Income Tax Litigation and judicial matters and is part of several committees formed by CBDT on Judicial/ Litigation Matters.

Executive Summary

There have been major amendments in the Income Tax Act since 1995 with regard to assessment of search cases. This article analysis the causes of litigation in search assessments as well as amendments made in the Income Tax Act. It also provides an insight into the new provisions for search assessments where search has been initiated after 1st April 2021.

Search and seizure action under Section 132 of Income Tax Act is one of the harshest provisions to detect concealed income of the tax payers. It involves invasion in privacy of the individual since search is carried out even at residence of the taxpayer. There have been various changes in provisions relating to search assessment in last few decades. In searches conducted prior to 01.07.1995, the assessments were reopened under Section147 of Income Tax Act and necessary additions made. Vide Finance Act 2015, Chapter XIV-B titled as 'Special Procedure for Assessment of Search Cases' was inserted containing Sections 158B to 158BI of Income Tax Act. Some important provisions are reproduced below:

"Computation of undisclosed income of the block period.

158BB. *(1) The undisclosed income of the block period shall be the aggregate of the total income of the previous years falling within the block period computed, [in accordance with the provisions of this Act, on the basis of evidence found as a result of search or requisition of books of account or other documents and such other materials or information as are available with the Assessing Officer and relatable to such evidence], as reduced by the aggregate of the total income, or as the case may be, as increased by the aggregate of the losses of such previous years, determined,—"*

www.taxguru.in

"Procedure for block assessment.

158BC *Where any search has been conducted under section 132 or books of account, other documents or assets are requisitioned under section 132A, in the case of any person, then,—*

82[(a) the Assessing Officer shall—

(i) in respect of search initiated or books of account or other documents or any assets requisitioned after the 30th day of June, 1995, but before the 1st day of January, 1997, serve a notice to such person requiring him to furnish within such time not being less than fifteen days

(ii) in respect of search initiated or books of account or other documents or any assets requisitioned on or after the 1st day of January, 1997, serve a notice to such person requiring him to furnish within such time not being less than fifteen days but not more than forty-five days, as may be specified in the notice a return in the prescribed form 83 and verified in the same manner as a return under clause (i) of sub-section (1) of section 142, setting forth his total income including the undisclosed income for the block period:"

"Levy of interest and penalty in certain cases.

158BFA.

(2) *The Assessing Officer or the Commissioner (Appeals) in the course of any proceedings under this Chapter, may direct that a person shall pay by way of penalty a sum which shall not be less than the amount of tax leviable but which shall not exceed three times the amount of tax so leviable in respect of the undisclosed income determined by the Assessing Officer under clause (c) of section 158BC:"*

The salient features of above scheme of Block Assessment were as follows:

(i) 'block period' as defined in Section 158B(a) meant the period comprising previous years relevant to ten assessment years preceding the previous year in which the search was conducted and also included the period up to the date of the commencement of such search. The block period was reduced to six years by Finance Act 2001 w.e.f. 01.06.2001. For the entire block period, the assessee was required to furnish single return of income and single assessment order was passed by the Assessing Officer.

(ii) Tax was chargeable at 60% as laid down in Section 113 of Income Tax Act. Penalty was chargeable under Section158BFA(2) of an amount equal to tax leviable and upto three times the tax leviable.

Thereafter, Hon'ble Delhi High Court in the case of *CIT vs. Ravi Kant Jain* [2001] 250 ITR 141 (Delhi) held that Block assessment under Chapter XIV-B of the Income-tax Act, 1961 is not intended to be a substitute for regular assessment. Its scope and ambit is limited in that sense to materials unearthed during search. It is in addition to the regular assessment already done or to be done. The assessment for the block period can only be done on the basis of evidence found as a result of search or requisition of books of account or documents and such other materials or information as are available with the Assessing Officer. Various other judicial decisions also held that additions in block assessment could be made only on the

www.taxguru.in

basis of evidence found as a result of search since tax was payable at a higher rate of sixty percent.

In order to allow Assessing Officer to make additions even in the absence of evidence found during search, new provisions for assessment in search cases were introduced by Finance Act 2003 w.e.f. 01.06.2003 vide Sections 153A to 153D of Income Tax Act. The tax rate was reduced from 60% to 30% and assessment was to be made for six assessment years immediately preceding the assessment year relevant to the previous year in which such search is conducted. Penalty was leviable under Section 271AAA of Income Tax Act upto 30.06.2012 and under Section 271AAB thereafter. Some important provisions are reproduced below:

Assessment in case of search or requisition.

153A. *[(1)] Notwithstanding anything contained in section 139, section 147, section 148, section 149, section 151 and section 153, in the case of a person where a search is initiated under section 132 or books of account, other documents or any assets are requisitioned under section 132A after the 31st day of May, 2003, the Assessing Officer shall—*

(a) issue notice to such person requiring him to furnish within such period, as may be specified in the notice, the return of income in respect of each assessment year falling within six assessment years [and for the relevant assessment year or years] referred to in clause (b), in the prescribed form and verified in the prescribed manner and setting forth such other particulars as may be prescribed and the provisions of this Act shall, so far as may be, apply accordingly as if such return were a return required to be furnished under section 139;

(b) assess or reassess the total income of six assessment years immediately preceding the assessment year relevant to the previous year in which such search is conducted or requisition is made [and for the relevant assessment year or years]

Assessment of income of any other person.

