Recent Landmark Decisions

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1. Whether it is permissible for Assessing Officer under section 145 to adopt different methods of valuation of (i) excise duty paid raw material when purchased and (ii) unconsumed raw material on hand at the end of the year?

CIT v. Indo Nippon Chemicals Co. Ltd. (2003) 130 Taxman 179 (SC)

The assessees were manufacturing units which were liable to pay excise duty. Under the Modvat scheme, they used to get credit for the excise duty already paid on the raw materials purchased by them and utilised in manufacturing of excisable goods. The proportionate part of the Modvat credit was being set off against their excise duty liability. The Assessing Officer took the view that the Modvat credit that was available to the assessees should be treated as an income or an advantage in the nature of income, and therefore, added back the said amount to the income of these assessees. On appeal, the High Court addressed itself to the issue as to whether the value of the closing stock of the duty paid inputs, work-in-progress and finished goods must necessarily include the element of Modvat credit available. The High Court took the view that unless the Assessing Officer acted under the circumstances indicated in section 145, he is bound to adopt the method of computation of income regularly employed by the assessee. However, if he comes to the conclusion that the method of accounting employed by the assessee makes it impossible to correctly compute the income, then the Assessing Officer is entitled to adopt any other suitable accounting method which is consistent with the accepted principles of accountancy. It is not open to the Assessing Officer to treat outgoings as income under section 145 of the Act.

On appeal, the Supreme Court held that the view of the Assessing Officer that merely because Modvat credit is an irreversible credit available to the manufacturers upon purchase of duty-paid raw material, it would amount to income which is liable to be taxed, could not be accepted.

The Assessing Officer adopted the 'gross method' at the time of purchase, and the 'net method' of valuation at the time of valuation of the stock on hand. The Supreme Court held that the method was wholly erroneous. The Supreme Court held that, consequent to adoption of the method, the Assessing Officer had wrongly assumed that the income, to the extent of the Modvat credit on the unconsumed raw material, was generated, which was not reflected in the accounts. Accordingly, the Assessing Officer attempted to bring the income to charge under the Act. The Supreme Court held that the Assessing Officer was wrong in adopting different methods of valuation of (i) excise duty paid raw material when purchased and (ii) unconsumed raw material on hand at the end of the year.

2. Whether words 'derived from' in section 80HH must be understood as something which has direct or immediate nexus with an industrial undertaking?

Pandian Chemicals Ltd. v. CIT (2003) 129 Taxman 539 (SC)

The question to be decided in this case was as to whether interest on deposits with Electricity Board should be treated as income derived by the industrial undertaking for the purpose of section 80HH.

The Supreme Court held that the words 'derived from' in section 80HH must be understood as something which has direct or immediate nexus with an industrial undertaking. Although electricity may be required for the purposes of the industrial undertaking, the deposit required for its supply is a step removed from the business of the industrial undertaking. The derivation of profits on the deposit made with Electricity Board cannot be said to flow directly from the industrial undertaking itself.

The Supreme Court held that the rules of interpretation would come into play only if there is any

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doubt with regard to the express language used. Where the words are unequivocal, there is no scope for importing any rule of interpretation as submitted by the appellant.

Note *– Section 80HH applies only to an industrial undertaking which begins to manufacture or produce articles after 31.12.70 but before 1.4.90 in any backward area. However, the above decision is relevant even in the context of section 80IA (Deductions in respect of profits and gains from industrial undertakings or enterprises engaged in infrastructure development etc.) and section 80IB (Deduction in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings).*

3. Whether under section 80HHC, in arriving at export profits, profits earned from export of both self-manufactured goods as well as trading goods have to be considered as a whole?

IPCA Laboratory Ltd. v. Deputy Commissioner of income-tax (2004) 135 Taxman 594 (SC)

The observations of the Apex Court held as follows:

(i) Even though a liberal interepretation has to be given to section 80HHC, being a beneficial provision, the interpretation has to be as per the wordings of the section. If the language of the section does not confer the benefit, it cannot be availed by the assessee.

(ii) A plain reading of sub-section 3(c) of section 80HHC shows that 'profits from such exports' includes profits from export of self-manufactured goods plus profits from export of trading goods. The profit has to be calculated in a manner laid down in sub-section 3(c)(i) and (ii).

(iii) Section 80HHC makes it clear that in arriving at profits earned from export of both self-manufactured goods and trading goods, the profits and losses in both the trades have to be taken into consideration. If, after such adjustments there is a positive profit, the assessee would be entitled to deduction under section 80HHC. If there is a loss, he will not be entitled to any deduction.

(iv) The argument that the word profit in section 80HHC(3)(c) would not include losses and if there are any losses they are to be ignored is not acceptable. The word 'profit' in section 80HHC(3) will mean profits after taking into account losses, if any. Thus, the word 'profit' has the same meaning in section 80HHC(1) and (3).

