E-Book

INCOME TAX CONCEPTS - JUDICIAL PATHWAY

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

Southern India Regional Council

Chennai

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JUDICIAL PATHWAY

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FOREWORD

Tax is the compulsory financial charge levied by the government on income, commodity, services, activities or transaction. The word 'tax' derived from the Latin word 'Taxo'. Taxes are the basic source of revenue for the government, which are utilized for the welfare of the people of the country through government policies, provisions and practices.

I am feeling elated to share my happiness amongst the members and other stakeholders in bringing out an informative e-book on **Income Tax Concepts – Judicial Pathway.**

This e-book is a compilation of various income tax concepts which have arisen from the judicial precedents rendered over the years. These concept are capable of application on an ongoing basis by authorities, tribunal and the courts under various circumstances.

We are confident that this e-book covers important topics like taxability of real income against notional income, Accrual of income, maintenance of books of accounts and its impact on taxability, principal of natural justice, Charging vs Machinery sections and many more of such interesting topics.

This e-book will help professionals who wish to educate themselves on the concept of income tax in India and its applicability by various judicial precedents.

This e-book, one in a series of member centric publications planned by SIRC, aims to serve as a Handbook and Guide for the professionals who intend to practice in the area of taxation and I am confident that it will serve the intended purpose.

On behalf of SIRC, I wish to place our sincere gratitude and appreciation to Adv. Bharat Agarwal, Adv. Ritika Agarwal and CA. Sneha Surbhusan, for sharing their rich experience and expertise on the Income Tax amongst our members through this e-book. I also acknowledge the contribution of CA. M K Sridhar who has reviewed the basic draft of this e-book with his rich of experience and professional excellence.

Comments and suggestions on the e-book are welcome at sirc@icai.in

CA.K.JALAPATHI
Chairman, SIRC of ICAI

Contents

Chapter I

Only “Real Income” can be Taxed Not “Notional Income”

Introduction

Tax is levied on “income” which is to be computed as per the provisions of the Income Tax Act. The entries in the books of accounts are not determinative of the income. In the “deeming provisions” chapter, we will analyse the various provisions under the Act, according to which certain transactions or amounts are deemed as income for tax purposes. This is at variance with the set rulings of courts that tax has to be levied on real income. As a prelude in this chapter, we will study whether the concept of taxing real income is still a reality or whether the various deeming provisions in the statute have rendered this concept a fiction.

In General Law

In India, taxes on income other than agricultural income are levied as per entry no. 82 of Union List – List I, Seventh Schedule.

Income under the Income Tax Act, 1961 are generally of two types :

(i) Real income

(ii) Notional income

The Major Lexicon defines the two phrases as under :

(i) Real income – Income after taking into account inflation. For example, a 10% pay rise when inflation is running 6% is worth only 4% in real income.

(ii) Notional income – Non-financial benefit that an owner receives from an asset. The term is most usually applied to the benefit received by the owner or occupier of a property. In such a case, the notional income is equal to the amount that would have otherwise been spent on rent.

Historical Background

The word "Tax" has emanated from "Taxation" which means an estimate. In ancient times, even agriculturists were required to pay taxes on their production. A part of agricultural produce was given to the government in the form of tax. This gave rise to the theory of real income i.e. paying a certain part of actual produce as tax.

The learned author K.B. Sarkar in his book "Public Finance in Ancient India", (1978 Edition) states as follows:

> "*Most of the taxes of ancient India were highly productive. The admixture of direct taxes with indirect taxes secured elasticity in the tax system, although more emphasis was laid on direct tax. The tax structure was a broad based one and covered most people within its fold. The taxes were varied and the large variety of taxes reflected the life of a large and composite population*".

Under Direct Tax laws

The scope of income under the Income Tax Act, 1961 is determined in section 5. As per the said section 5,for the purpose of determining the tax liability, the total income of any previous year of a person who is a resident shall include all income from whatever source derived which :

(i) is received or deemed to be received ; or

(ii) accrues or arise or is deemed to accrue or arise to him in India ; or

(iii) accrues or arise to him outside India.

Similarly, for a non-resident, income :

(i) received or is deemed to be received ; or

(ii) accrues or arises or deemed to accrue or arise to him in India.

Thus the determination of income under section 5 of the Act is based upon "real income" whether received or accrued and not any hypothetical income of an assessee.

Cannot ignore ground reality:

The Supreme Court in the case of *H. M. Kashiparekh & Co. Ltd. v. CIT*[1] points out that only that real income of the assessee is to be taxed. The court further observed that in examining any transaction and situation, the court would give credence to the facts and specification of the matter in reality rather than adapting a purely theoretical approach. The Court will lay more emphasis on the entire nature of the business without violating the express language of the statute. Thus, according to the Supreme Court, the interpretation of the statutory provisions cannot be made by ignoring the ground reality connected to the business of the assessee.

Thus, while taxing any income, the reality ought to be checked. Under section 50C(1), though the difference in stamp duty value and actual sale consideration is taxable on a notional basis, yet the Legislature w.e.f. 01/04/2019 has after considering the ground reality amended the said section to provide that where the value adopted by stamp duty valuation authority does not exceed 105% of the consideration received then in that case the full value of consideration shall be the actual consideration received.

Accrual backed by liability to pay

In the case of *CIT v. Excel Industries Ltd.*[2], the Supreme Court has held that Income tax cannot be levied on hypothetical income. Income accrues when it becomes due plus there should be a corresponding liability on the payer to pay the amount. An income can be taxed only when that income has

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[1] [1960] 39 ITR 706 (SC)

[2] (2013) 358 ITR 295 (SC)

actually accrued to that particular assessee and it is not just an hypothetical income. Whether or not it's assumed that the assessee was entitled to the advantages, there was no corresponding liability on the opposite party to pass the benefit. An hypothetical income may or may not materialise and its money value is therefore not income of the assessee.

Hypothetical income cannot be taxed:

Thus, before the income can be taxed, it was submitted that the accrual must be real and not hypothetical. For example, conversion of capital assets into stock in trade u/s. 45(2). As per the said section, on such conversion, income under the head "capital gain" will accrue not in the year of conversion but when the said stock in trade is sold. In case of *CIT v. M I Builders (P.) Ltd.*[3], the assessee reclassified its plot from current asset to fixed asset account and valued the same at market rate. The court held that the method of revaluation of stock by itself cannot usher in any real profit. The only thing that is taxable under the income tax law is "real income". There is no concept by which the stock in trade can be valued at market price for levying tax else it will result in unearned income getting taxed.

As per the provisions of section 2(47) of the Income Tax Act, if a landowner transfers possession of the land to a developer against consideration in the form of constructed area, then it is deemed to be a transfer of capital asset and the incidence of capital gain arises immediately under section 45(1) of the Act even though the owner has not received constructed area on the date of entering into the development agreement. However, now sub-section (5A) of section 45 has been introduced to dilute the effect of such deemed income as it states that where the capital gain arises to an assessee from the transfer of capital asset in a development agreement, the capital gains are taxable in the previous year during which occupancy /

[3] (2017) 81 taxmann.com 320 (All.)

completion certificate was issued by the competent authority subject to certain conditions. Thus, the said section has again moved from taxing a deemed income to real income.

Recently while dealing with section 14A in *Redington* (*India*) *Ltd.* v. *Addl. CIT*[4], the court declined to apply *CBDT's Circular no. 5/2014 dated 11/02/2014* which provides for disallowance of the expenditure even where the taxpayer in a particular year has not earned any exempt income. The court applied the matching concept and held that in a year where there is no exempt income, there should not be any disallowance of expenses with respect to that deemed income. The court, placing reliance on the decision of *CIT* v. *Walfort Share & Stock Brokers (P.) Ltd.*[5] also held that the provisions of section 14A are related to earning of actual income and not notional or anticipatory income. It was observed that :

(i) Section 5 provides for taxing of real income only. There is no concept of taxing any notional income under the statute ;

(ii) Rule 8D of the Income Tax Rules, 1996 is an artificial method of computation of disallowance of expenditure only where there is an exempt income earned by the assessee. Such computation cannot trigger in absence of any exempt income earned by the assessee. Invocation of disallowance of expenditure even where there is no exempt income, is extending the scope of provision which is not the mandate of law.

Interpretation Rules

A. <u>Accrual basis:</u>

In the case of income under the head “Profits and Gains from business or profession” , what is chargeable to tax is the profit and loss resulting from a transaction entered during the business in the previous year. Only the

[4] [2017] 77 taxmann.com 257 (Mad.)

[5] (2010) 326 ITR 1 (SC)

"real income" that is taxed based on actual transactions entered into by the businessman and not on any hypothetical transaction.

The Supreme Court while deciding what is actual income in the case of *Morvi Industries Ltd. v. CIT (Central)*[6], adapted the dictionary meaning of the word "accrue" and held that income can only "accrue" when it becomes "due" i.e. when it becomes legally recoverable irrespective of whether it is received or not and "accrued income" is that income which the assessee has a legal right to receive. Thus, until the amount is "due", no tax can be levied since there is no "real income". An example is section 28(v) which reads that any interest, salary, bonus, commission or remuneration by a firm to a partner shall be treated as income chargeable to tax under the head "profits and gains from business or profession" only when it is "due" or "received".

Similarly, in the case of *State Bank of Travancore v. CIT*[7], the court held that the word "accrue" in section 5 must be real taking into account the actuality of the situation. The court further held in para no. 33 that for the purpose of computation of income, it is difficult to evolve any acceptable formula of co-relating the "real income" with the accounting method. Taxation of any income is dependent on the facts and circumstances of each case. In what situation, an income is said to have actually accrued is well-settled law. The same is listed below:
(i) Considering the situation, the accrual must be "real";

(ii) The principles of real income theory must be applied to judge whether an "accrual" has taken place or not;

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[6] [1971] 82 ITR 835 (SC)
[7] (1986) 158 ITR 102 (SC)

(iii) After a particular income has accrued, it is not possible to accept that a particular assessee is not liable to income tax;

(iv) What has really accrued to the assessee has to be found out and what has accrued must be considered from the point of view of real income taking the probability or improbability of realisation in a realistic manner and dovetailing of these factors together but once the accrual takes place, on the conduct of the parties subsequent to the year of closing an income which has accrued cannot be made 'no income'."

B. Overriding title: The concept of real income would also apply where income has been surrendered; income has been accrued in theory but not in reality e.g. where a debt has become uncollectible and bad and deduction under the provisions of the Income Tax Act has been claimed and allowed. Where there is any diversion of income at source under any statute or by overriding title then the assessee has no income. In the case of *Associated Power Co. Ltd. v. CIT*[8], the Supreme Court held that *"13. The application of the doctrine of diversion of income by reason of an overriding title is quite inapposite. The doctrine applies when, by reason of an overriding title or obligation, income is diverted and never reaches the person in whose hands it is sought to be assessed*...".

We will discuss the concept of overriding title in detail in further chapters.

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[8] (1996) 218 ITR 195 (SC)

Specific Case Law

Citation – *Commissioner of Income Tax v. Shoorji Vallabhdas and Co.*[9]

Facts –

The assessee-firm was the managing agents of several shipping companies including M Ltd. and N Ltd. Under the agreements with these 2 companies, the assessee firm was entitled to receive commission @10% of the freight charged. Between 01/04/1947 to 31/12/1947, the assessee firm received a total commission of Rs.337,528/- and credited the same in assessee Firm's book with a corresponding debit to the 2 shipping companies for the year ended 31/03/1948. Subsequently, in 1947, the assessee firm started 2 new companies and desired that these 2 companies shall now be the managing agents of the 2 shipping companies and assessee firm to retire. Two shareholders of M Ltd. objected to the arrangement of 10% of freight charged and offered that either assessee firm shall be entitled to 10% of profit or 2½% of freight charged. The assessee firm accepted the offer of 2½% of freight charged. Accordingly, the assessee gave up 75% of its earnings during FY 1947-48. Similar, arrangement was made with N Ltd.