153C. *[(1)]Notwithstanding anything contained in section 139, section 147, section 148, section 149, section 151 and section 153, where the Assessing Officer is satisfied that any money, bullion, jewellery or other valuable article or thing or books of account or documents seized or requisitioned belongs or belong to a person other than the person referred to in section 153A, then the books of account or documents or assets seized or requisitioned shall be handed over to the Assessing Officer having jurisdiction over such other person and that Assessing Officer shall proceed against each such other person and issue such other person notice and assess or reassess income of such other person in accordance with the provisions of section 153A :]*

Thereafter, Hon'ble Delhi High Court in the case of *CIT vs. Kabul Chawla* [2016] 380 ITR 573 (Delhi) held that completed assessments can be interfered with by Assessing Officer while making assessment under Section 153A only on basis of some incriminating material unearthed during course of search which was not produced or not already disclosed or made known in course of original assessment. Consequently, all additions in completed assessments made in the absence of incriminating material unearthed during search were deleted. Hon'ble Kerala High Court in the case of *E.N. Gopakumar vs. CIT* [2017] 390 ITR 131 (Kerala) held that assessment proceedings

www.taxguru.in

generated by issuance of a notice under Section 153A(1)(a) can be concluded against interest of assessee including making additions even without any incriminating material being available against assessee in search under Section 132 on basis of which notice was issued under Section 153A(1)(a). Hon'ble Allahabad High Court in the case of *CIT vs. Raj Kumar Arora* [2014] 367 ITR 517 (Allahabad) held that Assessing Officer has power to reassess returns of assessee not only for undisclosed income found during search operation but also with regard to material available at time of original assessment. In view of conflicting decisions, huge litigation was generated on validity of additions made in search assessments.

In assessments under Section 153C, Hon'ble Delhi High Court in the case of *PCIT vs. N.S. Software (Firm)* [2018] 403 ITR 259 (Delhi) deleted additions on the ground that the Assessing Officer of searched person failed to record a specific satisfaction as to how said seized material 'belonged to' the assessee. Section 153C was amended by Finance Act 2015 w.e.f. 01.06.2015 and 'any books of account or documents, seized or requisitioned, pertains or pertain to, or any information contained therein, relates to' was inserted.The existing legislative provisions contained in Section 153A and 153C relating to assessments pursuant to search and seizure are no longer operative for searches conducted after 01.04.2021.

In order to minimize litigation in search cases, the Act was once again amended by Finance Act 2021. For searches conducted after 01.04.2021, assessment of search cases will be under Section 148 of Income Tax Act and it now reads as follows:

"148. Before making the assessment, reassessment or recomputation under section 147, and subject to the provisions of section 148A, the Assessing Officer shall serve on the assessee a notice, along with a copy of the order passed, if required, under clause (d) of section 148A, requiring him to furnish within such period, as may be specified in such notice, a return of his income or the income of any other person in respect of which he is assessable under this Act during the previous year corresponding to the relevant assessment year, in the prescribed form and verified in the prescribed manner and setting forth such other particulars as may be prescribed; and the provisions of this Act shall, so far as may be, apply accordingly as if such return were a return required to be furnished under section 139:

Provided that no notice under this section shall be issued unless there is information with the Assessing Officer which suggests that the income chargeable to tax has escaped assessment in the case of the assessee for the relevant assessment year and the Assessing Officer has obtained prior approval of the specified authority to issue such notice.

Explanation 1.—For the purposes of this section and section 148A, the information with the Assessing Officer which suggests that the income chargeable to tax has escaped assessment means,—

(i) any information flagged in the case of the assessee for the relevant assessment year in accordance with the risk management strategy formulated by the Board from time to time;

(ii) any final objection raised by the Comptroller and Auditor General of India to the effect that the assessment in the case of the assessee for the

relevant assessment year has not been made in accordance with the provisions of this Act.

Explanation 2.—For the purposes of this section, where,—

(i) a search is initiated under section 132 or books of account, other documents or any assets are requisitioned under section 132A, on or after the 1st day of Apri1,2021, in the case of the assessee; or

(ii) a survey is conducted under section 133A, other than under sub-section (2A) or sub-section (5) of that section, on or after the 1st day of April, 2021, in the case of the assessee; or

(iii) the Assessing Officer is satisfied, with the prior approval of the Principal Commissioner or Commissioner, that any money, bullion, jewellery or other valuable article or thing, seized or requisitioned under section 132 or under section 132A in case of any other person on or after the 1st day of April, 2021, belongs to the assessee; or

(iv) the Assessing Officer is satisfied, with the prior approval of Principal Commissioner or Commissioner, that any books of account or documents, seized or requisitioned under section 132 or section 132A in case of any other person on or after the 1st day of April, 2021, pertains or pertain to, or any information contained 5 therein, relate to, the assessee,

the Assessing Officer shall be deemed to have information which suggests that the income chargeable to tax has escaped assessment in the case of the assessee for the three assessment years immediately preceding the assessment year relevant to the previous year in which the search is initiated or books of account, other documents or any assets are requisitioned or survey is conducted in the case of the assessee or money, bullion, jewellery or other valuable article or thing or books of account or documents are seized or requisitioned in case of any other person.

Explanation 3.—For the purposes of this section, specified authority means the specified authority referred to in section 151."

Section 149 of Income Tax Act has been amended w.e.f. 01.04.2021 as follows:

149. (1) No notice under section 148 shall be issued for the relevant assessment year,—

(a) if three years have elapsed from the end of the relevant assessment year, unless the case falls under clause (b);

(b) if three years, but not more than ten years, have elapsed from the end of the relevant assessment year unless the Assessing Officer has in his possession books of accounts or other documents or evidence which reveal that the income chargeable to tax, represented in the form of asset, which has escaped assessment amounts to or is likely to amount to fifty lakh rupees or more for that year:

From a combined reading of amended provisions of Sections 148 & 149 of Income Tax Act, salient features of assessments in search cases can be summarized as follows:

www.taxguru.in

(i) A deeming fiction has been created in Explanation 2 to Section 148 that in search under Section 132, survey under Section133A and requisition under Section 132A cases, initiated on or after 1.4.2021, the Assessing Officer shall be deemed to have information which suggests that the income chargeable to tax has escaped assessment in the case of the assessee for the three assessment years immediately preceding the assessment year relevant to the previous year in which the search is initiated or books of account, other documents or any assets are requisitioned or survey is conducted in the case of the assessee or money, bullion, jewellery or other valuable article or thing or books of account or documents are seized or requisitioned in case of any other person. Reopening of assessments in these cases cannot be held invalid on the ground that satisfaction was not proper.

(ii) In search cases, assessments can be reopened only for a period of three years from end of the relevant assessment year. However, cases can be reopened beyond three years upto a period of ten years from end of the relevant assessment year only if the Assessing Officer has in his possession books of accounts or other documents or evidence which reveal that the income chargeable to tax, represented in the form of asset, which has escaped assessment amounts to or is likely to amount to fifty lakh rupees or more for that year.

