JUDICIAL UPDATE [FOR MAY, 2018 EXAMINATION]

1. Whether technical fee paid under a technical collaboration agreement for setting up a joint venture company in India is to be treated as revenue or capital expenditure, where, upon termination of the agreement, the joint venture would come to an end?

Honda Siel Cars India Ltd. v. CIT [2017] 395 ITR 713 (SC)

Facts of the case: The assessee, Honda Siel Cars India Ltd., is a joint venture company between Honda Motors, a Japanese company and Siel Ltd., an Indian company. The assessee and Honda Motors entered into a technical collaboration agreement (TCA) on May 21, 1996 under which a technical fee of 30.5 million USD was payable by the assessee in five equal instalments on a yearly basis. Under the TCA, Honda Motors had to provide manufacturing facilities, know-how, technical information, information regarding intellectual property rights to the assessee which the assessee was entitled to exploit only as a licensee, without any proprietary rights. The assessee treated the technical fees as revenue while the Revenue authorities contended that it is capital in nature.

Issue: Whether the technical fee of 30.5 million USD payable by the assessee is in the nature of revenue expenditure or capital expenditure?

Supreme Court's Decision: Affirming the decision of the High Court, the Supreme Court held that, in this case, technical fee is capital in nature since upon termination of TCA, the joint venture itself would come to an end.

Supreme Court held that if limited rights to use technical know-how is obtained for a limited period for improvising the existing business, the expenditure is revenue in nature. However, if technical know-how is obtained for setting up a new business, the know-how is a capital expenditure.

This Supreme Court Judgement is no more relevant because section 32 was amended w.e.f 01.04.1998. From 01.04.1998 depreciation shall be allowed on intangibles. Intangibles include know how, patent, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature.

2. Whether section 40(a)(ia) is attracted when amount is not 'payable' to a sub-contractor but has been actually paid?

Palam Gas Service v. CIT [2017] 394 ITR 300 (SC)

Facts of the case: The assessee, Palam Gas Service, is engaged in the business of purchase and sale of LPG cylinders. The assessee had arranged for the transportation to be done through three sub-contractors within the meaning of section 194C. During the relevant assessment year, when the assessee made freight payments of Rs.20,97,689 to the sub-contractors, it did not deduct tax at source. The Assessing Officer disallowed 30% of the freight expenses as per section 40(a)(ia) on account of failure to deduct tax. The assessee contended that section 40(a)(ia) did not apply as the amount was **not 'payable' but had been actually paid.**

Issue: Whether the provisions of Section 40(a)(ia) would be attracted when the amount is not 'payable' to a sub-contractor but has been actually paid? Would the obligation to deduct tax depend on the method of accounting followed by an assessee?

Supreme Court's Decision: The Supreme Court reaffirmed that the obligation to deduct tax at source is mandatory and applicable irrespective of the method of accounting adopted. If the assessee follows the mercantile system of accounting, then, the moment amount was credited to the account of the payee on accrual of liability, tax was required to be deducted at source. If the assessee follows cash system of accounting, then, tax is required to be deducted at source at the time of making payment.

The Supreme Court, accordingly, upheld the decision of the majority High Courts that section 40(a)(ia) would be attracted for failure to deduct tax in both cases i.e., when the amount is payable or when the amount is paid, as the case may be, depending on the system of accounting followed by the assessee.

3. Whether rental income earned from letting out of premises is to be treated as business income or as income from house property?

Raj Dadarkar and Associates v. Assistant Commissioner of income Tax [2017) 394 ITR 592 (SC)

Facts of the case: The assessee had acquired the right to construct a market on certain land from Municipal Corporation, Greater Bombay under an auction on May 28, 1993. The premises allotted to the appellant was a bare structure and it was for the appellant to make the premises fit to be used as a market. The appellant spent substantial sums to construct 95 shops and 30 stalls. From the years 1999 to 2004, the assessee treated income from sub-letting of such shops and stalls as business income. The case of the assessee for assessment year 2000-2001 was reopened by Assessing Officer by issuing notice under section 148.