The AO and AAC held that the commission had already accrued during the previous year ending 31/03/1948, and was thus assessable. However, the President of the Tribunal held that even though the actual reduction took place after the previous year was over, there was, in fact, an agreement to reduce the commission even during current year, and the income neither accrued nor was received by the assessee firm. The High Court shares the Tribunal President's opinion.

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[9] [1962] 46 ITR 144 (SC)

Question before the Supreme Court –

Whether the amount equivalent to 75% of commission was income of the assessee for the "previous year" ended as on 31/03/1948 ?

Rule –

Events during the accounting year were themselves sufficient to show that the larger income neither accrued to the assessee firm nor was received by it so as to become taxable [*CIT v. Chamanlal Mangaldas & Co*.[10] affirmed by Supreme Court[11]].

Analysis –

(i) Income-tax is a levy on income which is triggered either of two points of time:

(a) accrual of the income; or

(b) its receipt,

but the substance of the matter is the "income". If income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made about a 'hypothetical income', which in reality has not materialised.

(ii) Where income has, in fact, been received and is subsequently given up in such circumstances that it remains the income of the recipient, since it is an application of the income. However, where the income is held not to have resulted at all, there is obviously neither accrual or receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account.

(iii) In the present case, the agreements within the previous year replaced the earlier agreements, and altered the rate in such a way as to

[10] (1956) 29 ITR 987 (Bom.)
[11] (1960) 39 ITR 8 (SC)

make the income different from what had been entered in the books of account

Held –

Unless an income has actually accrued / resulted, a mere book-keeping entry cannot be income. This reduction of rate was not a gift by the assessee firm to the managed companies. The reduction was a part of the agreement entered into by the assessee firm to secure a long-term managing agency arrangement for the two companies which it had floated.

Key Principle –

(i) Where there is no accrual or receipt, income is said to have not resulted at all, even if there is an entry in the books of accounts to that effect.

(ii) Events during the year are to be considered while treating any amount as income.

Further Reference –

(i) CIT v. Excel Industries Ltd. (supra)

(ii) CIT v. State Bank of India[12]

(iii) CIT v. Shiv Prakash Janak Raj & Co. (P.) Ltd.[13]

(iv) CIT v. Balbir Singh Maini[14]

Authors' Analysis

Any receipt has to be tested on the following four rules before it qualifies as an "income" for the purpose of levy of tax :

(a) the income has accrued and is "due";

(b) there exists a corresponding liability on the opposite party to pay such amount;

[12] (1988) 169 ITR 298 (Bom.)
[13] (1996) 222 ITR 583 (SC)
[14] (2017) 398 ITR 531 (SC)

(c) there exists a "real," and not a "hypothetical," income; and
(d) practically, there is a possibility of realization of benefits by the taxpayer.

Time and again, the various courts have held that only "real income" is chargeable to tax. However, over the years the legislature has introduced such provisions that make the "notional income" taxable, thereby creating a cleavage between the "notional income" and "real income". For instance the Supreme court has the case of *K.P Varghese vs. ITO*[15] held that fair market value of the asset cannot be treated as consideration for sale of that asset where there is no evidence of such understatement by the assessee.

Thus even if the asset is sold below the fair market value the tax can only be levied on actual consideration received and not on the presumed fair market value. Accordingly, the real income theory was upheld. To overcome the issue of understatement in property sale transactions, legislature brought in an amendment by introducing section 50C in the Act (and subsequently section 43CA) as discussed in preceding paras. Thus the legislative amendment was brought in to overcome the hurdle of taxing only the real income.

The legislature has also been amending the laws in such a way that the "capital receipts" are treated as "income" and "revenue expenses" are being disallowed. For instance, as per section 28(ii)(e) of the Income Tax Act, 1961 any compensation or other payment due to or received by any person as a result of termination or modification of a business contract is treated as income under the head "profit or gains from business or profession". Thus now even if a person receives compensation for loss of source of income which was earlier capital receipt exempt from taxation is now taxable u/s. 28(ii)(e). Similarly, if TDS on an expenditure, say on professional income deductible u/s. 194J is not deducted then 30% of the said expenditure is

[15] (1981) 131 ITR 597 (SC)

disallowed u/s. 40(a)(ia). Thus, the legislature is not holding back anything to overcome the concept of real income and is taking long strides towards taxing “notional income” rather than “real income”.

As mentioned above, the Supreme Court in the case of *State Bank of Travancore v. CIT* (supra), has laid down situations in which income is said to have accrued and is taxable. These rules have been followed subsequently in various decisions by the courts over the years and have concluded that hypothetical income even if credited in the books of accounts may not be taxable in the view of theory of real income.

Although the theory of taxing real income is well established yet it cannot be applied in contravention to enacted law as has been upheld by the Supreme Court in the case of *CIT v. Shiv Prakash Janak Raj & Co. (P.) Ltd.*[16]. The assessee company had advanced a loan to the firm in which the directors were interested. During AY 1966–67 and AY 1967-68, the assessee company charged interest on the said loan and offered the same to tax. However in the next three assessment years i.e. AYs 1969-70, 70-71, 71-72, the assessee company passed resolution after the end of the accounting year thereby waiving interest on such loan. The contention of the assessee company was that the resolution waiving the interest was passed on the request made by the firm that they are facing financial difficulties and are unable to pay interest. The AO, ACC and the Tribunal observed that the assessee was following a mercantile system of accounting. Accordingly, interest has already accrued in AYs 1969-70, 70-71, 71-72 even if it was waived and no entry is passed in the books of accounts. The Supreme Court upheld the decision of the Tribunal and further observed that the concept of real income cannot be used in a manner that conflicts with the provisions of the Act or Rules. The concept of real

[16] (1996) 222 ITR 583 (SC)

income cannot be used to whittle down, qualify or defeat the statutory provisions.

Mercantile systems do not create income. It only records accrual of income. These concepts have been explained in detail in the next chapter “accrual of income”.

To sum up, though the ‘real income’ concept is active and thriving, it sometimes gives way to ‘notional income’ due to specific enactments made by the legislature.

Chapter - II

Accrual of Income

Introduction

Maintaining proper and prescribed books of accounts is an integral part of any business. Section 145(1) of the Income Tax Act, 1961, provides two methods of accounting namely (i) cash system of accounting and (ii) mercantile system of accounting.

Under the cash system, the revenue and expenditure are accounted for on the actual receipts and payments; and the concept of accrual is irrelevant. On the other hand, under mercantile system of accounting, revenue and expenditure are accounted for on the accrual basis; even if not actually received or paid. In this chapter, we have discussed the concept of "accrual" of income.

In General Law

As per Oxford Dictionary, the term "accrue" means a benefit or a sum of money that is receivable in regular or increasing amounts over time. It also means to make provision for a charge at the end of a financial period for work that has been done but not yet invoiced.

The term "accrue" has been analysed in the case of *Morvi Industries Ltd v. CIT*[17]. The Supreme Court has observed that the dictionary meaning of the word "accrue" is "to come as an accession, increment, or produce: to fall to one by way of advantage: to fall due". Thus income is said to accrue when it becomes vested in a person, even if it is not due. There arises a corresponding obligation on the payer to pay that amount when it becomes due. If tomorrow, the assessee does not receive the income, then such non

[17] [1971] 82 ITR 835 (SC)

receipt will not divert or delete the income recognition. However, in certain circumstances, such non receipt may be a valid ground for claiming deductions as a bad debt or a business loss..

The Court further observed that the accrual of an income is not to be equated with the receipt of the income. That the two, “accrual” and “receipt” of income, have a variety of meaning is also plain in the language of section 4 of the Income Tax Act. Section 5(1)(a) of the Income Tax Act, deals with “receipt” of income while “accrual” of income is dealt with section 5(1) (b) of the Act (for reference, section 4(1)(a) of the Income Tax Act, 1922).

Historical Background

The word ‘accrue’ has been derived from the Latin word ‘*accrescere*’.

The word “accrue” forms part of Income Tax Act, 1922 in section 4 which reads as under :

> *“4. Application of Act.—(1) Subject to the provisions of this Act, the total income of any previous year of any person includes all income, profits and gains from whatever source derived which—*
>
> *(b) if such person is resident in [the taxable territories] during such year,—*
>
> *(i) <u>accrue</u> or arise or are deemed to accrue or arise to him in [the taxable territories] during such year, or*
>
> *(ii) <u>accrue</u> or arise to him without [the taxable territories] during such year, or*
>
> *(iii) <u>having accrued</u> or arisen to him without [the taxable territories] before the beginning of such year and after the 1st day of April, 1933, are brought into or received in [the taxable territories] by him during such year, or*
>
> *(c) if such person is not resident in [the taxable territories] during such year, <u>accrue</u> or arise or are <u>deemed to accrue</u> or arise to him in [the taxable territories] during such year…..”*

Accounting Standards

Accounting standards ("***AS***") as recognised by the Institute of Chartered Accountants of India have also treated "accrual" as one of the fundamentals of accounting assumptions in AS 1 – Disclosure of Accounting Policies. Further, in AS 9 – Revenue Recognition, it is stated that the revenue should be recognised on the accrual basis. AS 22 – Accounting for taxes on income states that tax on income is determined on the concept of accrual.

<u>Accounting Standard ("AS") 1: Disclosure of Accounting Policies:</u>

AS 1 lays down that certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are not required to be generally expressly mentioned in the accounts. Disclosure is not required unless they are not followed. The following are accepted fundamental accounting assumptions :

i. Going Concern
ii. Consistency
iii. Accrual

In respect of accrual, as per AS 1 the financial statements records the revenue and cost when accrued during the particular period i.e. acknowledged as accrued or incurred and not as received or paid . However, the factors that impact the accrual – cost – revenue matching process are not addressed in this standard.

The said accounting standard further states that no specific disclosure is required, the financial statements are prepared in consistency with the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual. However, if the fundamental accounting assumptions are not taken into account while preparing the financial statements then suitable disclosure ought to be made in the notes to accounts / auditor's report.

AS 9: Revenue Recognition

This Standard deals with the basis on which income / revenue is recognised in the statement of profit and loss of an enterprise. As per the said standard, revenue means gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of the enterprise from

(i) the sale of goods,

(ii) the rendering of services, and

(iii) the use by others of enterprise resources yielding interest, royalties and dividends.

As per the said accounting standard, "interest accrues" in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Similarly, revenue from royalties is to be recognised on accrual basis as per the terms of the agreement.

AS 22: Accounting for Taxes on Income:

This accounting standard lays down that the tax on income is to be determined as per accrual concept. Accordingly, tax must be calculated in the year in which the related revenues and expenses are recorded. Simply put, tax is recorded on an accrual basis and not on the liability to pay basis.

Under Direct Tax Laws

The word "accrual" is not defined in the Income Tax Act, 1961. However, the word "accrue" appears in section 5 of the Income Tax Act, 1961 which talks about the scope of income. As per section 5, the total income for the previous year of a resident person shall include all income from any source which :

(i) is received or deemed to be received ; or

(ii) accrues or arise or is deemed to accrue or arise to him in India ; or

(iii) accrues or arise to him outside India.

Similarly, for the a non-resident, income :

(i) received or is deemed to be received ; or

(ii) accrues or arises or deemed to accrue or arise to him in India.

The words used in section 5 are “accrues”, “arise” and “receive”. These terms have different meaning. The word “accrues” and “arise” do not mean actual receipt of profits or gains. Both these words indicate a right to receive as stated in Part B States (Taxation Concessions) Order referred in the case of *Seth Pushalal Mansighka (P.) Ltd. v. CIT*[18].