(iii) Tax is chargeable at normal rates and penalty is leviable under Section 270A of Income Tax Act.

(iv) In view of recent amendments in the Income Tax Act with regard to assessment of search cases, it is hoped that litigation would be minimized and there would be faster resolution of disputes in search cases.

* * * * * * * * * *

www.taxguru.in

Transfer Pricing "Financial Transactions"—Settled Issues & Case Laws in Favour of Revenue

Shardul
(IRS: 2017)
ACIT TPO 1(3)(2)

Shardul is an IRS officer of 2017 batch. He did his Btech. in Electrical Engineering from Indian Institute of Technology - Delhi and is presently posted as ACIT TPO 1(3)(2) , Delhi .

Executive Summary

Financial Transactions from Transfer pricing perspective include Financial Guarantees (Corporate Guarantees, Performance Guarantees, Letter of Credit), Outbound Share Application money, Cash pooling, Outbound and Inbound loans, Outstanding receivables, Hedging, Risk free and Risk adjusted return, Captive Insurance etc. The aim of this article is to discuss Transfer Pricing issues related to Financial transactions which have been settled by courts in India and important case laws in favour of revenue with special emphasis on Financial transactions like Financial Guarantees, Outbound Share Application money, Outbound and Inbound loans, Outstanding receivables..

Transfer Pricing is an accounting practice that represents the price that one division in a company charges another division for goods and services provided. Transfer Pricing (TP) comes into play when there are transactions between related parties, these transactions have important tax implications. It becomes important that these transactions are done at Arm's Length Price (ALP) i.e. at a price as if it was done with an unrelated third party. Hence, TP Regulations were introduced in India vide Finance Act, 2011.

For the purpose of Transfer Pricing, "Financial Transactions" are transactions between related parties involving tangibles, intangibles, services etc. These are subject to transfer pricing rules and principles. These 'Financial Transactions" have not received due attention in TP parlance in earlier times. However, since the release of two important publications of OECD namely *BEPS (Base Erosion and Profit Shifting), Discussion Draft on Financial Transactions* in 2018, and *Transfer Pricing Guidance on Financial*

www.taxguru.in

Transactions in 2020, worldwide attention has been attracted to the issue, especially of the tax authorities of various jurisdictions. In this background, it becomes important to understand the important legal opinions of various courts in India with regards to TP Financial transactions.

TRANSFER PRICING: FINANCIAL TRANSACTIONS

To begin with, it is imperative to understand what is meant by these "Financial Transactions" as far as TP is considered. Financial transactions for the purpose of transfer pricing are basically common intra-group or intra-company transactions whereby transfer of tangibles, intangibles, services, capital etc. takes place. There are various types of 'Financial Transactions' these include Financial Guarantees (Corporate Guarantees, Performance Guarantees, Letter of Credit), Outbound Share Application Money, Cash Pooling, Outbound and Inbound Loans, Outstanding Receivables, Hedging, Risk-free and Risk-adjusted return, Captive Insurance. Some of these transactions have come up in front of courts in India and various important judgements have been pronounced.

Before moving ahead, one word of caution here is that financial transactions which though not explicitly named, could be implicitly found in the functioning of the company through agreements or business restructuring. Such Financial Transactions are very important because these may sometimes not be reported by the tax-payer. For example, such agreements or business restructuring may not be reported in Form 3CEB. Hence, in this background requisite care needs to be taken by Transfer Pricing Officers (TPOs) to identify and benchmark such transactions.

Now, we shall discuss major types of 'Financial Transactions' which have become very important vis a vis TP in India along with various important judgements discussing the settled issues. Further, special emphasis of this article is going to be on case laws in favour of Revenue in Transfer Pricing as far as Financial Transactions are considered.

FINANCIAL GUARANTEES

'Financial Guarantee' is an umbrella term which includes instruments like Corporate Guarantee, Performance Guarantee, Letter of Comfort. Out of these, corporate guarantee is a major issue in Transfer Pricing and other financial guarantees are seen as being similar to corporate guarantee. A corporate guarantee is an agreement in which one party, called the guarantor, takes on the payments or responsibilities of a debt if the debtor defaults on the loan. In simple words, A takes the liability of B to pay off its debt in case it defaults.

This transaction is very important from TP point of view because often one company X may provide financial guarantee to its AE without charging any fee using which the AE may be able to take a loan. In an uncontrolled scenario, such a thing is unlikely to happen because unrelated party won't give corporate guarantee for someone else to help them take a loan. As a result, this transaction needs to be benchmarked in order to determine the fee that should be charged. This fee then becomes the income of company X.

In case such a transaction has been incurred by the tax-payer, a first good step is to move ahead to check if the economic analysis of tax-payer can be rejected. In *Coca Cola Pvt. Ltd.* 309 ITR 194 the Hon'ble High Court of Punjab & Haryana held that there is no need to show motive of profit-shifting to attract the TP provisions. Thus, TP provisions can be attracted in such cases at the outset. Similar positions have been affirmed in the case of *Aztec Software & Technology*

Services Ltd. vs. ACIT [2007] 107 ITD 141 (BANG. ITAT) (SB).

This stand has been reiterated *in ACIT vs. MSS India Pvt. Ltd.* 2009-TIOL-416-ITAT-PUNE and *UE Trade Corporation (India)* (2011-TII-04-ITAT-DEL-TP) & *M/s ADP Pvt. Ltd.* (2011-TII-44-ITAT-HYD-TP).

On the basis of above judgements, grounds may be made to not accept the TP study provided by the tax-payer under Section 92C(3)(c) read with Section 92 CA and further TPO may benchmark the transaction.

Going ahead, we come to the point of dispute whether 'corporate guarantee is an international transaction or not' as the same dispute is raised many times by the assessee. This issue was earlier disputed; however, vide Finance Act 2012 and Finance Act 2014 amendments has been introduced in the Income-tax Act, 1961 (the Act) which has sought to bring clarity regarding corporate guarantee being an international taxation.

Finance Act, 2012 included Sub-section (c) of Clause (i) of Explanation to Section 92B (with retrospective effect from 2002) clearly demarcating 'Guarantee' as part of lending borrowings and capital financing transactions with retrospective effect from 2002.