Issue: Whether the income earned by the appellant is to be taxed under the head 'Income from house property' or 'Profits and gains from the business or profession'?

Supreme Court's Observations: The Supreme Court held that wherever there is an income from leasing out of premises, it is to be treated as income from house property. However, it can be treated as business income if letting out of the premises itself is the business of the assessee.

The only evidence produced in present case, for proving that letting out and earning rents is the main business activity of the appellant was the object clause of the partnership deed. The clause provided that "The Partnership shall take the premises on rent to sub-let or do any other business as may be mutually agreed by the parties from time to time." The Supreme Court held the clause to be inconclusive and observed that the assessee had failed to produce sufficient material to show that its entire or substantial income was from letting out of the property.

Supreme Court's Decision: The Supreme Court, accordingly, held that, in this case, the income is to be assessed as "Income from house property" and not as business income, on account of lack of sufficient material to prove that the substantial income of the assessee was from letting out of the property.

Note - In Chennai Properties and investments Ltd. v. CIT (2015) 373 ITR 673, the Supreme Court observed that holding of the properties and earning income by letting out of these properties is the main objective of the company. Further, in the return of income filed by the company and accepted by the Assessing Officer, the entire income of the company comprised of income from letting out of such properties. The Supreme Court, accordingly, held that such income was taxable as business income. In present case, however, on account of lack of sufficient material to prove that substantial income of the assessee was from letting out of property, the Supreme Court held that the rental income has to be assessed as "Income from house property'.

4. Whether the nature of an expenditure can be considered debatable for not invoking prima facie adjustment under section 143(1)(a), where the jurisdictional High Court has taken a view that the expenditure is capital in nature even though some other High Courts have held that the same is revenue in nature?

Deputy Commissioner of income Tax v Raghuvir Synthetics Ltd. [2017] 394 ITR 1 (SC)

Facts of the case: The assessee is a public limited company. For the relevant assessment year, it had filed its return claiming revenue expenditure of Rs.65,47,448 on advertisement and public issue. The company claimed that if the sum cannot be considered as revenue expenditure, then, alternatively, the said expenditure may be allowed under section 35D by way treating such expenditure as preliminary expenses. The Assessing Officer issued an intimation under section 143(1)(a) disallowing the sum incurred on public issue.

Supreme Court's Observations: The Supreme Court noted that there was divergence of opinion amongst the various High Courts on the nature of the expenses incurred on raising share capital. While the High Courts of Madras, Andhra Pradesh and Karnataka had held the preliminary expenses to be revenue in nature, High Courts of Allahabad, Himachal Pradesh, Delhi, Calcutta, Bombay, Punjab and Haryana, Gujarat and Rajasthan had held the expenses to be capital in nature.

Supreme Court's Decision: The Supreme Court held that, in the case of the assessee, the issue was not debatable, since the registered office of the assessee is in Gujarat, the law laid down by the Gujarat High Court is binding on the assessee and expenditure is capital in nature.

5. Whether "premium" on subscribed share capital is "capital employed in the business of the company" under section 35D to be eligible for a deduction?

Berger Paints India Ltd v. CIT [2017] 393 ITR 113 (SC)

Facts of the case: The assessee is a company engaged in the manufacture of paints. For the relevant assessment years, the assessee claimed deduction under section 35D of a sum representing share premium as being a part of the capital employed. The said deduction was disallowed by the Assessing Officer.

Issue: Whether "premium" on subscribed share capital is "capital employed in the business of the company" under section 35D to be eligible for a deduction?