Further, the Supreme Court in the case of *E.D. Sassoon & Company Ltd. v. CIT*[19] has explained the words, “accrues”, “arise” and “received” as under :

> *“'Accrues', 'arises' and 'is received' are three distinct terms. So far as receiving income is concerned there can be no difficulty; it conveys a clear and definite meaning, and I can think of no expression which makes its meaning plainer than the word 'receiving' itself. The words 'accrue' and 'arise' also are not defined in the Act. The ordinary dictionary meanings of these words have got to be taken as the meanings attached to them. 'Accruing' is synonymous with 'arising' in the sense of springing as a natural growth or result. The three expressions 'accrues', 'arises' and 'is received' having been used in the section, strictly speaking ‘accrues' should not be taken as synonymous with 'arises' but in the distinct sense of growing up by way of addition or increase or as an accession or advantage; while the word 'arises' means comes into existence or notice or presents itself. The former connotes the idea of a growth or accumulation and the latter of the growth or accumulation with a tangible shape so as to be receivable. It is difficult to say that this distinction has been throughout maintained in the Act and perhaps the two words seem to denote the same idea or ideas very similar, and the difference only lies in this that one is more appropriate than the other when applied to particular cases. It is clear, however, as pointed out by Fry, L.J., in Colquhoun v. Brooks [1888] 21 Q.B.D. 52 at 59 [this part of the decision not having been affected by the reversal of the decision by the Houses of Lords [1889] 14 App. Cas. 493] that both the words are used in contradistinction to the word 'receive' and indicate a right to receive. They represent a state anterior to the point of time when*

[18] (1967) 66 ITR 159 (SC)

[19] (1954) 26 ITR 27 (SC)

the income becomes receivable and connote a character of the income which is more or less inchoate"

Further, Sec 9 of the Act gives the list of the income which is deemed to accrue or arise in India; business income of a foreign company or non-resident person is chargeable to tax in India to the extent such income accrues or arises in India. Such income that accrues or arises in India directly or indirectly can be in form of :

(i) business connection in India or through or from any property in India or through or from any asset or source of income in India or through transfer of a capital asset situated in India;

(ii) income which falls under the head "salaries", if it is earned in India for services rendered in India and the rest period or leave period which is preceded and succeeded by services rendered in India and forms part of service contract of employment ;

(iii) income chargeable under the head "salaries" payable by the Government to a citizen of India for services outside India;

(iv) a dividend paid by an Indian Company outside India ;

(v) Income by way of interest payable in respect of any debt incurred or moneys borrowed and used, for carrying out any business or profession by:
   - a non -resident in India;
   - Resident outside India

(vi) Income by way of royalty / fees for technical services payable in respect of any right, property, or information or services utilised for carrying out any business or profession or making / earning any income from any source by:
   - a non-resident in India;
   - Resident outside India.

Scope / Object

The scope of this concept i.e. the ‘accrual of income’ is to bring to tax the income of persons following mercantile system of accounting, the receipt of which is deferred but is legally enforceable. This is based on the logic that if a person is claiming expenses which have not yet been incurred which substantially reduce his profit, then the income which has legally accrued to the person should also be brought into the scope of taxation.

Interpretation Rules

A. Right to Receive:

Income would accrue or arise only if the assessee acquired the right to receive income as held by the Supreme Court in the case of *E.D. Sassoon & Company Ltd. v. CIT (supra)***.** In this case, the Court has observed that income may accrue to an assessee without actually receiving it. If the assessee becomes entitled to receive the income, it can be said that the income has been accrued to him, although it can be received later on its being ascertained. The basic concept is that someone should be indebted to him. The Mumbai ITAT in the case of *Bina Power Supply Co. Ltd. v. ITO*[20] held that in case of mercantile system of accounting, for making the income taxable, we have to ascertain when the entitlement to receive the income arose. Income is taxable only in the previous year in which entitlement to receive such income arose.

To give a simple example: Suppose a person has booked an FDR for one year on 1st May, with option to receive interest on maturity, interest upto 31st March next year shall accrue to him and become taxable for that year, even though the bank will be obliged to pay it only on the maturity of FDR on 30th April, alongwith balance interest.

[20] 2013 (9) TMI 523 (ITAT Mum)

B. <u>Corresponding liability to Pay:</u>

Similarly, in the case of *CIT v. Excel Industries Ltd.*[21], the Supreme Court held that income "accrues" only when it is "due". However, the opposite party must be under an obligation to pay such an amount. Thus, the income is taxable only when it has really accrued to an assessee and no hypothetical income which has not accrued and due is made taxable.

C. <u>Real Income Theory:</u>

In the case of *State Bank of Travancore v. CIT*[22]*,* the Supreme Court has observed that whether an accrual has taken place or not must in appropriate cases, be judged on the principle of real income theory. It is important to know what has really accrued to the assessee, and what has accrued must be looked at from the perspective of real income, taking the probability or improbability of realisation realistically and harmonising those factors. But once the accrual takes place, on the conduct of the parties subsequent to the year of closing, an income which has accrued cannot be made 'no income'. In this connection inter alia the following propositions emerge :

a) Income actually accrued or arisen to the assessee is taxable. Whether the income has really accrued or arisen to the assessee must be evaluated after considering the facts of the matter.

b) The concept of real income would apply where there has been a surrender of income which in theory may have accrued but in the reality of the situation no income had resulted because the income did not really accrue.

[21] (2013) 262 CTR 261 (SC)
[22] (1986) 158 ITR 102 (SC)

c) The conduct of the parties in treating the income in a particular way is significant evidence of whether or not income has been accrued.

d) Mere improbability of recovery, where the conduct of the assessee is unequivocal, cannot be treated as significant evidence of whether or not income has resulted or accrued to the assessee. After debiting the debtor's account and not reversing that entry, but taking the interest merely in suspense account, cannot be such evidence to show that no real income has accrued to the assessee or has been treated as such by the assessee.

Specific Case Law:

Citation- *CIT v. Harivallabhadas Kalidas & Co.*[23]

Facts –

The assessee firm was appointed as a managing agent of Shri Ambica Mills Limited ("***managing company***"). The duration of the managing period was 20 years. The terms of the managing agreement were: (1) the managing company was to be paid 5% commission every year on the proceeds of the total sales of yarn and all cloth by the company or three pies per pound on the sale, whichever the managing agents chose. Accordingly, the managing company had an option which he can exercise at the end of the each year; (2) The managing company was entitled for additional 10% commission on sale proceeds of all other materials; (3) the mills were under an obligation to pay to the managing Company each year after 31st December, or before end of the accounting period; and (4) however, if the net profit of the mills were not sufficient to enable the directors to announce a dividend of 8% p.a., then the managing company were bound to forgo a 1/3rd of their commission.

[23] (1960) 39 ITR 1 (SC)

Subsequently, on 09/12/1950, the said agency agreement was modified with respect to the commission payable. Vide the said modification agreement, the managing agents had agreed to charge 3% on sales instead of 5%, for the year ending 31-12-1950.

For AY 1951-52 and 1952-53, the AO contended that :

(i) as per the agreement, the commission of the managing company was correlated to the sale proceeds. Accordingly, since the mills followed mercantile system of accounting, the commission accrued as and when the sales took place ;

(ii) Since, vide modified agreement, the managing company had voluntarily relinquished a portion of their commission income which had accrued to them when sales took place, the whole of the commission income had already accrued and is liable to income-tax;

On appeal before ITAT, the ITAT held that the agreement to receive commission @ 3% of the total sales was a valid one and took effect from 1-1-1950. The ITAT also held that commission accrued only at the end of the year when the whole profit was determined. The High Court also agreed with the view of the ITAT.

Question before the Supreme Court – whether the commission accrued on the proceeds of every single sale or it accrued only when the assessee firm exercised its option to charge its commission on the total sale proceeds or on the weight of the yarn sold?

Rule – It is as per the provisions of the contract that it must be decided, as a question of construction and therefore of law, when the commission was earned [observed by Lord *Wright in Commissioners of Inland Revenue v. Gardner, Mountain & D'Ambrumenil Ltd.*[24]].

Supreme Court analysis –

All the provisions of the agreement relating to payment of commission to the managing company are as an indivisible and an integral whole. On a proper construction of the contract, it is obvious that the managing company was to be paid at the end of the year. They had the option of either receiving a percentage of total sales or three pies per pound. The said option was exercisable only at the end of the accounting year. However, in case of contingencies, the managing company had to forgo a certain portion of its commission, which also could be determined only when the accounts were made up for the year. It is thus clear that there was no accrual of any commission till the end of the year.

Held –

On the above analysis, the Supreme Court held that it cannot be said that the commission had accrued as the sales happens and that as a result of their agreeing to the modification of the agreement the managing agents had voluntarily relinquished a portion of their commission.

Key Principle - Terms of the contract are to be read in full to determine whether any income has accrued or not.

Further References:

(i) *Poona Electric Supply Co. Ltd. v. CIT*[25]*;*

(ii) *State Bank of Travancore v. CIT (supra) ;*

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[24] [1945-47] 29 Tax Cas. 69]

[25] (1965) 57 ITR 521 (SC)

(iii) *CIT v. Chamanlal Mangaldas & Co.*[26].

Authors' Analysis:

The concept of 'Accrual of Income' aims at taxing that income which is 'real' under the mercantile system of accounting, which although not received but has legally arisen. It does not aim to tax any hypothetical income. Thus, if an assessee acquires the right to receive the income and the other party is liable to make the payment, then the income is said to have accrued to such assessee and is taxable depending on the facts and circumstances of each case. The main purpose of this concept is that the corresponding expenses and income should be accounted for in the same period. The accrual concept does not obliterate the use of the cash system of accounting. However, the provisions of section 145 of the Income Tax Act, mandates following an accrual system for determining certain specific incomes like interest income. Thus whatever system the assessee is following for maintaining its books of accounts, the computation of income will depend upon the specific provisions of Income Tax Act and accordingly the computation of income will be drawn up.

[26] (1960) 39 ITR 8 (SC)

Chapter - III

Books of Accounts are not Determinative of Taxability

Introduction:

Recording of transactional entries is a fundamental element of accounting. It is essential that all the business transactions of financial character are recorded in an orderly manner. It enables timely financial decisions and keeps track of the fund flow. In terms of income tax law, such entries are made as per the permitted accounting system and enable the business to record its income, claims, liability to pay income tax, TDS etc. However, these entries are not absolute in nature and are subject to inherent limitations. The computation of taxable income is determined not purely on the basis of the entries passed in the books of accounts but on the basis of the provisions of the taxing statute. Sometimes, a difference exists between the two and hence there arises a different taxable income than the income shown in the books of accounts. The purpose of this chapter is to understand those variations and to analyze, to what extent are the entries in books of account determinative of the tax on the profits of the business.

In General Law

Bookkeeping begins with recording business transactions in the journal and ledger and ends with preparing the Trial Balance. This is followed by preparation of final accounts and their analysis and interpretation. Preparation of final accounts is described as financial accounting whereas their analysis and interpretation is termed as management accounting. This is further followed by audit as per statutory requirements to ensure compliance with statutes and applicable accounting standards.

According to the American Institution of Certified Public Accountants, Financial Accounting is “the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof.”

Historical Background

The concept of accounting has been recognized in India since ancient times. In 1872, the concept of accounting was recognized under the Indian Evidence Act, 1872, in the form of section 34 which has been amended as per developments in technology. As per Section 34, entries in the books of account, including those maintained in an electronic form, regularly kept in the course of business, are relevant whenever they refer to a matter into which a court has to inquire but such entries and financial statements shall not, on their own, be sufficient to affix liability on the owner of the books of account.

Illustration: A sues B for Rs. 1,000/- and records entries in his books of accounts showing B to be indebted to him for Rs.1,000/-. The entries are relevant, but insufficient, without other evidence, to prove the debt. It is open for B to contend and prove that he had never taken a loan from A, or that he had returned it.

The said section has been examined by the Gauhati High Court in the case of *Ajit Chandra Bagchi v. Harishpur Tea Company (P.) Ltd.*[27]. In this case, the Court observed that the entries in the books of account showing the defendants to be indebted to the plaintiff for certain amount might be relevant but are not sufficient to prove the debt.

[27] AIR 1991 Gau 92

Under Direct Tax Laws

The Income Tax Act, 1961 contains various provisions which support the rule that entries in books are not absolutely determinative of taxable income. This is because of several factors, such as differential tax rates applicable to different heads of income, accrual concept, capital receipts, deemed incomes, admissibility of expenses claimed, differential depreciation rates, capital expense vs revenue expense vs deferred expense etc.