(v) The proviso to section 80HHC(3) enables a disclaimer only to enable the export house to pass on deductions. It in no way reduces the turnover of the export house. Therefore, if there is no deduction available, because there is a loss, then the export house cannot pass on or give credit of such non-existing deduction to a supporting manufacturer.

(vi) (a) Section 80AB, which is a part of Chapter VI-A, applies in respect of all deductions permissible under Chapter VI-A, which also includes section 80HHC. Further, section 80AB has been given an overriding effect over all other sections in Chapter VI-A. Section 80HHC would thus be governed by section 80AB.

(b) Section 80AB makes it clear that the computation of income has to be in accordance with the provisions of the Act. If the income has to be computed in accordance with the provisions of the Act, then not only the profits but also losses have to be taken into consideration.

4. Whether the word 'otherwise' used in section 45(4) takes into its fold not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of a retiring partner?

Commissioner of Income-tax v. A.N. Naik Associates (2004) 136 Taxman 107 (Bom.)

The High Court applied the "mischief rule" about interpretation of statutes and pointed out that the idea behind the introduction of sub-section (4) in section 45 was to plug in a loophole and block the escape route through the medium of the firm.

The High Court observed that the expression 'otherwise' has not to be read *ejusdem generis* with the expression 'dissolution of a firm or body of individuals or association of persons'. *The expression 'otherwise' has to be read with the words 'transfer of capital assets by way of distribution of capital assets.* If so read, it becomes clear that even when a firm is in existence and there is a transfer of capital asset, it comes within the expression 'otherwise' since the object of the amendment was to remove the

loophole which existed, whereby capital gains tax was not chargeable. *Therefore, the word 'otherwise' takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of retiring partners.*

The only other contention is that section 2(47) has not been amended and consequently, even if sub-section (4) has been inserted in section 45 by the amendment, yet there is no transfer. However, this is not the correct position, since, firstly, the definition of transfer itself is inclusive. Before the introduction of sub-section (4), there was clause (ii) of section 47 which provided that any distribution of capital assets on the dissolution of a firm, body of individuals or other association of persons is not a "transfer". The Finance Act, 1987, had with effect from 1.4.88, omitted this clause, the effect of which is that the distribution of capital assets on the dissolution of a firm would henceforth be regarded as "transfer".

Therefore, instead of amending section 2(47), the amendment was carried out by omitting section 47(ii), the result of which is that distribution of capital assets on the dissolution of a firm would be regarded as "transfer". Thus, the contention that it would not amount to transfer is incorrect.

5. Whether the Settlement Commission can restrict the interest chargeable under section 234AB to 50%? Whether it has the power to waive such interest?

CIT v. Sant Ram Mangat Ram Jewellers & Others (2003) 264 ITR 564 (SC)

The Settlement Commission has no power to waive mandatory interest as contemplated under section 234A (for default in furnishing return), section 234B (for default in payment of advance tax) and section 234C (for deferment of advance tax) of the Income-tax Act, 1961. Therefore, the Settlement Commission was not entitled to restrict interest chargeable under section 234B for default in payment of advance tax to 50 percent.

6. What is the legal position of a departmental circular when it is apparently inconsistent with the provisions of the Act? What is the nature and scope of the planning measures?

Union of India v. Azadi Bachao Andolan (2003) 132 Taxman 373.

The Hon'ble Supreme Court had an occasion to examine the DTAA entered into with the Government of Mauritius in the case of *Union of India v. Azadi Bachao Andolan (2003) 132 Taxman 373.* Under the DTAA, capital gains accruing in India to a resident of Mauritius is not liable to tax in India subject to certain exceptions. This was clarified by the CBDT by Circular No.682 dated 30.3.94 by stating that capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius and the same will not be liable to tax in India. Subsequently, the issue of 'treaty shopping' by non-resident foreign companies to avoid capital gains tax on transfer of shares in Indian companies arose. In order to clarify the situation, the CBDT issued Circular No.789 dated 13.4.2000 stating that a certificate of residence issued by Mauritius authority will be conclusive proof of residential status and beneficial ownership in Mauritius for the purpose of applying the DTAA.

The Supreme Court reversed the above decision of the Delhi High Court and made wide-ranging observations on many matters including tax planning considerations. The Court held that the judicial consensus in India has been that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a DTAA. Therefore, the provisions of such an agreement would operate even if inconsistent with the provisions of the Income-tax Act. Circular 789 is a circular within the meaning of section 90, therefore, it must have the legal consequences contemplated by section 90(2). In other words, the circular shall prevail even if it is inconsistent with the provisions of the Income-tax Act, insofar as assessees covered by the provisions of DTAA are concerned.

The Court observed that many developed countries tolerate or encourage "treaty shopping", even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to significant loss of tax revenue. The Court cannot judge the legality of "treaty shopping" merely because one section of thought considers it improper. The court cannot characterize the act of incorporation under the Mauritian law as a sham or a device actuated by improper motives. The Court held that the impugned circular was issued under section 119 and hence valid. ■