Supreme Court's Observations: Section 35D allows deductions of preliminary expenses to the extent of 5% of "Capital Employed". "Capital Employed" is defined as aggregate of the issued share capital, debentures and long term borrowings. The Supreme Court observed that the share premium collected by the assessee on its subscribed issued share capital could not be part of "capital employed in the business of the company' for the purpose of section 35D. If it were the intention of the legislature to treat share premium as being "capital employed in the business of the company", it would have been explicitly mentioned. Moreover, column III of the form of the annual return in Part II of Schedule V to the Companies Act, 1956 under Section 159 dealing with capital structure of the company provides the break-up of "issued share capital" which does not include share premium at the time of subscription. Hence, in the absence of the reference in section 35D, share premium is not a part of the capital employed. Also, section 78 of the Companies Act, 1956 requires a company to transfer the premium amount to be kept in a separate account called "securities premium account".

Supreme Court's Decision: Affirming the decision of the High Court, the Supreme Court held that the assessee is not entitled to claim deduction in relation to the premium amount received from shareholders at the time of share subscription.

6. Whether payments made by the agents in India responsible for booking cargo and acting as clearing agents, to use a centralized communication system maintained by the assessee-company engaged in shipping business, can be treated as fees for technical services?

Director of Income-Tax (International Taxation) v. A.P. Moller Maersk [2017] 392 ITR 186 (SC)

Facts of the case: The assessee was a foreign company engaged in shipping business and was a tax resident of Denmark. The assessee had agents working for it across the globe, who booked cargo and acted as clearing agents. In India, the assessee had three agents. The assessee had set up and maintained a vertically integrated communication system called Maersk net system in order to help all its agents. The agents paid for the system on a pro rata basis. The Assessing Officer contended that the amounts paid by the Indian agents were fees for technical services taxable under Article 13(4) of the India and Denmark DTAA. The assessee argued that the arrangement was merely a cost sharing system and the payments were only a reimbursement of expenses.

Supreme Court's Observations: The Supreme Court observed that, for the sake of convenience of its agents, the assessee had set up a centralised communication system which was an integral part of the international shipping business of the assessee. The expenditure incurred for running this system was shared by all the agents and payments to assessee were merely as reimbursement of expenses incurred. The payments could not be treated as fees for technical services. **Moreover, the Revenue authorities had accepted that assessee's freight income in the relevant assessment years was not chargeable to tax as it arose from the operation of ships in international waters in terms of Article 9 of the India and Denmark DTAA, Once that was accepted and it was found that the communication system was an integral part of the shipping business, payments received from agents could not be treated as in lieu of any technical services.**

Supreme Court's Decision: The Supreme Court, accordingly, held that amounts paid by Indian agents to the non-resident company would not be liable to tax as fee for technical services under Article 13(4) of the India and Denmark DTAA.

7. Whether payment of sums due, after the deadline stipulated by the Settlement Commission, would save the petitioner from withdrawal of immunity from prosecution?

Sandeep Singh v Union of India [2017] 393 ITR 77 (SC)

Facts of the case: The petitioner is a dealer in real estate at Amritsar. A search was conducted on August 21, 2009 at his business and residential premises under section 132(1) subsequent to which the assessee filed an application before the Settlement Commission under section 245C(1). The case was settled before the Settlement Commission on December 12, 2014. Pursuant to the assessment after settlement, the petitioner was unable to pay the amount due by the stipulated date. He sought an extension for 14 months but was only given time until July 31, 2015.

The assessee filed a writ petition before the High Court seeking quashing / modification of the Settlement Commission's order granting partial extension of time. By the time the matter was heard by the Supreme Court, he had paid off all pending amounts.

Supreme Court's Observations: The Supreme Court explained that in case payments are not made within the time granted by the Settlement Commission or in case the person fails to comply with any other condition, subject to which the immunity was granted, the immunity shall stand withdrawn.

It is not in dispute that all payments were made by the assessee on January 20, 2016 before approaching the Supreme Court. Though the time originally granted was only up to July 31, 2015, all sums having been paid now, there is no need to relegate the assessee to the Settlement Commission. Settlement Commission has the power to extend the timelines. Hence, in the instant case, it shall be taken that the assessee has made the payments within the time granted under section 245H(1A).