A stark demonstration is in the case of 'income accrued but not due'. In case of accrual basis of accounting, some entries have to be recorded on time basis though they may not actually result in income to the other party.

For example, banks credit interest on fixed deposits at the end of every quarter, but the same becomes income in the hands of the depositor only at the end of the financial year or as per FDR instructions, whichever is earlier.

Taking another example, *Bachubhai Patel v. ITO*[28]. In this case, Akshar Developer, a partnership firm in which the assessee was one of the partners, agreed to pay interest to its partners on their credit balance, which could be drawn only on the completion of ongoing project. The firm passed entries every year in respect of interest on capital to partners on accrual basis for three years. However, the said interest was "due" only on completion of the project in the firm as per the deed of partnership. Until then, the partners could not claim the said interest. Thus, the partners did not declare the said interest as income on the ground that Section 28(v) of the Income Tax Act, 1961 stated that any interest, salary, bonus, commission or remuneration, by whatever name called, "due to", or "received" by, a partner of firm from such firm shall be chargeable to tax under the head "Profit and gains from business or profession". In the given case, the interest was only "accrued" but was neither "due" nor "received".

[28] ITA no. 6245 and 6246/Mum/2016 and 2675/Mum/2017, order dt. 28/02/2018

Thus, the said interest did not constitute income in the hands of the Partners of the Firm even though the partnership firm accounted for the said liability. Subsequently, the project ran into rough weather and the interest credited to partners' capital account was reversed. Thus, the partners now lost even the future claim to income. The assessing officer added the interest income to the partners' total income for these three years. The Tribunal deleted the same by holding that if the firm has not claimed interest on capital as expense against its profits and reversed interest on capital by reducing it from work-in-progress, then certainly, exclusion made by the partners in their individual hands in revised return is in accordance with the law.

Another example is deemed dividend under section 2(22)(e) of the Income Tax Act, 1961. The purpose of the enacting subsection (e) is that persons who manage such closely held company should not divert the liquid assets of the company to the shareholders without payment of statutory taxes. Thus, any payment made to eligible shareholders is treated as his deemed income on the basis of entry in the books of the company. However, if it is shown that the payment was for permitted activities, say in the nature of a trade accommodation or trade advance, the same entry falls outside the purview of deemed income and is not considered as income in the hands of the shareholder.

Further, where a person sells shares of a listed company held by him more than 12 months, the net gain is entered in the books of accounts as "profit from sale of shares / long term capital gain on sale of shares". However, under the Income Tax Act, the said gain was hitherto exempt from taxation u/s. 10(38).

Recently, deeming provision section 43CA was inserted w.e.f. 01/04/2014 to provide that if a builder sells a flat being stock in trade, below stamp duty valuation, then the shortfall shall be deemed to be the undisclosed income of the assessee builder. Thus, profit in the books will be based on the entry of actual sale consideration less cost of construction whereas in the computation of income, profit will be computed by deeming the sale consideration to be the stamp duty valuation. Thus, the statute has gone beyond the book entries to compute taxable income.

Similarly, provisions of Minimum Alternate Tax u/s. 115JB compare book profit of a company computed as per book entries and taxable profit, and artificially calculate tax in appropriate cases. Accordingly, the section provides for a method for calculation of "book profit" thereby including / excluding certain items. The said section read as under:

> *"115JB - Special provision for payment of tax by certain companies*
> *(1)………...*
> *(2)……..*
> *Explanation [98][1].—For the purposes of this section, "book profit" means the profit as shown in the statement of profit and loss for the relevant previous year prepared under sub-section (2), as increased by—*
> *(a) to (k)*
>
> *if any amount referred to in clauses (a) to (i) is debited to the [15][statement of profit and loss] or if any amount referred to in clause (j) is not credited to the [15][statement of profit and loss], and as reduced by –*
> *(i) to (viii)"*

Thus, book entries, though recorded correctly, are superseded for calculation of minimum tax. There are further such items, discussed in a chapter dedicated to deeming provisions, which change the computation of taxable income from the accounted book profit.

Section 68: Cash credit: As per this section, where any sum of money is found credited in the books of accounts maintained by the assessee and the assessee offers no explanation about the nature or source or offers explanation which is not satisfactory as per AO, then in that case, the AO can treat the said amount as income chargeable to tax. Example: Unsecured loan received by an assessee during any previous year is recognized as "liability" in his financial statement. During the course of assessment proceedings, the assessee has to prove the identity and creditworthiness of the creditor and genuineness of the transaction. However, if he fails to prove any of the ingredients, then in that case, the AO will treat the said liability as income. Thus, again, the entries in the books are not determinative of liability. Similarly, if the assessee fails to prove evidence in support of purchases deductible from turnover, the AO can treat the said as bogus simply on the ground that the assessee has just booked fake bills to reduce its profit without actual purchase; and added to the total income as chargeable to tax.

Similarly, Section 69: Unexplained investment: Where an investment is found to be held by an assessee but the same is not recorded in his books of accounts and the assessee fails to offer any explanation about the nature and source of acquisition of such investment or offers an explanation which is not satisfactory as per AO, then in that case, the value of investment may be deemed to be income of the assessee for that financial year.

Thus, it is not the entries in the books of accounts but the true nature of the transaction that has to be checked before determining its taxability.

Another instance is where the AO calculates income on presumption basis thereby rejecting the books of accounts. When it is found that the books of account are not maintained as per accounting system and standards provided in section 145 of the Income Tax Act, or the officer is not satisfied about the correctness or completeness of the accounts, the books are liable to be rejected and the officer shall make a best judgment assessment on the basis of available material and comparative cases.

In the case of *Vrajlal Manilal & Company v. CIT*[29], the hon'ble High Court held that once the books of accounts are rejected, the income has to be estimated and the previous orders of assessment will constitute good material or evidence. Similarly, the AO can estimate income on the basis of

[29] (1973) 92 ITR 287 (MP HC)

comparative cases. In the case of *Seth Nathuram Munnalal v. CIT*[30] the High Court held that the ITO can assess higher percentage of profit in consistency with the Industry norms or certain specific circumstances, if the assessee fails to satisfy the ITO as to the correctness of the profits returned by him. However, the ITO must disclose the basis and procedure for computation of such higher percentage of profit, provide fair opportunity of hearing to the assessee and pass a speaking order.

Thus, in case of rejection of financial statement / books of accounts and calculating the income as per best judgment assessment u/s. 144, the entries in the books of account do not determine taxable income.

Interpretation Rules

The judicial authorities have time and again held that the manner in which entries are made by an assessee in his books of accounts are not absolutely determinative of the quantum as whether an assessee has earned profit or suffered loss.

In case of, *CIT v. Mogul Line Ltd.*[31], the assessee, a limited liability company had its head office in India. Its business was plying ships on hire and it had an agency at Karachi. When the Indian rupee was devalued in September, 1949, the company had a balance standing in its agent's books at Karachi at Rs.7,33,794/- as on 30-4-1950. After devaluation, the company ascertained that the value in Indian rupees of the amount which was to its credit in its agent's books at Karachi would have to be increased by a sum of Rs.3,22,869 in the Bombay books in terms of the Indian currency. It credited this amount to an account styled as "Pakistan Exchange Suspense Account". The question before the Court was whether the sum of Rs.3,22,869/- is the income of the assessee and liable to tax?

[30] (1954) 25 ITR 216 (Nag.)
[31] (1962) 46 ITR 590 (Bom.)

With reference to this question, the Bombay High Court observed whether an income is taxable or not has to be decided on the basis of relevant provisions of the Act and not on the basis of the entries passed by the assessee in his accounts. For determining the taxability it is relevant to verify whether the said item can be regarded either as a profit or loss under the provisions of the Income Tax Act and not simply on the basis that the assessee has shown a particular item as a profit or loss in the accounting year in his books of accounts.

Similarly, in the case of *CIT v. Shoorji Vallabhdas & Co.*[32], the Supreme Court inter alia observed that income tax is levied on income. If income does not result at all, there cannot be a tax, even though in books of accounts, entry is made about a "hypothetical income" which does not materialize.

Thus, it can be stated that the true nature of the entry is required to be determined with reference to the pertinent provision of the Act and attendant circumstances before treating it as taxable income.

Similar proposition has been observed by the Supreme Court in the case of *Sutlej Cotton Mills Ltd. v. CIT*[33]. The Supreme Court observed that how an assessee pass entries in his books of account are not determinative of the question whether the assessee has actually earned profit or suffered any loss. The assessee may by making entries which do not conform to the correct accounting principle, conceal net result or claim losses that are actually not incurred by him. Thus, entries in the books of account cannot be regarded as conclusive in nature. What is necessary to ascertain is the true nature of any transaction and whether such transaction has actually resulted in profit or loss to the assessee.

[32] (1962) 46 ITR 144 (SC)
[33] (1979) 116 ITR 1 (SC)

Specific Case Law:

Citation - *State Bank of India v. CIT*[34]

Facts – The Assessee, a banking company, is engaged in the business of purchase of foreign currencies and other negotiable instruments drawn in foreign currencies from its clients. Subsequently, these assets were sold or encashed through the assessee's corresponding bank in foreign country and the said foreign bank credited the proceeds to the account of the assessee held with the foreign bank. Due to devaluation of Indian Rupee, the amount receivable by the assessee appreciated in value.

Question before the Supreme Court – Whether the profit arising on the devaluation of the Indian rupee was income chargeable to income tax?

Supreme Court analysis: The Supreme Court referred to the decision of *CIT v. Mogul Line Ltd. (supra)* and observed that:

(i) If the fund is utilized by the Company for trading purposes, then in that case profit from the business arising on devaluation would be recognized and such profit would be taxable.

(ii) If the fund was utilized by the Company for non business operation i..e other than for trading purpose, like payment of Income-tax in the foreign country, there was no profit. The difference in the exchange value could not be assessed to Income-tax but will be capitalised.

Supreme Court held: When the foreign currency has increased in value in terms of Indian rupee and that amount has been utilized by the assessee in carrying on his business, it was incidental to the banking business and hence taxable, irrespective of the book entries in that regard.

[34] (1986) 157 ITR 67 (SC)

Key Principle:

It is not the entry in the books of accounts but the true nature of the transaction is to be considered while deciding whether in fact that entry entailed profits or losses to that assessee.

Further Reference

(i) *Hydrocarbons India Ltd. v. Inspecting Assistant Commissioner*[35]

(ii) *Bharat Forge Co. Ltd. v. CIT*[36]

(iii) *Universal Radiators v. CIT*[37]

Authors' Analysis:

The entries that are made in books of account or absence of any entry in the books by itself cannot be considered conclusive for the function of ascertaining the taxable income of the enterprise.

One needs to consider whether entries are in accordance with accounting principles and standards, correlation with the documents on record and nature of business as well as the interpretation of taxing statutes. As a bundle, these elements determine the true nature of the transaction entered into and whether such transaction has actually resulted in profit or loss to the assessee.

Over the years the income tax laws have been amended to bridge the gap between the income tax computation and the book profit. Section 145 of the Income Tax Act, 1961 has prescribed certain accounting standards to be made mandatory for computation of income under tax laws. However, recently the introduction of the Income Computation and Disclosure Standards ("ICDS") applicable to tax computation have again deviated from

[35] [1988] 24 ITD 203 (Delhi)
[36] [1993] 69 Taxman 165 (Bombay)
[37] [1993] 68 Taxman 45 (SC)

book profits and created a larger cleavage. Thus, the concept of accounting profit and tax profit being at variance survives and makes this concept a germane and interesting study.

Chapter - IV

Deeming Fiction

Introduction

Income Tax is a tax on real income. Real income is an income in the hands of a person who is eligible to receive or has actually received that sum from another person. In other words, Mr A has an obligation to pay a certain amount to Mr B and that amount becomes taxable in the hands of Mr B. This concept has been accepted by the Supreme Court as far back as in 1962 in the case of *CIT v. Shoorji Vallabhdas and Co.*[38] and subsequently in the case of *Poona Electric Supply Ltd. v. CIT*[39].