While referring to this amendment introduced vide Finance Act, 2012, in the case of *Everest Kanto Cylinders Limited* [ITA No. 542/Mum/2012] Hon'ble Mumbai ITAT has held that guarantee is an international transaction. ITAT while stating this observation has relied on ITAT Bench A Chennai in the case of *Siva Industries & Holdings Ltd.* and *DCIT vs. Tech Mahindra Ltd.* 46 SOT 141 (MUM - ITAT) and *Four Soft Ltd. vs. DCIT* ITA No. 542/2012 Hon'ble ITAT Hyderabad which reaffirm the position that corporate guarantee is an international transaction.

In an important case law, often quoted by assesses, *Bharti Airtel Ltd vs. ADIT* ITA 5816/Del/2012 by Hon'ble ITAT Delhi the divergent view was taken that corporate guarantee is not an international transaction when it does not have a bearing on profits, income, losses or assets of the assessee. This, however, may be countered by TPO by arguing that such a transaction is bound to have a cost element on at least one of the AEs since at least one AE is taking some risk, which the basic principle behind issue of guarantee. As a result, guarantee can be stated to be an international transaction.

From international perspective, there is a dispute regarding the issue that if corporate guarantee from TP point of view is an international financial transaction, or a service. The landmark USA Tax Court decision in the case of *Container Corporation vs. Commissioner* 134 T.C. No 5 (2010) has held that guarantee is more similar to a service.

Further, in the case of *General Electric Capital Canada Inc.* with the *Tax Court of Canada* has held that corporate guarantee has economic value. From both point of view, guarantee can be said to be an international transaction.

The same position is mostly agreed to according to OECD TP Guidelines and also which multiple times talk about guarantees being provided intra-group as a service to group member. Even with respect to these views corporate guarantee has been considered as an international transaction relevant for the purpose of TP benchmarking.

One related matter in this regard is that assessee contends that guarantee is part of 'shareholder activity' and thus does not constitute to be part of international transaction. In this regard, the

www.taxguru.in

Tax Court of Canada has held in *Duha Printers (Western) Ltd. vs. Canada* that directors of companies owe duty not to shareholders but to the corporations for their day-to-day function; hence, as a result, such business decisions to undertake transactions related to guarantees does not fall under the purview of shareholder activity.

Further, assessee might contend that such transactions were done on the grounds of business expediency only and any income gain from such would be notional and thus not taxable. As a counter, this Hon'ble Delhi ITAT has decided in *Perot Systems TSI (India) Ltd. vs. DCIT* that business expediency has no role to play here and the real income theory of taxation does not apply to Chapter X of the Act. This opinion was further upheld in VVF Ltd vs. DCIT (2010-TIOL-55-ITAT-MUM).

One important issue which remains is the issue of benchmarking of corporate guarantee. There are various methods in theory which may be used to benchmark corporate guarantee like internal CUP, option pricing, yield method/interest saving approach, credit default swap, insurance, bank guarantee, standby letter of credit, cost-to-guarantor, capital introduction, and profit split. In India, however, the most widely used method has been 'bank guarantee' method. Though this method has not been accepted by various judicial authorities like in case of *Everest Kanto Cylinder Ltd & Glenmark Pharmaceuticals Ltd.* the court has held that TPO has brought nothing on record to show that terms and conditions in the comparable transactions of corporate guarantee are same. Thus, care needs to be taken that if bank guarantee is used as a benchmark details need to obtained regarding similar transactions undertaken by bank, contractual terms to establish that it is a valid comparable for corporate guarantee. Simply using the bank guarantee rates is not feasible in the background of these judgements.

Further, efforts need to be made to standardize use of *'yield method or interest saving approach'* which is the most internationally acceptable method of benchmarking corporate guarantees. For this, credit ratings of guaranteed entity and guarantor needs to be determined using methodologies followed by S&P, Fitch, Moody, Crisil , ICRA and CARE ratings (last three being Indian agencies which don't determine credit ratings of foreign companies) or using various databases available for the purpose of determining credit rating to the maximum extent possible.

As far as performance guarantees are considered, they are seen as being at par or similar to corporate guarantees from TP point of view the only difference is that performance guarantee is usually related to projects. The courts have taken similar view as corporate guarantees like in the case of IL&FS Technologies Ltd. ITA Nos. 4469 & 1551/Mum/2016 whereby the Hon'ble ITAT has agreed that performance guarantee is an international transaction.

As far as Letter of Comforts are considered, they also may be viewed in similar nature as discussed above only difference to be kept in mind is that enforceability of Letter of Comforts is not same, or as forceful as that of guarantee.

OUTBOUND & INBOUND LOANS

Outbound loans from TP perspective are those loans that are given by Indian companies to their foreign subsidiaries or group concerns. This is important from TP point of view because no prudent businessperson acting in uncontrolled situation would lend money below its cost of funds which might not be the case in related entities.

Such international transactions were generally undertaken while charging an interest rate of 2% to 6% using LIBOR (London Inter-bank Offered Rate) + Interest spread (additional interest depending on credit rating) while in the Indian scenario the companies charged 9% to 17% for such transaction based on Prime Lending Rate (PLR) etc. Thus, Indian rates were used to charge interest by TPOs in earlier times, irrespective of currency involved. However, many case laws came up whereby judiciary has deemed adoption of such rate as unacceptable.

In *Siva Industries & Holdings Ltd* ITA 2148 (Mad.) of 2010 dated 20.05.11, Hon'ble Mumbai ITAT has observed that once the transaction is in foreign currency and being an international transaction, commercial principles of international transactions have to be applied. Further, it was stated that domestic PLR would not be applicable and international rate being LIBOR would come into play.

Similarly, in *Tech Mahindra Ltd.* [ITA 1179 of 2010] Hon'ble Mumbai ITAT directed that in case transaction is there in other currency, then interest rate for other currency should be used. Again, in the landmark judgement of *M/s Cotton Naturals (I) Pvt Ltd.* [ITA 233/2014] Hon'ble Delhi High Court rejected the interest rate of 14% adopted by the TPO and stated clearly that interest vary and are dependent on the foreign currency in which repayment is made. Further, in *Tata Autocomp Systems Ltd* [TS 45 HC 2015 (MUM)–TP] Hon'ble Mumbai High Court held that interest has to be taken in the currency in which the loan is received/ consumed. Even internationally, the Australian Tax Office & UK TP guidelines has agreed with this position justifying use of LIBOR in case of Eurocurrency loans and SIBOR (Singapore Inter-bank Offered Rate) in case of Asian currency loans.