Supreme Court's Decision: The Supreme Court held that the assessee having cleared all taxes due vide order of Settlement Commission, albeit after stipulated deadline, is immune from prosecution.

8. Is loan to HUF who is a shareholder in a closely held company chargeable to tax as deemed dividend?

Gopal & Sons (HUF) v. CIT (2017) 391 ITR 1 (SC)

Facts of the case: The assessee is a HUF which holds 37.12% shares in M/s. G.S. Fertilizers (P.) Ltd., a closely held company. During the relevant previous year, it received loans and advances from the company. Its return was scrutinized by the Assessing Officer who treated the loans and advances as deemed dividend under section 2(22)(e). The company declared in its annual return that the advances were given to the HUF but the share certificates were issued in the name of the HUF's Karta, Shri Gopal Kumar Sanei,

Issue: Whether loan given by a closely held company to a HUF is chargeable to tax as deemed dividend under section 2(22)(e) despite the stated position of law being that a HUF cannot be a shareholder in a company?

Supreme Court's Observations: When a loan is given by a closely held company, it is chargeable to tax as deemed dividend if the loan was given to a shareholder (having more than 10% shares in the company) or to a concern in which the shareholder has substantial interest (having more than 20% share in the concern). 'Concern' includes HUF.

In the instant case, loans were given to the HUF. There was some dispute as to who was the shareholder -the Karta or the HUF as share certificates were issued in the name of the former but the annual return mentioned the latter. **The Court observed that in either scenario, section 2(22)(e) would be attracted. If the HUF was the shareholder, as it held more than 10% shares, situation was covered. If the Karta was the shareholder, the HUF would be the concern in which the Karta has substantial interest.**

Further, on the issue whether a HUF can be a shareholder or not, it was observed that on account of Explanation 3 to section 2(22)(e), a concern includes a HUF.

Supreme Court's Decision: The Supreme Court, accordingly, held that the loan amount is to be assessed as deemed dividend under section 2(22)(e).

9. Whether receipt of higher compensation after notification of compulsory acquisition would change the character of transaction into a voluntary sale?

Balakrishnan v. Union of India & Others (2017) 391 ITR 178 (SC)
Facts of the case: The assessee owned vast area of agricultural land. The State Government acquired the property for development of a techno park. The assessee was awarded compensation of Rs.14.37 lakhs. Aggrieved by the amount, the assessee initiated negotiations with the Collector, further to which compensation was increased to Rs.38.42 lakhs. The assessee claimed exemption from capital gains under section 10(37)(iii) stating that the transfer of agricultural land was on account of compulsory acquisition. The Revenue authorities contended that the exemption should be denied as it was not a compulsory acquisition but a voluntary sale.

Issue: Whether receipt of higher compensation on account of negotiations transforms the character of compulsory acquisition into a voluntary sale, so as to deny exemption under section 10(37)(iii)?

Supreme Court's Observations: The Supreme Court observed that the acquisition process was initiated under the Land Acquisition Act, 1894. The assessee entered into negotiations only for securing the market value of the land without having to go to the Court. Merely because the compensation amount is agreed upon, the character of acquisition will not change from compulsory acquisition to a voluntary sale. The Court also drew attention to a recently enacted legislation titled, Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Act, 2013, which empowers the Collector to pass an award with the consent of the parties. Despite the provision for consent, the acquisition would continue to be compulsory.

Supreme Court's Decision: The Supreme Court held that when proceedings were initiated under the Land Acquisition Act, 1894, even if the compensation is negotiated and fixed, it would continue to remain as compulsory acquisition. The claim of exemption from capital gains under section 10(37)(iii) is, therefore, tenable in law.