However, over a period of time, the said theory has been modified as the Income Tax Act has introduced provisions, to bring to tax certain 'unreceived income,' in light of the evolving business/ economic scenario. These provisions have resulted in taxing income that is hypothetical / notional and deemed income.

In this chapter we are going to study these deeming provisions which tax hypothetical income and the situations in which such deemed income can be said to arise.

Under General Law

The word "deem" has been defined in the Black's Law Dictionary as to treat something as if (1) it were really something else, or (2) it had qualities that it does not have.

[38] (1962) 46 ITR 144 (SC)
[39] (1965) 57 ITR 521 (SC)

Lord Radcliffe in *St. Aubyn (L.M.) v. A.G. (No. 2)*[40] case has defined the word "deemed". As per him the word 'deemed' is used a great deal in modern legislation. It is used:

a) to impose for the purposes of a statute, an artificial construction of a word or phrase, that would not otherwise prevail;
b) to put beyond doubt a particular construction, that might otherwise be uncertain;
c) to give a comprehensive description that includes what is obvious, what is uncertain and what is, in the ordinary sense, impossible.

DIFFERENT FROM PRESUMPTION

The deeming provisions are different from the presumption provisions and one should be careful not to mix up the two.

The word "presume" has been variously defined. In Black's Law dictionary it means "to believe or accept upon probable evidence". In the Shorter Oxford English Dictionary it has been mentioned that in law "presume" means "to take as proved until evidence to the contrary is forthcoming". Stroud's Legal Dictionary states "<u>A presumption is a probable consequence drawn from facts (either certain, or proved by direct testimony) as to the truth of a fact alleged.</u>"

The Supreme Court in the case of *M/s. Bhuwalka Steel Industries Ltd. and another v. UOI*[41] in the context of Indian Evidence Act, 1872 has pointed out the difference between "deeming provision" and "presumption" which is as under :

[40] (1951) 2 ALL E.R. 473 (HL)
[41] (2017) 5 SCC 598

Deeming provisions	Presumption
1. Assumption	
Deeming provision or fiction something that's known as something else.	Presumption whether conclusive or rebuttable assumes something that might be true
2. Reality	
Deeming provisions always conflict with reality.	Presumption may prove to be true.
3. Related	
Deeming provisions involves presuming a fact which is not real.	Presumptions are closely associated with legal fictions but their functioning is different.
4. Creation	
Deeming provision creates an artificial situation under a legislative mandate.	Presumptions are rules of evidence used to determine whether certain facts exist in the dispute.
5. Plead or argue	
When a fiction is created by law, it is deliberate and intentional, not open for rebuttal, so far as the conditions prescribed are satisfied..	Presumptions are open for rebuttal by leading appropriate evidence..

Historical Background

The deeming provisions go way back to the year 1881. James Lords Justice in *Ex - parte, Walton, In re, Levy,*[42] speaks on deeming fiction as "*When a statute enacts that something shall be deemed to have been done, which in fact and in truth was not done, the Court is entitled and bound to ascertain for what purposes and between what persons the statutory fiction is to be resorted to*".

The Supreme Court in the case of *M/s. Bhuwalka Steel Industries Ltd. and another v. UOI* (supra) also held that deeming provisions compel the Court as well as everyone concerned to believe the existence of artificial state of facts contrary to the real state of facts.

Under Direct Tax Laws

The Income Tax Act, 1961 contains several such deeming enactments. Some of these provisions are as under:

(i) Nature of Transaction: Under section 2(22)(e) of the Income Tax Act, 1961, certain transactions of advances, loans and deposits are deemed to be dividend.

(ii) Definition: Section 2(42A) defines the term "short term capital asset" means a capital asset held by an assessee for not more than 36 months immediately preceding the date of its transfer. Thus the nature of holding is deemed as short term or long term based upon the period of holding.

[42] 1881 (17) Chance. D. 746

(iii) Computation of Consideration: Where a company issues shares (unquoted shares), the consideration for the purpose of capital gain shall be deemed as per section 56(2)(viib) read with Rule 11U and 11UA of the Income Tax Rules, 1962.

(iv) Period: As per section 23(5) inserted w.e.f. 01/04/2018, property which remains unsold and vacant for a period of two years from the date of completion certificate, is deemed to have been rented out and rental income is calculated on notional basis.

There are several other deeming provisions in the Income Tax Act which are discussed below as per head of income.

Income is computed under the Income Tax Act, 1961 under 5 heads as mentioned in Chapter IV – Computation of total income "Heads of income" – section 14 :

(i) Income from Salary
(ii) Income from House Property
(iii) Profits and gains of business and profession
(iv) Capital Gains
(v) Income from other sources

Except in case of "income from salary", all other heads of income contain deeming provisions.

(i) "Income from house property" – where a person owns more than one house property, any one house shall be deemed to be self occupied and the other house will be deemed to be "let-out", at the option of the owner assessee, even if the said other house is vacant for the entire previous year. The annual value of such other house shall be deemed to be rental income u/s. 23(1)(a) chargeable to tax.

(ii) “Profits and gains of business and profession”- contains section 43CA which has been introduced in the Income Tax Act w.e.f. 1.4.2014. As per the said section “notional income” will be added in the hands of the seller where the consideration in respect of sale of assets other than “capital asset being land or building or both i.e. stock in trade, is less than the value adopted by any authority of State Government for the purpose of payment of stamp duty in respect of such transfer. In such a situation, the value adopted for payment of stamp duty shall be deemed to be the consideration and income shall be computed accordingly.

(iii) “Capital Gains” :

a) contains section 50C introduced by the Finance Act, 2002 w.e.f. 01/04/2003: As per section 50C, consideration in case of transfer of capital asset being “land” or “building or “both”, shall be deemed to be the stamp duty valuation as adopted by the State Government if the actual consideration is less that the stamp duty value.
b) Section 59 creates a deeming fiction that “short-term capital gain” shall arise on sale of depreciable assets that was held for a period beyond 36 months and the said short term capital gain would be set-off against brought forward long-term capital losses and unabsorbed depreciation.

(iv) “Income from other sources” – Earlier Gift Tax Act, 1958, provided for the levy of gift tax in various situations such as : (a) property is transferred for less than adequate consideration; (b) individual property is converted into property of HUF.

After the repeal of the Gift Tax Act in the year 1998, the Income Tax Act introduced Section 56(2)(v) for taxing gifts in the hands of recipients. Later w.e.f. 01/04/2017, section 56(2)(x) was introduced. The said section seeks to tax the receipt of following items, deeming the receipt as income, subject to conditions :

(a) Any sum of money;

(b) Immovable property;

(c) Any property other than immovable property.

Both the Gift Tax Act and sub-sections (v) and (x) to section 56(2) under the Income Tax Act, 1961 are deeming provisions.

The scope of deeming fiction extends beyond the aforementioned heads of income. Some examples are set out below:

(i) Section 14A(3) provides that even in a case where the taxpayer claims that no expenditure was incurred for the earning of exempt income, the tax authority has to presume the incurring of such expenditure as provided u/s. 14A(2) read with Rule 8D of the Income Tax Rules and disallow the same. For several years when dividend income was exempt, huge disallowances would be made in respect of interest expenditure incurred by business entities.

(ii) Section 68 to section 69C are deeming provisions, in which the assessing officer has the latitude to reject assessee's explanation and make additions by altering the nature of transaction:

Section 68 : Cash credit : where any sum of money is found credited in the books of accounts maintained by the assessee and the assessee either fails to offer any explanation about the nature and source of the money or his explanation is considered unsatisfactory, the AO can treat the said amount as income chargeable to tax.

Section 69: Unexplained investment : Where any investment made by the assessee is not recorded in the books of accounts and the assessee offers no explanation about the nature or source or offers unsatisfactory explanation, the AO may deem the value of that investment as the assessee’s income for that financial year.

Section 69A : Unexplained money, etc.: where the assessee is found to be owner of money, jewellery, bullion or other valuable article which is not recorded in the books of accounts and the assessee offers no explanation about the nature or source or offers unsatisfactory explanation,, the AO may deem the value of such bullion, jewellery or other valuable article as assessee’s income.

Section 69B : Amount of investments, etc. not fully disclosed in books of accounts: Where in any financial year, the assessee is found to be owner of any bullion, jewellery or other valuable article and the value of such articles is in excess of the value recorded in the books of accounts; and the assessee offers either nil or unsatisfactory explanation about its nature or source, the AO may deem such excess amount as assessee’s income for that financial year.

Section 69C : Unexplained expenditure, etc.: where the assessee has incurred any expenditure and the assessee offers either nil or unsatisfactory explanation about its nature or source, the AO may deem such expenditure to be income of the assessee for that financial year.

Section 69D : Amount borrowed or repaid on hundi: where any amount is borrowed on a hundi from or any amount due is repaid to any person otherwise through an account payee cheque drawn on a bank, the amount so borrowed or repaid shall be deemed to be the income of the person borrowing or repaying the amount.

Section 50: Capital Gain on sale of depreciable asset is deemed as a short term capital gain without providing any indexation benefit even if the said asset is held for more than the prescribed period and is therefore a long term asset. The Courts have held that such deeming as short term capital gain is only for the purpose of calculating the tax under the head capital gain and it does not apply to investment benefits under section 54, 54F etc for which purpose the asset is treated as long term asset.

Judicial Challenge to deeming provisions

Often the assessees' have agitated against constitutional validity of such deeming provisions of computing income, but without much success. The Supreme Court in the case of *J.K. Cotton Spinning and Weaving Mills Ltd. v. UOI*[43] held that it is a well settled law that a deeming provision is an admission of the non-existence of the fact deemed. The competency of Legislature in enacting a deeming provision to presume the existence of a fact that does not really exist, cannot be doubted. While interpreting such deeming fictions, the Court is required to assume certain state of affairs to exist in real and should think as real the consequences and incidents which inevitably flow therefrom and accordingly, give effect even when such situations do not in actual exists. The purpose of deeming provisions may be to broaden the meaning of a particular word or to include matters that may or may not otherwise fall under the principal provision.

[43] (1987) Supp 1 SCC 350

Scope / Object

The scope of application of deeming provisions is well defined in the Income Tax Act, 1961:

(i) some provisions are all pervasive – eg. definition in section 2 applies to the whole Act as it starts with "*In this Act, unless the context otherwise provides*…".

(ii) some deeming provisions apply only to a particular section or clause- eg. Explanation to Section 56(2)(vii) defines "property" for the purpose of clause (vii) of section 56(2) and says that "for the purpose of section 48" full value of consideration shall be value adopted by stamp duty authority.

In the case of the State *of U.P. v. Hari Ram*[44], the Court has held that "Legal fiction is created by the Legislature to attain a particular objective". The intention of a deeming provision, in laying down a hypothesis, is that the hypothesis shall be carried so far as necessary to achieve the legislative purpose but no further.

For example, to combat tax evasion through under-reporting of sale consideration in sale deeds, section 50C was inserted in the Act by the Finance Act, 2002 w.e.f.1-4-2003. In cases of transfer of capital asset being land or buildings or both, the said section deems stamp duty value as the full value of consideration where the consideration shown in sale deed is less than the stamp duty value.

Thus, the enactment of deeming provisions has been considered necessary in order to achieve the legislative purpose and larger social welfare.

[44] [2013] 4 SCC 280

Interpretation Rules

Deeming provisions are to be strictly interpreted. It is a settled law that one should not take a deeming provision's "hypothesis further than is warranted". The Hon'ble Supreme Court in *CIT v. Amarchand N. Shroff*[45] has considered the scope of a deeming provision and came to hold that it cannot be extended beyond the object for which it is enacted. Similarly, in the famous case of *Vodafone International Holding BV v. DIT*[46] Chief Justice Late Sh.S. H. Kapadia held that "*a legal fiction has a limited scope. A legal fiction cannot be expanded by giving purposive interpretation particularly if the result of such interpretation is to transform the concept of chargeability..".*

For example, section 50C is applicable only to "land" or "building" or "both". Thus, the said section cannot be extended in case of transfer of "leasehold rights". The Mumbai ITAT in the case of *Atul G. Puranik v. ITO*[47] has held section 50C is applicable only "capital asset" being Land" or "building" or "both" and it cannot be extended to leasehold rights in a land.