Finally, these judgements have been accepted in TP parlance in India as a settled issue.

An assessee may, in such cases also like that in corporate guarantee, invoke the principle of business expediency which is countered by *Perot Systems TSI (India) Ltd vs. DCIT* and also the real income theory of assessee is not acceptable on this issue further in the backdrop of VVF Ltd vs. DCIT (2010 TIOL 55-ITAT Mum).

It should be noted that while the issue of currency and its relevance has been put to rest other issues in determination of interest remain. In *Aithent Technologies (P.) Ltd.* [2012] 134 ITD 521/17 taxmann.com 59 Delhi, Hon'ble ITAT Delhi has laid down other relevant factors like credit quality of borrower, terms of loan, period of loan, amount, convertibility etc. as per which TPOs are required to determine the final interest rate.

Now coming to the issue of inbound loans, these are loans taken by Indian companies from foreign related parties. These may be in foreign or Indian currency and interest paid out needs to be properly benchmarked for the purpose for TP.

The decision of *M/s Cotton Naturals (I) Pvt Ltd.* [ITA 233/2014] Hon'ble Delhi High Court has stated that same principles shall apply to inbound loans also and interest rates need to be determined based on the currency. Hence, where the loans have to be repaid in foreign currency market determined LIBOR may be used in case it needs to be repaid in INR domestic PLR rates may be used.

Similarly, in *Goodyear South Asia Tyres Pvt Ltd.* [TS 933 ITAT 2016 (Mum)- TP] Hon'ble Mumbai ITAT held that rate of interest on External Commercial Borrowing (ECB) (dominated in foreign currency) should be based on LIBOR + interest spread (spread means additional interest

www.taxguru.in

determined based on the credit rating and risk assumed).

Further, in *ADAMA India Pvt Ltd.* [TS-16-ITAT-2017(Hyd)] Hon'ble ITAT Hyderabad has held that loans/ CCDs (Compulsorily Convertible Debentures) availed in Indian rupees should be based on Indian PLR. For this, the ITAT has relied on case laws *M/s India Debt Management Pvt. Ltd* .. ITA 7518/Mum/2014 and *Brahma Center Development Pvt Ltd* ITA 373/Del/2016.

Thus, regarding the question of currency lot of clarity has been brought about by the courts and the same should be followed. Other issues regarding determination of interest rate and how much interest spread to charge is to be decided by TPO based on credit rating, agreements etc.

OUTSTANDING RECEIVABLES

An overseas AE (Associate Enterprise) may defer payment of payables due to Indian companies beyond contractual period or normal period in a type of business. Thus, the AE keeps credit beyond the reasonable period which otherwise any uncontrolled unrelated party would be allowed to keep. This, thus, becomes important from TP perspective because in this way now a related party may allow undue benefit of extra credit to its related party.

Whether outstanding receivable is international transaction or not was earlier contested. In case of *Nimbus Communications Ltd.* (2011 43 SOT 695 Mum, *Patni Computer Systems Ltd.* (2012 19 taxman 180 Pune), Indo American Jewellery (2012 18 303 Mumbai) held that it is not an international transaction. However, with Finance Act 2012 'receivable' was introduced as part of Explanation to Section 92B Clause (i)(c). With this the issue that outstanding receivable is in fact an international transaction was settled.

Now, a follow up issue which came to emerge after this is whether outstanding receivable is a separate international transaction requiring them to be benchmarked separately, or not. According to one view it is not a separate transaction and it is in fact existing on account of the principal transaction, like sales. Thus, if sales are benchmarked outstanding receivables need not be benchmarked separately according to this view. This view has been supported by *Kusum Healthcare Pvt Ltd.* ITA No. 6814/ Del/2014 by Hon'ble ITAT Delhi; *Det Norske Veritas* ITA 2200/Mum/2014; *Information Systems Resource Centre Pvt Limited* 2015 (Mum) and others.

The other view is that there is a component of income arising on account of deemed interest on late payment of receivables and thus it is different from sales. This view is currently being held and used majorly among TPOs in India. This view has been supported by various judgements also like *Logix Micro Systems Ltd.* IT (TP) A 453/ Bang/2015; *Techbooks International Private Limited* ITA No. 240/Del/2015 and *Ameriprise India Private Ltd.* ITA no. 7014/Del/2014. Hence, these case laws may be used to justify the benchmarking of outstanding receivables as a separate international transaction.

Another important dispute on this issue is whether 'Working Capital Adjustment' takes into account the outstanding receivables or not. Thus, there is one view that if working capital adjustment is done, no adjustment on the ground of outstanding receivables can be made. This is a ground which may be used by the assessee to defend itself against adjustment on the issue of outstanding receivables. Some ITATs have opined that working capital adjustment is nullifying the effect of excess funds being locked up as working capital requirement.

However, this view is countered by stating the fact that working capital considers only opening and closing balances for the year whereas pending receivables depends on any number of days 30/60/90/180 depending on the industry standard or contractual terms. This is what was held in *Ameriprise India Private Ltd.* ITA No. 7014/Del/2014 by Hon'ble ITAT Delhi. Further, in the case ITAT has stated that allowing working capital adjustment in international services transaction can have no impact on determination of ALP of interest on receivables which is a separate international transaction also.

Hence, such transaction may be benchmarked keeping in mind the above discussed case laws. Also, *M/s Cotton Naturals (I) Pvt Ltd.* [ITA 233/2014] of Hon'ble Delhi High Court is to be kept in mind while benchmarking receivables that if they are in Indian currency then PLR to be used, or in foreign currency LIBOR etc. is to be used.

OUTBOUND SHARE APPLICATION MONEY

Share Application Money (SAM) is money received by company from applicants who wish to purchase its shares. This is an intermediary stage in equity financing in which company receives money but the allotment of shares to those who have paid share application money is pending.