10. Whether omission to issue notice under section 143(2) is a defect not curable in spite of section 292BB?

Travancore Diagnostics (P) Ltd v. Asstt. CIT (2017) 390 ITR 167 (Ker)

Facts of the case: The assessee had a diagnostic laboratory in Kollam and has a branch at Kottarakara. A survey under Section 133A was conducted, consequent to which the assessee filed its return of income. On the basis of certain incriminating documents and materials unearthed during the survey, a notice under section 148 was issued. Subsequently, the incomes were assessed for assessment years 2009-10 and 2010-11 under section 143(3) read with section 147.

The assessee raised additional jurisdictional grounds before the Appellate Tribunal. The assessee contended that for the assessment year 2009-10, the assessment was completed under section 143(3) read with section 147. However, a notice under section 143(2) was not issued. The Tribunal held that in view of section 292BB, the assessee's participation in the reassessment proceedings would condone the omission to issue a notice.

Issue: Whether failure to issue notice under section 143(2) would invalidate the assessment notwithstanding the assessee's participation in the proceedings? Would section 292BB come to the rescue of the Revenue authority if they omit to issue notice under section 143(2)?

High Court's Decision: The Apex Court had, in Asstt. CIT v. Hotel Blue Moon (2010) 321 ITR 362, held that without the statutory notice under section 143(2), the Assessing Officer could not assume jurisdiction. Here, Assessing Officer recorded his inability to generate a notice as the return was not filed electronically. Such defect cannot be cured subsequently, since it is not procedural but one that goes to the root of the jurisdiction. Even though the assessee had participated in the proceedings, in the absence of mandatory notice, section 292BB cannot help the Revenue officers who have no jurisdiction, to begin with. **Section 292BB helps Revenue in countering claims of assessees who have participated in proceedings once a due notice has been issued.**

11. Is interest on enhanced compensation under section 28 of the Land Acquisition Act, 1894 assessable as capital gains or as income from other sources?

Movaliya Bhikhubhai Balabhai v. ITO (TD) (2016) 388 ITR 343 (Guj)

Facts of the case: The petitioner's agricultural lands were compulsorily acquired for undertaking an irrigation project. The petitioner challenged the compensation awarded by the Collector which led to award of additional compensation of Rs.5,01,846 and interest amounting to Rs.20.74 lakhs under section 28 of the Land Acquisition Act, 1894. The petitioner filed an application in the prescribed form to the Assessing Officer for issuance of a certificate with 'nil' tax deduction at source.

The application was rejected by the Assessing Officer on the ground that the interest amount is taxable at source as per section 57(iv) read with sections 56(2)(viii) and 145A(b). Aggrieved with the rejection of application, the assessee filed a writ before the High Court.

High Court's Observations: The High Court observed that the assessee has received interest under section 28 of the Land Acquisition Act, 1894 which represents enhanced value of land and thus, partakes the character of compensation and not interest. Hence, the interest under section 28 is liable to be taxed under the head of 'Capital Gains' and not under 'Income from Other Sources'. On the other hand, interest under section 34 of the Land Acquisition Act, 1894 is for the delay in making payment after the compensation amount is determined. Such amount is liable to be taxed under the head 'income from Other Sources'.

High Court's Decision: The High Court held that the interest awarded under section 28 of the Land Acquisition Act, 1894 was not liable to tax under the head of 'Income from other sources' and thus, tax was not deductible at source. The Revenue authority had erred in refusing to grant a certificate under section 197 to the petitioner for non-deduction of tax at source.

12. Whether the Assessing Officer is bound to consider the report of Departmental Valuation Officer (DVO) when it is available on record?

Principal CIT v. Ravjibhai Nagjibhai Thesia (2016) 388 ITR 358 (Guj)

Facts of the case: The assessee sold his property for Rs.16 lakhs. The State stamp valuation authority valued the property at Rs.233.71 lakhs. During the course of assessment proceedings, at the request of the assessee, the Assessing Officer referred the matter of valuation to the DVO who valued the property at Rs.24.15 lakhs. The Assessing Officer passed the order before the receipt of the report of the DVO by treating Rs.217.71 lakhs (difference between Rs.233.71 lakhs and Rs.16 lakhs) as undisclosed income. The report of the DVO was received by the Assessing Officer after the date of assessment order but before the order was received by the assessee.