Specific Case Law:

Citation - *CIT v. VADILAL LALUBHAI* [48]

Facts-

The assessee owned shares and controlled several companies including certain managing agency companies. After the Companies Act, 1956 came into force and to safeguard its selling agency rights, the managing agency companies gave up their managing agency rights. Subsequently, the assessee sold its shareholding in the managing agency companies. A few

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[45] (1963) 48 ITR 59 (SC)
[46] (2012) 341 ITR 1 (SC)
[47] (2011) 132 ITD 499 (Mum.)
[48] (1972) 86 ITR 2 (SC)

days later, the managing agency companies went into voluntary liquidation. As a consequence, assets of the company were distributed among the shareholders including assessee.

The AO treated the distribution of assets of the managing agency companies on liquidation as "dividend” within the meaning of section 2(6A)(*c*) and consequently is "income" u/s. 44F of the Act.

Question before the Supreme Court -

Whether the department was right in applying section 44F read with section 2(6A)(*c*) of the Indian Income-tax Act, 1922?

Rule -

The term “income” defined in section 2(6A)(c) is an inclusive definition which includes within its folds, the. Income in the form of “Dividend”. Consequently, if a receipt is regarded as a "dividend", then it has to be regarded as an "income" under section 2(6A)(c).

Section 44F(1) to (3) : Avoidance of tax by sales cum dividend concerns itself with income arising from securities or shares, during a period of time. When a company goes into liquidation, the share-scrips are no more income yielding assets. They are mere pieces of paper. No income arises from those shares thereafter. What the shareholder gets on liquidation is not any income from shares but a share of the assets of the quondam company. Such a receipt is incapable of being deemed to accrue from day to day.

Analysis -

While deciding the said case, the Court held that "dividends" mentioned in section 2(6A) of 1922 Act are only deemed dividends. They are not real dividends. By a legal fiction, they are deemed as dividends. Hence, the deeming provisions are only for one specific purpose and should be restricted to the purpose for which they are created and must not be extended beyond the legitimate field.

Held – Accordingly, the Court held that the deemed dividend contemplated by section 2(6A)(c) cannot be considered as "income" u/s. 44F of the Income Tax Act, 1922.

Further Reference

(i) *Sole Trustee, Loka Shikshana Trust v. CIT*[49]

(ii) *Tangerien Exports v. ITO*[50]

(iii) *Saamag Developers (P.) Ltd. v. ACIT*[51]

Penalty On Deemed Income:

In keeping with the strict interpretation rules, deemed income has been held by courts as not eligible to penalty. Penalty u/s 271(1)(c) is leviable to the extent of 100%- 300% of tax sought to be evaded, where income has been concealed or any inaccurate particulars of income have been furnished by an assessee. Since under deeming fiction, it is understood that income is not real, there is no occasion for concealment or misinformation on the part of the assessee. Reference is invited to the following decisions:

(a) Disallowance u/s. 40(a)(ia) - *Tanushree Basu v. ACIT*[52]

(b) Section 50C – *Renu Hingorani v. ACIT*[53]

However, the above is not an absolute proposition. There is no escapement from penalty if the income is determined under section 68 to 69C. The said provisions are enacted as a counter to tax evasion practises and hence the

[49] (1975) 101 ITR 234 (SC)
[50] (1994) 49 ITD 386 (Bom.)
[51] (2018) 90 taxmann.com 20 (Delhi Trib.)
[52] ITA no. 2922/Mum/2012 order dated 22/05/2013
[53] BCAJ P. 38, Vol. 42-B, part 6, March 2011 (Mum.)

applicability of penalty cannot be ruled out only on the ground that income has been deemed.

Authors' Analysis:

As discussed, the Income Tax Act, 1961 was originally based on the theory of real income. However, with the passage of time, a plethora of deeming provisions have been introduced. Earlier the deeming provisions were applied to curb the incidence of tax evasion where the assets were sold below the fair market value or the companies gave loans to avoid dividend tax. However, of late the legislature has introduced deeming provisions to bring to tax, instances of 'gifts' where no suitable relationship exists between the two parties, with the introduction of section 56(2) as also deeming the transaction value which is different from the actual transaction value. Thus, the scope of deeming provisions have widened. Therefore, before entering into any transaction that is considered to be non-taxable, it will be beneficial to do a full sweep of all the deeming provisions. While interpreting any deeming provisions, the main objective behind the introduction of said deeming provisions is to be kept in mind.

Chapter - V

Expenses Chase Income

Introduction:

The term “income” has been defined in section 2(24) of the Income Tax Act, 1961. To earn any “income”, the person has to incur certain “expenses”. The net income after reducing the incidental expenses, is chargeable to tax. Hence the phrase, expenses chase income. Lord Chancellor Halsbury in *Gresham Life Assurance Society v. Styles*[54] observed that “The thing to be taxed is the amount of profits or gains”.

The expression “profits and gain” has to be understood in its commercial sense and there can be no computation of such profits and gains until the expenditure which is necessary for the purpose of earning the receipts is deducted therefrom.

The term “expense” is not directly defined under the Income Tax Act, 1961. However, under each head of income, the list of allowable expenditure is enlisted. For example, “income” chargeable to income tax under the head “Profits and Gains from business or profession” is provided in section 28. As per section 29, this income is to be computed after allowing expenses that are provided in section 30 to 43D of the Act.

Historical Background:

Accounting history can be traced back thousands of years. In historic times, there was a barter system of accounting. One had to exchange an item for purchasing another item. Thus, a person had to forgo the item he owned for earning or purchasing another item. When money was introduced, every

[54] 3 Tax Cas. 185

item was valued in terms of legal tender. Accordingly, a manufacturer who sets up a factory and incurs various expenses for operations and purchase of raw material, is entitled to deduct those expenses from his sales for that period, in order to determine taxable income. .

Sales do not result in immediate cash inflow; sometimes goods are sold on credit and every now and then, the debtor defaults. Whether such bad debt is to be reduced from 'accrued revenue' as expense? Before 1939, bad and doubtful debts were not treated as deductible allowance for the purpose of computation of profit or gains of a business under the Income Tax Act. It was only after amendment of the Income Tax Act, 1939, that bad and doubtful debts were also allowed as expenditure. The Privy Council in *Income Tax Commissioner v. Chitnavis*[55] observed that

> *"Although the Act nowhere in terms authorises the deduction of bad debts of a business, such a deduction is necessarily allowable. What are chargeable to income tax in respect of a business are the profits and gains of a year; and in assessing the amount of the profits and gains of a year account must necessarily be taken of all losses incurred, otherwise you would not arrive at the true profits and gains."*

Further, apart from the allowable expenses specifically provided under sections 30-36, there may be certain other expenses incurred by a person, which can reasonably be attributed to earn income. To cover such a situation the Act contains a residuary section 37(1) which states that any expenses incurred wholly and exclusively for the purpose of business shall be allowable as expenses to determine the income.

[55] (1932) LR 59 IA 290

Under Tax Laws:

As per the Act, income is to be computed under five heads of income mentioned in Section 14:

(i) Salary – Section 15 to 17;

(ii) Income from house Property – Section 22 to 27;

(iii) Profits and Gains of business or profession – Section 28 to 44DB;

(iv) Capital Gains – Section 45 to 55A;

(v) Income from other sources – Section 56 to 59.

The expenses claimable under each head are as follows:

(i) Salary - None;

(ii) Income from House Property – Gross rental income is determined under section 22 and 23. The allowable deductions are provided under section 24. The disallowable expenditures are provided in section 25.

(iii) Profits and Gains of business or profession – Section 28 lists all the income chargeable to tax under this head of income. The allowable expenditure is listed in sections 30 to 43D of the Act.

(iv) Capital Gains: The income is determined under section 45, whereas the mode of computation is provided in section 48 and 49 of the Act. It is provided that "capital gains" shall be computed by deducting from the full value of consideration received the following items:

- Expenditure incurred wholly and exclusively in connection with such transfer;
- Cost of acquisition of asset;
- Cost of improvement of assets.

(v) Income from other sources: The income is chargeable to tax under section 56 of the Act and the deductions are listed in section 57.

Interpretation Rules:

Under the cash system of accounting, the entries relating to both income and expenditure are entered on an actual basis. However, under the mercantile system of accounting, income is credited when it becomes legally due even if not actually received; likewise expenditure is debited when a legal liability has been incurred before it is actually paid out. The mercantile system of accounting has been very well explained by the Supreme Court in the case of *Keshav Mills Ltd. v. CIT*[56].

> *Under the mercantile system of accounting, only those expenses are allowed which are "accrued" during the accounting year even if discharged at a future date. In the case of Peter Merchant Ltd. v. Stedeford (Inspector of Taxes)*[57] *has drawn a distinction between an actual, i.e. legal, liability, which is deductible and a liability which is future or contingent for which no deduction can be made.*

Further, Simon in his Income Tax Commentary., second edition, volume II, at page no. 240, under the caption "accrued liability" observed that:

> "*In cases, however, where an actual liability exists, as is the case with accrued expenses, a deduction is allowable; and this is not affected by the fact that the amount of the liability and the deduction will subsequently have to be varied. A liability, the amount of which is deductible for income tax purposes, is one which is actually existing at the time of making the deduction, and is distinct from the type of liability accruing in Peter Merchant Ltd. v. Stedeford (Inspector of Taxes) (1948) 30 Tax Cas. 496 which although allowable on accountancy principles, is not deductible for the purposes of income tax.*"

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[56] (1953) 23 ITR 230 (SC)
[57] (1948) 30 Tax Cas. 496

Another example to explain the concept of “expenses chase income” is “provision for expenses” in case of a construction project. Imagine a builder is constructing a project named “XYZ” and offers income on percentage completion method. The occupancy certificate is received in 5th year and accordingly the entire income of the project is to be offered until then. However, he still has to incur certain expenses on finishing and maintaining the project which spills over to the next accounting period. Under the Act, the builder calculates income from the said project after accounting for sales, expenses incurred till date and “provision for expenses” to be incurred in future. The said “provision for expenses” is accounted for in the book of account in the same year in which final income is offered to tax even though the said expense will be incurred in future. This is done to arrive at an accurate amount of income from the project even though the expense is being incurred in future periods. The concept of providing “provision for expenses” is accepted by courts in various cases. Some of these are as under:

(i) *CIT v. M/s. Sane & Doshi Enterprises*[58]*;*

(ii) *Bharat Earth Movers v. CIT*[59]*.*

There may be cases where expenditure, even if incurred for obtaining an advantage of enduring benefit, may be on the revenue account and the test of enduring benefit may break down, but what is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field, that the expenditure would be disallowable on an application of this test. In the case of *Commissioner of Income Tax, Bombay v. Associated Cements Companies Ltd.*[60] which in turn cited with

[58] 2015 (4) TMI 882 (Bom.)
[59] (2000) 245 ITR 428 (SC)
[60] 1988 (Supp) SCC 378

approval the dictum of Viscount Cave. L.C. in *Atherton v. British Insulated and Helsby Cables Ltd.*[61] as under:

> *"But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade. I think that there is a very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."*

Specific Case Law

Citation - *Calcutta Co. Ltd. v. CIT*[62]

Facts:

The assessee carries on the business of land development. The business procedure was that when a plot is sold and the purchaser pays a 25% amount, charge of the purchaser is created on the said land. The assessee undertakes to carry out the development within six months from the date of sale. The assessee maintains its accounts in mercantile method.