Outbound share application money has important implications from TP point of view. This is the case because sometimes what might happen is that a company receives a loan under the garb of SAM. As a result, the recipient company may just end up using the money without allocating shares or it might use up the money for its requirement then cancel the share allocation and return the money, thereby benefiting in the form of loan received without it being benchmarked for TP purposes.

Subsequent to the order of Hon'ble Bombay High Court in the landmark judgement of *Vodafone India Services Pvt. Ltd. vs UOI WP* no. 871 of 2014 dated 10.10.2014 the CBDT has come out with Instruction No. 2/2015 whereby CBDT has accepted that issue of shares at premium is a transaction on capital account and thus could not be included in the definition of income within the meaning of Chapter X of the Income-tax Act, 1961. Hence, this issue has been settled and there is no longer any scope to make adjustment in this regard.

Another important case law to discuss here is *PCIT vs. PMP Auto Components Pvt. Ltd* (Bombay High Court) ITA 1685 of 2015. As per this judgement, the Hon'ble Court held that in case Indian company has purchased shares of its foreign wholly owned subsidiary in excess of FMV (Fair Market Value), still it does not give rise to income for the purpose of Chapter X of the Act. Interestingly, the court held that there is no distinction between outbound investment as in the case of Vodafone and inbound investment as in this case and both capital transactions do not give rise to income for Chapter X purpose.

However, this was a case for AY 2010–11 and various changes in the Act have come up concerning this concept. With effect from 01 April 2013, Section 2(24)(xvi) has been introduced which says that any consideration received in excess of FMV of a share is income with reference to Section 56(2)(viib). Also, with effect from 01 Apr 2017, the scope of income has been expanded to say that any value of property (shares) received for less than FMV would be income as per Section 2(24)(xviia) with reference to Section 56(2)(x). Hence, the meaning of income from point of view of receipt

www.taxguru.in

of shares is expanded now and there is great scope of examination from point of view of Transfer Pricing.

Now coming to the case laws regarding SAM to be treated as a loan. In case of *Logix Microsystem Ltd* [TS-181-ITAT-2017 (Bang)-TP] Hon'ble ITAT held that there was inordinate delay in allotment of shares and directed to apply LIBOR rate. Further, in the case of *Taurian Iron & Steel Co Pvt Ltd* [TS-768-ITAT-2016 (Mum)-TP] Hon'ble ITAT Mumbai characterized refunded SAM as loan. Similarly, in *KSS Ltd (K Sera Sera Productions Ltd.)* [TS-591-ITAT-2019(Mum)-TP] Hon'ble Mumbai ITAT justified re-characterization of SAM which has been pending for quite some time, in opinion of the court, as loan.

CONCLUSION

Hence, from the above discussion it can be appreciated that while few issues have been laid to rest by the courts in clear terms many points remain where disputes are ongoing and multiple views exist. This is natural in the ever-changing field of international taxation. However, being able to understand the TP jurisprudence through these judgements can help the officers of the department make efforts to check Base Erosion and Profit Shifting from India. The scope of TP adjustments in financial transactions is yet to be fully utilized in India. There are many transactions like cash pooling, hedging, risk free/ risk adjusted rate or return, captive insurance, business restructuring which have not been highlighted enough to reach the attention of courts in India. As a result, neither are there many TP adjustments on these issues in India nor anything has been concretely decided on these issues in India by Indian judicial authorities. Hence, the field is open for TPOs in this regard. Further, it can be seen from the above discussion how the legislations have been enacted actively to deal with novel upcoming issues in Transfer Pricing and International Taxation. This shows how India is continuously stepping up to the challenges of global tax policy. Internationally speaking Transfer Pricing of financial transactions is further going to be one of the most critical aspects of Transfer Pricing since the thinking of OECD and UN has just started evolving in this respect and possibilities of how international financial transactions may impact tax bases in different tax jurisdictions are limitless.

* * * * * * * * * *

Earlier Articles: Issues (1–7)

S. No	Topic	Issue No	Title of Article	Authors
A	Assessment	1	Assessment of Bogus Purchases	Surinder Jit Singh
		1	"Borrowed Satisfaction" for "Reason to Believe" for Reopening U/s 148 of Income Tax Act 1961.	Kalyan Nath
		1	Tracing the Powers of AO to Make Assessment u/s 153A w.r.t Presence or Absence of Incriminating Material.	Ajay Kumar Srivastava
		2	Understanding the Applicability of Section 115BBE	Ajay Kumar Srivastava
		2	Taxability of Capital Gain in Case of Joint Development Agreement (JDA)	G.V. Hemalatha Devi
		2.	Principles of Cross Examination in the Context of Income Tax Proceedings	Sulekha Verma
		2.	A Bird's Eye View of HUF Taxation in India	Sowmya V.
		2.	Search Assessment u/s 153 A & 153 C	Santosh Kumar
		3.	Capital Gain from Sale of Agriculture Land	Raja Ram Sah
		3.	Need for Amendment in Section 36(1)(va) of the IT Act, 1961	Sudha Kumari
		3.	Avoidable Mistakes in Assessment	Satender Singh Rana
		4.	Assessment of Income from Transactions in Shares and Securities as Business Income	Mr. Ramesh Narain Parbat,
		4.	Assessment of " On-Money"	Mr. Sanjiv Shankar
		4.	Assessment Years to be Considered under Section 153 C : Revenue's Perspective	Mr. Krishan Gopal Goyal,
		4.	Assessment and Investigation of Contractors	Mr. Shardul Singh
		4.	Taxation of Share Premium	Mr. Kalyan Nath
		4.	Issue of Notice/Assessment Order in the Name of 'Deceased Person' or 'Amalgamated / Merged Company'	Mr. Satpal Gulati
		4.	Issues Related to Section 14 A	Ms. Parmita Biswas Ms Rakhi Vimal Mr. Satpal Gulati and Mr. Surinder Pal
		4.	Issues in Respect of Reopening of Assessment	Mr. Jay Kishore Mishra and Ms. Sushama Singh
		4.	Reckoning the Period of Six Assessment Years for Making Assessment under Section 153 C(1) – Whether the Amendment w.e.f. 01.04.2017 IS Retroactive?	Mr. Ajay Kumar Srivastava
		5.	Revisionary Powers Under Section 263 of the Income Tax Act	Nidhi Srivastava and Satpal Gulati