Issue: Whether the Assessing Officer having made reference to the DVO must consider the report of the DVO for the purpose of assessment?

High Court's Observations: The High Court observed that when the Assessing Officer has referred the matter to DVO, the assessment has to be completed in conformity with the estimate given by the DVO. As the DVO has estimated the value of the capital asset at an amount lower than the value assessed by the stamp valuation authority, as per 50C(2), it is such valuation which is required to be taken into consideration for the purposes of assessment.

High Court's Decision: The High Court held that capital gains has to be computed in conformity with the value so determined by the DVO.

13. Does the CIT (Appeals) have the power to change the status of assessee?

Mega Trends Inc. v. CIT (2016) 388 ITR 16 (Mad).

Facts of the case: The assessee filed its return of income as a partnership firm for the relevant assessment year admitting a total income of Rs.174.36 lakhs. The firm consisted of thirteen individuals and two firms. The return of income was selected for scrutiny which led to disallowance of certain deductions to the tune of Rs.262.50 lakhs. The assessee preferred an appeal. The CIT (Appeals) invoked section 251 and issued a show cause notice proposing to change the assessee's status to AOP on the reasoning that a partnership firm cannot be a partner in another firm. The assessee filed writ of petition to High Court to quash the show cause notice.

High Court's Observations: The Revenue contended that the CIT (Appeals) has power to modify assessee's status, since a partnership firm is a relationship between persons who have agreed to share the profits of the business carried on by all or any of them acting for all, and the term persons only connotes natural persons. Since some of the partners are other firms, the assessment cannot be carried out as a firm. They relied on the Supreme Court's ruling in Dhulichand Laxrninarayan v. CIT (1956) 29 ITR 535 (SC) to argue this point.

The High Court observed that, under section 251(1), the powers of the first appellate authority are coterminous with those of the Assessing Officer and the appellate authority can do what the Assessing Officer ought to have done and also direct him to do what he had failed to do. If the Assessing Officer had erred in concluding the status of the assessee as a firm, it could not be said that the Commissioner (Appeals) had no jurisdiction to go into the issue. The appeal was in continuation of the original proceedings and unless fetters were placed upon the powers of the appellate authority by express words, the appellate authority could exercise all the powers of the original authority.

High Court's Decision: The High Court held that the power to change the status of the assessee is available to the assessing authority and when it is not used by him, the appellate authority is empowered to use such power and change the status.

14. Is the increase in gross total income consequent to disallowance under section 40(a)(ia) eligible for profit-linked deduction under Chapter VI-A?

CIT v. Sunit Vishwambharnath Tiwari (2016) 388 ITR 630 (Bom)

Facts of the case: The assessee engaged in development of housing projects filed his return of income for the relevant assessment year after claiming deduction of Rs.16.82 lakhs under section 80-IB(10). The return was selected for scrutiny. In the assessment, a sum of Rs.83 lakhs towards sub-contract payment; Rs.1.75 lakh as commission payment and Rs.7.96 lakhs towards advertisement expenses were disallowed for nor -deduction of tax at source by invoking section 40(a)(ia).

The issue arose whether deduction under section 80-IB shall increase if Profits & Gains of Business or Profession increases because of disallowances.

The CBDT has, in its Circular No.37/2016 dated 2.11.2016, mentioned that the courts have generally held that if the expenditure disallowed is related to the business activity against which the Chapter VI-A deduction has been claimed, the deduction needs to be allowed on the enhanced profits. Thus, the settled position is that the disallowances made under sections 32, 40(a)(ia), 40A(3), 43B, etc. and other specific disallowances, relating to the business activity against which the Chapter V1-A deduction has been claimed, result in enhancement of the profits of the eligible business, and that deduction under Chapter VI-A is admissible on the profits so enhanced on account of such disallowance.