During the year under consideration, the assessee entered into a sale deed for a total consideration of Rs.43,692/-. As per the agreement, the assessee had to complete the construction within six months. Since the assessee was following a mercantile system of accounting, the assessee booked "income" even though not "received" and also "expenses" even though not "incurred". In the assessment proceedings, the AO disallowed the claim of expenses on the ground that the expenses had not been actually incurred in the year of account. The AAC upheld the order of the AO. On appeal, the Tribunal dismissed the appeal and held that it was by no means certain what the actual cost would be when the developments were carried out and that although the assessee had undertaken to carry out certain developments,

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[61] (1924) 10 Tax Cases 155

[62] (1959) 37 ITR 1 (SC)

it could bring expenses into account only when the expenses were actually incurred.

On reference the High Court also disallowed the claim of the assessee.

Question before Supreme Court -

(i) What was the nature of liability which was undertaken by the assessee, whether it was an accrued liability or contingent on happening of a certain event in future?

(ii) Whether the sum represented as estimated expenditure can legally be allowed as an expense of the year under consideration?

Rule applied by the Supreme Court –

The Supreme Court applied the definition of "accrued liability" as captioned by Simon in his Income Tax Commentary second edition, volume II, at page no. 240, as mentioned earlier. It further held that the difficulty in the estimation of a liability again would not convert an accrued liability into a conditional one, because it is always open to the authorities concerned to arrive at a proper estimate thereof having regard to all the circumstances of the case [*Gold Coast Selection Trust Ltd. v. Humphrey (Inspector of Taxes)*[63]].

Supreme Court Analysis -

Question 1: What was the nature of liability which was undertaken by the assessee, whether it was an "accrued" liability or "contingent" on the happening of a certain event in future?

The assessee undertakes to carry out the development within 6 months from the date of sale deed. The assessee is absolutely bound to carry out

[63] 17 ITR (Suppl.) 19

the same. The said undertaking is unconditional and not depended on the happening of any event. The only condition is to carry out the development within six months and the time was not of the essence of the contract. If that undertaking imported any liability on the assessee the liability had already accrued on the date of Sale Deed, though that liability was to be discharged at a future date. Thus, an accrued liability and estimated expenditure which would be incurred in discharging the same would be deducted from the profit and gains of the business.

As in the case of assets received during the accounting year which could not be immediately realized in a commercial sense, so in the case of the liabilities which have already accrued during the accounting year, though they may not have to be discharged till a later date. It will be always open to the authorities to fix an appropriate money value of that liability as at the end of the accounting period by taking all the circumstances into consideration and the estimate of expenses given by the assessee would be liable to scrutiny at their hands having regard to all the facts and circumstances of the case.

Question 2: Whether the sum represented as estimated expenditure can legally be allowed as deduction in the computation of income?

The assessee had claimed the deduction of estimated expenditure wholly for the purpose of its business under section 10(2)(xv) of the Income Tax Act, 1922 (section 28(i) of Income Tax At, 1966). On an interpretation of that provision, it is clear that a definite liability had accrued about which all preliminary proceedings causing the accrual of the liability in a concluded form had already been gone through although the actual disbursement had not yet taken place, section 10(2)(*xv*) would cover accrued liabilities though the amount may not actually have been expended on the footing that the liability being certain, the amount was as good as spent and on that basis there would be room in the clause for debits which are proper debits under the mercantile system of accounting.

The assessee is being assessed in respect of the profits and gains of its business and the profits and gains of the business cannot be determined unless and until the expenses or the obligations which have been incurred are set off against the receipts.

Supreme Court held -

The estimated expenditure which had to be incurred by the assessee in discharging a liability which it had already undertaken under the terms of the deeds of sale of the lands in question and was an accrued liability which according to the mercantile system of accounting, the assessee was entitled to debit in its books of accounts for the accounting year as against the receipt which represented the sale proceeds of the said lands.

Authors' Analysis:

All expenses incurred by an assessee are linked to its income. An income would attract expense and an expense will chase the income. Therefore, net income from a business is generally, all the money coming into business, minus all of the business expenses. If that number is positive, then the business is making a profit. It bears repetition that all expenses have to satisfy the test of allowability as laid down in the Act and is referred to in this chapter. Hence, at times the accounting period has to be ignored to determine the correct and real profit of the venture especially in the case of project accounting.

Chapter - VI

All Receipts are not Necessarily Income

Introduction

All human enterprise is carried out in the hope of a gain which helps to fulfil all the material needs of that individual or entity. In common parlance all the receipts of an enterprise arising out of sale of products or services are considered to be its income.

But such is not the case so far as the taxation laws of a country are concerned because there are certain receipts which are exempted from tax for various reasons. At the same time, the government may treat it as taxable income, a sum which has not actually been received. Thus, it becomes necessary to distinguish between receipt which is the general inflow of the business and income which is specifically taxable.

In this chapter we have tried to explain the difference between the two and to discuss the tests which helps us to distinguish between the two concepts for the purpose of better understanding of the taxation of an enterprise.

Under General Law:

Receipts:

Black's Law Dictionary defines “Receipt” as written acknowledgment of the receipt of money, or a thing of value, without containing any affirmative obligation upon either party to it; a mere admission of a fact, in writing. A receipt may be defined to be such a written acknowledgment by one person of his having received money from another as will be prima facie evidence of that fact in a court of law. Also, the act or transaction of accepting or taking anything delivered.

Income:

According to Oxford Dictionary (Vol. V. P. 162, Stroud, vol. II, PP14-16), the expression “income” means “a thing that comes in”. Earning for any source such as land, capital or labour can be termed as “income”.
In the common economic sense, the Supreme Court in the case of *Bhagwan Dass Jain vs Union Of India*[64] has opined that the expression “income” does not only include what is received or what comes through exploitation of a property, but also what is saved by using it oneself. What can be translated as ``income” can reasonably be considered as “source of income”.

Historical background:

Income Tax is one of the most significant sources of revenue for the government. It is the levy of tax on income arising out of exchange of commodity, services, activities or transaction, i.e. all economic activity in the country. The word ‘tax’ is derived from the Latin word ‘Taxo’. Sir James Wilson introduced Income Tax in India for the first time in 1860 to offset the loss “military mutiny” in 1857. Entry 82 of List I of Seventh Schedule of Constitution of India conferred power on Parliament to levy taxes on “income” other than agricultural income.

Under Direct Tax Laws:

Under the Income Tax Act, 1961, tax is levied on the “total income” of the previous year of every person. The word “total income” and “income” both are defined in the Income Tax Act, 1961 under section 2(45) and section

[64] AIR 1981 SC 907

2(24) respectively. The various characteristics of “income” under the Income Tax Act, 1961 are as under:

a) A perusal of the definition of “income” u/s. 2(24), shows that it's an “inclusive” definition. Accordingly, whenever the Legislature intended to bring any receipt to tax, the scope of definition of income u/s. 2(24) was expanded. For instance, vide Finance Act, 2017, a clause was inserted in section 56(2) for treating as income, a sum of money or value of property, if it fell within described parameters.

b) Further section 50C and 50CA were legislated to bring to tax as income, amount which had not even been received thereby deeming certain transactions as income for the purpose of computing the tax liability. Thus, income as per the Act may even be deemed fiction, which means that an amount that has not been received, is treated as income.

c) Under special circumstances, income can even include an amount received as loan, for example deemed dividend u/s 2(22)(e). Similarly, a loan whose antecedents cannot be satisfactorily established by an assessee, is treated as his income u/s 68. Hence, even though the nature of a receipt is not income, yet under the tax law it is treated as “income” for levy of tax.

However, there is a flip side to the above too. Some receipts are not necessarily “income” for tax purposes even though they have been actually received. Under the Income Tax Act, 1961, income is chargeable to tax only when it falls under the charging provisions of section 4. All income is classified under any one of the following heads of income as per section 4:

(i) Income from salary

(ii) Income from house property

(iii) Profits and gains of business or profession

(iv) Capital gains

(v) Income from other sources

<u>Types of receipts and its taxability under Income Tax Act:</u>

Receipts are of two types:

1. Capital Receipt
2. Revenue Receipt

Under the tax laws the revenue receipts are taxable unless specifically exempt whereas the capital receipts are exempt unless specifically made taxable. The Supreme Court has in the case of *Padmaraje R. Kardambande v. CIT*[65] laid down this proposition as under:

(i) Capital receipts in principle does not form part of taxable income;

(ii) A receipt cannot be taxed as income unless it either is in the nature of "revenue receipt" or is specifically charged to tax under any provisions of the Act;

(iii) Section 2(24) of the Income Tax Act cannot erase the distinction between "capital receipt" and "revenue receipts" regardless of the scope of income u/s. 2(24).

The terms "Capital Receipt" and "Revenue Receipt" have not been formally defined in Income Tax Act, 1961. In common use, we can say that a revenue receipt is one which is arising out of the main business activity of the enterprise and is to be considered for calculating income whereas capital receipt is one which is received as impetus for creating a long term income yielding asset. The distinction between the two is very important and has

[65] [1992] 195 ITR 877

captured the attention of courts for decades, because the provisions of Income Tax Act apply very differently to both. Revenue receipt goes to create taxable income whereas capital receipt does not attract tax levy.

Interpretation by Courts

Courts have been instrumental in shedding light on the distinction between capital and revenue receipts. and in framing guidelines for determination of the character of a particular receipt.

The Bombay High Court in the case of *Cadell Wvg. Mill Co. (P.) Ltd. v. CIT* [66] affirmed by Supreme Court[67] has defined revenue receipt and capital receipt as under:

(i) "Revenue Receipt" is an amount which is charged to tax unless expressly exempt in accordance with the provisions of law.

Example: Long term capital gain on sale of listed shares is actually a "revenue receipt". However, the Income Tax Act, 1961 has specifically by virtue of u/s. 10(38) exempted the same from tax, subject to fulfilment of certain conditions.

(ii) "Capital Receipt" is not taxable under the Income Tax Act, unless expressly sought to be taxed by the Act. It may be in the form of a subsidy from the government for carrying on a specified business activity or it may be compensation for a profit-making apparatus.

The Bombay High Court in the case of *Bombay Burmah Trading Corporation Ltd. v. CIT*[68] recognized the receipt in question as capital receipt due to the existence of following conditions:

- There was a breach of contract;

[66] (2001) 249 ITR 265 (Bom.)
[67] (2005) 142 Taxman 713 (SC)
[68] (1971) 81 ITR 777 (Bom)

- Resulting in loss to “capital asset”;
- Such capital asset was for business;
- Compensation was received for recovery of said capital loss.

As per the decision of *Cadell Wvg. Mill Co. (P.) ltd. v. CIT (supra)*, such compensation is taxable only when specifically provided under Income Tax Act.

Example: Till AY 2018-19, compensation received by the partner for reduction in profit sharing ratio in his partnership firm did not result in relinquishment of rights and thus, did not tantamount to Capital Gains chargeable to tax u/s 45(1) as held by the Mumbai ITAT in the case of *Anik Industries Ltd. v. DCIT*[69] . The ITAT was guided by the decision of Karnataka High Court in the case of *CIT v. Panjawani*[70] and observed that under the provisions of the Indian Partnership Act,1932, the firm is not recognized as a separate legal entity. However, the Income Tax Act recognized the firm as a distinct legal entity. Therefore, during the life of a partnership, a partner had no particular interest in a particular asset of the partnership. Thus, the compensation received by an assessee partner for reduction in profit sharing ratio was a “capital receipt” not chargeable to tax.

However, from AY 2019-20, by insertion of clause (e) in section 28(ii), compensation by whatever name called, received or receivable in connection with termination or modification of terms and contract of a business contract was made taxable. Therefore, now Revenue can say compensation received by a retiring partner, over and above his capital balance, although a capital receipt, was rendered taxable.

[69] (2020) 116 taxmann.com 385 (Mum.)
[70] (2012) 356 ITR 676 (Kar.)

In the case of *CIT v. Kamal Behari Lal Singh*[71] the apex court held that taxability has to be seen in the hands of the receiver of the amount and not the payer.Nature of receipt is to be analyzed in the hands of the receiver and not payer; Therefore, the source of payer is inconsequential. Even if for the payer it is a capital expenditure, yet for the recipient it can be revenue receipt and taxable as such.