www.taxguru.in

S. No	Topic	Issue No	Title of Article	Authors
		5.	Supreme Court Decision in the Case of NRA Iron and Steel Pvt . Limited	Sanjeev Sharma
		6.	China Garden Story	Sanjay Puri
		6.	Chargeability of Consultancy Fee Received by Consultants Working in International Organizations or Agencies	Ashis Mohanty
		6.	Applicability of Higher Tax Rate to Deemed Income of Assessment Year 2017-18 : Prospective Nature of Amendment	Byomakesh Panda
B	Best Practices	1.	The Times They Are A- Changing	Prasenjit Singh
		7.	CSR: Impact of COVID-19 and Foreseeable End to Tax Litigation	Sourabh Nayak,
		7.	Caveat Assessing Officer! of the implications of Insolvency and liquidation proceedings in the National Company Law Tribunal	Ramesh Chander
C	Dispute Resolution	1.	Authority for Advance Rulings and Settlement of Tax Disputes	Justice Arijit Pasayat
		1.	Advances need to be Made in the Field of ' Advance Rulings'	Ramesh Chander
		1.	Advance Pricing Agreement Programme in India	Sanjeev Sharma
		1.	Reduction in Income Tax Litigation	Krishna Mohan Prasad
		2.	Judgments in Favour of Revenue in Penny Stock Cases	Kalyan Nath
		2.	Quo Vadis – Retrospective or Prospective	Dr. Abani Kanta Nayak
		5.	Managing Work in ITAT by DR and Sr. DRs	Subhash Bains
D	Exemptions	1.	Disallowance for Violation of Section 13(2) (b) of the Act- Denial of Entire Exemption, or Limited Only to the Amount Diverted – Recent Judicial Decisions	Dr. N.C. Swain
		2.	Trust But Verify	Somogyan Pal
		5.	Philanthropy , Trusts and Their Taxation : A Glance Back	Chandra Prakash Bhatia
		6.	Taxability of Income Of Urban Development Authorities	N.C. Swain
E	International Taxation	1	Policy for Taxation of Digital Economy	Chandana Ramachandran
		1.	Challenges of Framing New International Taxation Rules in Digital Economy- Determining Value Creation	Priyabrata Pramanik
		1.	Taxation of Cloud Computing Services – An Analysis	CA Narendra J Jain
		1.	Claim of Deduction of Expenses on Payments to Non-residents	Nilay Baran Som
		2.	International Taxation : A User's Guide	Nilay Baran Som
		3.	Automatic Exchange of Information – Confidentiality and Appropriate Use of the Data	Navneet Manohar

S. No	Topic	Issue No	Title of Article	Authors
		4.	Applicability of Section 2(47)(vi) in Offshore Indirect Transfer of Immovable Property	Mr. Shreshth Tayal
		4.	Retrospective Law : Global and Indian Instances	Mr.Chandra Prakash Bhatia
		5.	Scope of Preparatory and Auxiliary Activities: Recent Developments	Sanjeev Sharma
		5.	Residential Status : A User' s Guide	Nilay baran Som
		5.	The MFN Clause Debate on Dividends to Foreign Shareholders	Shreshth Tayal
		5.	Deep Dive into " Effective Connection with Permanent Establishment "	Satpal Gulati
		6.	OECD Mutual Agreement Procedure Co-operation Award for India : Looking Back	Rajat Bansal
		7.	Interplay of Article 7 and Article 12: Understanding through the lens of a case.	Nilay Baran Som
		7.	Tax Treaty Benefit at the Time of Payment of Dividend Distribution Tax (DDT)	Kamlesh Chandra Varshney
F	Penalty	1.	New Penalty Provisions under Section 270 A	Satender Singh Rana
		2.	Approval of Penalty Proposals Moved by the Assessing Authority	Ramesh Chander
		6.	Penalty under Section 271 AAD : Facets and Fallout	Raja Ram Sah
G	Tax History	1.	RT. Hon'ble James Wilson-Architect of Modern India Budgeting System	Chandera Prakash Bhatia
		1.	Post-liberalisation Direct Tax Reforms in India	Ajai Das Mehrotra
		2.	Taxation , Business and Gujarat : Some Historical Facts	Chandra Prakash Bhatia
		3.	Literature on Tax-evasion and Black Money in India	Krishna Mohan Prasad
		3.	History @ Workplace : Some Historical Office Buildings of Kolkata	Chandra Prakash Bhatia
		3.	History of Computerization in the Income Tax Department	Yogesh Pande
		4.	Mohini Mills Limited : An Unforgettable Legacy	Chandra Prakash Bhatia
		5.	Origin and History of Some Revenue and Legal Term	Chandra Prakash Bhatia
		6.	Fiscal Management – Methods Prescribed in the " The Arthashastra"	Chandra Prakash Bhatia
H	Tax Policy	1.	Designing Trust for Indian Tax System	Smarak Swain
		1.	Efficacy of Tax Breaks	Dr. Rajeev Ranade
		5.	Direct Taxes and Taxpayer's Services in India	Pratibha Chaudhary
		5.	The Problem of Low Personal Income-Tax Base of India : An Alternate Perspective	Amit Shukla
		5.	Evolution of General Anti-Avoidance Rule in India	Raghav Gupta
		5.	GAAR in India	Deepak Chaudhary

www.taxguru.in

S. No	Topic	Issue No	Title of Article	Authors
I	TDS	1.	The Missing Link : A Collaboration between GSTN and TDS	K. Ravi Ramachandran
		2.	Tax Deducted at Source – Scope and Way Forward	Aman Preet
		2.	Emerging Issues in TDS	Pratap Singh
		2.	Technology Leads to Higher Rate of TDS Convictions	Vinod Pandey
J	Transfer Pricing	1.	Transfer Pricing in India	S.C. Mishra
		2.	Transfer Pricing Audits in the Case of a Service Provider	Sanjeev Sharma
		2.	Tax Havens and Developing Countries : Policy Challenges in post BEPS Regime	Abhishek Anand
		3.	BEPS in India and Conflicting Interpretation of Business Connection	Justice A.K. Sikri, P.K. Dash and Kritika Krishnamurthy
		3.	Intra- Group Services : A 360 Degree Perspective	Manesh Kumar Gupta
		4.	Traditional Transaction Methods in Transfer Pricing : An Appraisal	Mr. Rajiv Kumar Singh
K	E- assessment	2.	Group & Faceless Assessment: The E-assessment Scheme, 2019	Krishna Mohan Prasad
L	Faceless e- Assessment	3.	The E-Assessment Scheme – 2019 : A Quality Enhancer	Smita Jhingran
		3.	Novel Initiatives in Faceless e-Assessment Eco-system	Chandan Kumar Srivastav
		5.	Risk Analysis for Faceless Assessments : 'Ratio Analysis' and' Setting Benchmarks' for Organize Business	Sanjiv Shankar
M	Ideation	2.	Mistakes are the Stepping Stones to Learning	Prasenjit Singh
		2.	Assessment of Cash Deposits in OCM Cases	S.S. Rana
		2.	The Civil War between Globalists and Nationalists : Evidence from Efforts to Tax the Digital Economy	Smarak Swain
		2.	Digital Evidences & Handling during Assessment Proceedings	Harsh S. Gautam Pawan K. Minz
		3.	A Job Well Done : Shree Changdeo Sugar Mills Limited Case	Chandra Prakash Bhatia
		3.	Black Money & the Unreported Digital Economy Including the Darknet	Ashish Abrol
		4.	OECD's Unified Approach on Pillar One to Address the Tax Challenges Arising from the Digitalization of the Economy : A Critical Analysis	Mr. Manesh Kumar Gupta
		4.	Digital Taxation in India	Mr. Deepak Chaudhary,

S. No	Topic	Issue No	Title of Article	Authors
		4.	Alternative Investment Funds : Indian Experiments and Way Forward with Tax Efficiency	Mr. P.K. Dash (Retd.) and Mr. Anuroop Omkar
		4.	Moratorium under Insolvency and Bankruptcy Code, 2016 and Initiation/ Continuation of Assessment Proceedings under the Income - Tax 1961	Mr. Akhileshwar Sharma
		5.	A Human Story in a Taxman's Life : My Gift of Magi	Krishna Mohan Prasad
		5.	Tryst with Auction	N.P. Sinha
		5.	Sadhguru, Ireland and Taxes	Subhash Jangala
		5.	Psychological Factors Behind Tax Compliance	Anupama Anand
		5.	Relevance of IBC Process for Income - Tax	M. Karthik Manickam
		5.	Interpretation of Taxation as a Pyscho-Sociological Phenomenon	Rachna Chhokar
		5.	Analysis of Admissions and Retraction vis-a – vis Indian Evidence Act	Dr. Sudha Kumari
		6.	A Few Legal Concepts which we do not know Much About	Ramesh Chander
		6.	Slavery , Tax Havenry and Great Britain	Subhash Jangala
N	Economy	3.	Yes and No : The Bank that Went Bust	Subhash Jangala
O	Budget	3.	Demystifying Annual Budget Making of the Union Government	Ramesh Chander
P	Income Tax Settlement Commission	6.	Applicability of Section 115 BBE to Settlement Proceedings	V.K. Saksena Retd.)
		6.	Applicability of Section 40 A (3) to Settlement Cases	V.K. Saksena (Retd.)
		6.	Whether the Doctrine of Stare Decisis is Applicable to Settlement Proceedings ?	V.K. Saksena (Retd.)
		6.	Scope of Enquiries that can be Ordered u/s 245 D(3)	V.K. Saksena (Retd.)
		6.	Taxation of Real Income vs. Total Income in Settlement Cases	V.K. Saksena (Retd.)
		6.	Settlement Commission – Suggestions for Amendments and clarifications	V.K. Sakena (Retd.)
Q	NCLT	6.	State vs. Secured Credit Priority of Claim	Akhileshwar Sharma
R	Angel Taxation	7.	Is Angel Taxation Still Hanging Over the Start-up's Head	Sowmya. V,
S	Search and Seizure	7.	Sitting on the Fence - Can the Joint Commissioner Remain Non-committal while Granting Approval u/s 153D of the Income Tax Act	Neeraja Pradhan
		7.	Role of Search & Seizure in detecting black money	Manoj Kumar
T	Litigation Management	7.	Managing Litigation via Technology	Ashok Kumar

www.taxguru.in

S. No	Topic	Issue No	Title of Article	Authors
U	Agriculture Income Tax	7.	Agricultural Income Tax : A Panacea for States' Fiscal Woes	Reghu M
V	Leaderspeak	7.	35 Years of Long Journey in Income Tax Department (Hindi Article)	Rakesh Kumar Paliwal
W	Audit	7.	Internal Audit set up in the Income Tax Department The Path Ahead	Sameer K Srivastava
X	ICDS	7.	Demystifying Income Computation & Disclosure Standards(ICDS)	Shreshth Tayal
Y	TAS	7.	Taxpayer Advocacy : A Frontier for Citizen Centric Tax administration	Reghu M
Z	Miscellaneous	6.	My Ankara Visit on OECD Programme	Kalyan Nath

* * * * * * * * * *

www.taxguru.in

Disclaimer (Taxalogue)

The thoughts views and opinions expressed in the texts belong solely to the author, and do not purport to be the view of the Income Tax Department. The content uploaded on the portal should not be used before Courts as the stated policy or position of Income Tax Department. Readers are advised to ascertain the correct position/prevailing law before relying on the document

Undertaking by Authors

The author certifies that the reported work submitted for publication in Taxalogue is an original work and has not been published elsewhere. The author further certifies that proper citations to the previous reported work have been given and no data/tables/ figures have been quoted verbatim from other publications without giving due acknowledgement and without the permission of the original author(s).

www.taxguru.in

Designed by: Excel Printing Universe, New Delhi-110067, e-mail:printing@groupexcelindia.com • www.groupexcelindia.com

An Initiative by
Directorate of Legal & Research, Central Board of Direct Taxes
Income Tax Department
Government of India