Even though there are settled principles, it is difficult to ascertain whether a particular receipt is "capital receipt" or a revenue receipt". Applying these principles to a specific set of facts is a complicated exercise. Overall, the determination is based on the facts of each case.

Interpretation Rules

In *Siddeshwar Sahakari Sakhar Karkhana Ltd. v. CIT*[72], the word 'income' or 'profit' was examined and interpreted. In the said case, the non-refundable deposits were collected from members by the sugar cane factory (a society) by way of deduction from the price of sugarcane purchased from the members. The said non – refundable deposit was utilized by the Society for payment of term loans, expansion programmes and capital expenditure. The question before the Supreme Court was whether the amount received by way of deduction from the price of sugarcane, revenue receipt or not? The Supreme Court emphasized that the true nature, character and purpose of the receipt is determinative and relevant and accordingly, treated the deposit as a trading receipt liable to tax.

[71] (1971) 82 ITR 460 (SC)
[72] (2004) 270 ITR 1 (SC)

Accordingly, the Supreme Court expounded that the following questions should be raised and answered to decide whether any receipt is to be treated as "income":

(1) Do the receipts have any "income" character when they reach the hands of the assessee? Say for example, interest has been "accrued" to the assessee, however, "not due". The said interest bears a character of the income. However, taxability of the said interest income will depend upon the other answers.

(2) Does the title in the receipt vest with the assessee? Say in the above example, interest is credited as accrued but not due in the account of the assessee. In that case, it cannot be said that the assessee has a title in the receipt.

(3) Does the assessee exercise complete dominion over the funds in question? Say in the above example, the interest amount ought to be due only on the happening of an event. In that case, though the assessee has a title, the assessee has no dominance on the said amount until the happening of the particular event.

(4) Does the assessee stand in the position of debtor in relation to those funds/deposits? No, because, if the particular event does not take place, the assessee will not have any right to receive the said interest.

(5) What is the primary purpose of collection of said amount? Say in the above example, the amount is received as interest on capital contribution in the firm in which the assessee is a partner. Here the interest income is linked to business purpose and is revenue in nature.
(6) Does the assessee regard the money as that of a third party, with the assessee having no unfettered dominion over the same?

The Court further held that though the manner in which the sums are treated by the assessee in its accounts is neither conclusive nor a sure indication of the nature and character of the receipt, yet it is a relevant factor.

Specific Case Law

Citation – *Parimisetti Seetharamamma v. CIT*[73]

In this case, the Supreme Court once again had occasion to determine the nature of a receipt.

Facts –

The assessee was a businesswoman and had in the past been associated with the Maharani of Baroda (Sita Devi) for a period of 8 years during which she received some jewellery and money from the Maharani in AY 1947-48. The assessee submitted that the said money and jewellery was a gift given out of love and affection. Accordingly, the assessee filed her return of income for the impugned assessment year without treating the said money and jewellery as taxable income.

The ITO treated the said receipt as taxable income on the ground that the same was received as remuneration for services rendered by the assessee to the Maharani. Successive appellate fora upheld the ITO's order.

Question before the Supreme Court - Whether or not the receipts in the form of money and jewellery received by the assessee from Maharani are in the nature of a revenue receipt, assessable to tax?

Rule applied by Supreme Court -

(i) Sections 3 and 4 of the Income Tax Act impose a general liability to tax upon all income. However, the Act does not require that anything received by a person must be treated as taxable income.

(ii) Where a receipt is in the nature of income, it is the taxpayer's responsibility to prove that it is tax exempt. Where a receipt is sought to be

[73] (1965) 57 ITR 532 (SC)

taxed as income, the onus is on the department to prove that it is subject to the tax provision. (The detailed discussion on the burden of proof is covered in a separate chapter in this book).

Held -

The Supreme Court observed that in this case, the assessee claimed the receipt to be a gift which the department sought to tax as income. So, the onus lay on the department. There was no material with the department to justify that the assessee was an employee of the Maharani except the information that the assessee had disbursed salary to her servants. The material on record was insufficient to establish that the assessee would receive such large amounts for such meagre service, when the record pointed out to their personal friendship. Accordingly, the money and jewellery received by the assessee was held to be in the nature of a gift, not assessable to tax.

Further Reference:

(i) *CIT v. Rajkumar Ashok Pal Singh Ji*[74]

(ii) *Reliance International Corporation Ltd. v. ITO*[75]

(iii) *CIT v. Mahavirprasad R. Morarka*[76]

(iv) *Sumati Dayal v. CIT*[77]

(v) *Saamag Developers (P.) Ltd. v. ACIT*[78]

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[74] (1977) 109 ITR 581 (Bom.)
[75] (1986) 16 ITD 43 (Delhi)
[76] (1991) 58 Taxman 111 (Bom.)
[77] (1995) 80 Taxman 89 (SC)
[78] (2018) 90 taxmann.com 20 (Delhi – Trib.)

Authors' Analysis :

The Income Tax Act provides the rules and guidelines, elaborated by courts from time to time, based on which receipts and sometimes non receipts are treated as income. Taxing statutes also recognize the difference between revenue and capital receipts, while determining the taxability thereof.

Revenue receipts are generated from business activities and are taxable unless specifically exempt whereas capital receipts are generally non-taxable unless specifically so provided. Mere receipt of an amount in course of normal business is also not determinative of its nature as taxable income. Even the manner of its recording in the books of account is not an irrefutable test.

The determinative factor, with reference to the tests laid down by Courts is the true nature , character and purpose thereof. Department while seeking to tax as income a particular receipt, which is not so offered by the assessee, has to apply these tests to the satisfaction of the courts. The Revenues that are generated from the normal course of trade and come out as income after applying the above tests, based on the provisions of the Income tax Act, are treated as income.

The legislature has tried to bridge the gap between the "revenue income" and "capital receipts" by bringing in specific taxing provisions in the Act itself. Section 28(ii)(e) has been added which has now brought to tax compensation which is received in connection with the business of the assessee. In some earlier decisions such compensations have been treated as capital receipt. Thus specific enactments are erasing the difference between the capital receipt and revenue receipt for the purpose of determining the tax liability.

Chapter-VII

Diversion of Income by Overriding Title

Introduction

The taxable income of a person is determined not only on the basis of receipts but also on the accrual basis. However, at times income does not end up in assessee's hand but is diverted at source itself due to some statutory compulsions or contractual obligations. Such incomes which are diverted to another person at the source itself do not form part of the income of the assessee. However, if such income is diverted after accrual to assessee then it is application of income and is taxable in the hands of assessee even though not received by such assessee. The concept of "Diversion of income by overriding title" is judicially well recognized and has been employed over the years for tax planning in respect of incomes falling under the heads ``capital gain" and "profits and gains from business or profession".

An income is said to have been diverted by an overriding title when that income is taken away at source itself due to:

a) an act of the parties;

b) by operation of law

c) by court order or decree

so that the said income never reaches the person. However, if the income is diverted after its receipt or accrual to an assessee, then such diversion is not by an overriding title but is treated as application of income.

Under General Law

This concept of Diversion of income by overriding title is based upon the statutory or contractual right of another person to claim a sum which would otherwise have been received in the hands of the assessee. Such right in another person emanates from a statute and hence the assessee is duty bound to ensure that the income is received by such other person. Such a right is specifically enforceable by the other person. Under the general law it means that the other person has a primary and prior title to an income or part thereof instead of the assessee. Thus, it's important to determine how such a right has got vested in the other person i.e. whether due to any contract or operation of any law.

Historical background

The earliest discourse on the subject can be found in the case of *CIT v. Sitaldas Tirathdas*[79] wherein the Supreme court observed as under:

(i) the real test is whether the amount sought to be deducted actually never reached the assessee as income;

(ii) nature of obligation is a decisive factor;

(iii) there is a difference between an amount which a person is obliged to apply out of his own income and an amount which by nature of obligation cannot be said to be part of income of the assessee;

(iv) deduction is available where the income is diverted at source i.e. before it reaches the assessee since the income never reached the assessee;

[79] (1961) 41 ITR 367 (SC)

(v) deduction is not available when income is diverted after it reaches the assessee since it is merely an obligation to pay a portion of assessee's own taxable income.

Thus, the court clearly explained the difference between an obligation to pay the income before it accrues to the assessee and the income which he is obliged to apply in a particular manner.

This decision was subsequently followed in a large number of cases such as *V. Venugopal Varma Rajah v. Commissioner of Agricultural Income Tax*[80].

Under Direct Tax laws

Income is chargeable to tax under section 4 of the Income Tax Act, 1961 and other specific charging sections as described in a separate chapter – "Charging provisions vs machinery provisions". Under tax laws, income is charged on receipt or accrual basis, unless when specifically exempt (eg. Section 80IBA, section 10). The Privy Council in the case of *Raja Bejoy Singh Dubhuria v. CIT*[81] held that income that reached the individual as income is intended to charge as per section 3 of Income Tax Act, 1922 (i.e. section 4 of Income Tax Act, 1961).

However, if any income of a person is diverted at the source itself, then in that case income falls outside the scope of section 4 of the Income Tax Act, 1961 and accordingly, income is not chargeable to tax. The diversion of income under section 4 can be in the following ways:

(i) <u>Diversion by order / decree of the court</u> – eg.: say an arbitration award is passed in case of dispute between the partners of the firm. As per the arbitration award, Group A is entitled to receive

[80] (1972) 84 ITR 466 (SC)
[81] (1933) 1 ITR 135 (PC)

Rs.1 crore as compensation for breach of partnership terms by Group B. The said amount is secured against charge on certain flats in the project developed out by the firm. As and when the said flats are sold, the sale consideration will be credited directly to the personal accounts of Group A. In this case, the income is never recorded in the books of the firm due to the operation of decree of the court. Reference is made to the decision of Patna High Court in the case of *Raja Shiva Prasad Singh v. CIT*[82] wherein the Court held that a widow of the deceased holder of an impartible estate is entitled to maintenance allowance against charge on the estate as per the Court decree. The said amount would not form part of the assessee's income as there would be diversion by overriding title.

(ii) Statutory provision – In *Keshkal Co-Operative Marketing Society Ltd. v. CIT*[83], the Madhya Pradesh HC held that statutory deposit transferred to reserve fund under section 43(2) of the Madhya Pradesh Co-Operative Societies Act, 1960 is deductible in the hands of the assessee under the concept of diversion by overriding title.

(iii) Contractual obligation – eg: say if a land owner enters into a revenue sharing Development Agreement with the Developer. The revenue of the land Owner is never accounted for in the books of the developer due to operation of contract between the land owner and developer. Reference is made to the decision of Punjab and Haryana High Court in the case of *CIT v. Seth Motilal Pal Jain*[84] wherein the Court held that under a partition deed, male

[82] (1942) 10 ITR 249 (Pat.)
[83] (1987) 165 ITR 437 (MP)
[84] (1989) 180 ITR 262 (P&H)

members are under an obligation to pay a certain sum of money out of their individual income to female members, then in that case, the income is taxable in the hands of the female members by virtue of diversion by overriding title.

Interpretation Rules

As mentioned above, diversion of income by overriding title can be created by contract between two individuals. The said concept has been accepted by the Madras High Court in the case of *CIT v. Madras Race Club*[85]. According to the facts arising in this case, the collections did not reach the assessee since there was a contract between the assessee and the Government for handing over the collection to the beneficiaries. The assessee conducted races for three days for the benefit of and on behalf of beneficiaries. Therefore, the right to receive the aforesaid three days' collection was vested in the beneficiaries and even before the commencement of races, it was known that the collections were earmarked for the benefit of the beneficiaries. Thus, there was a diversion of income by overriding title, and the collection is not treated as income chargeable to tax of the assessee here.

In the case of *Warner Lambert Co. Ltd. v. CIT*[86], the Court observed that the agreement between the assessee and the Indian company does not either expressly or by implication create charge over the preferential dividend. The Indian company had no exclusive right on the amount of the preferential dividends. This is a case of receipt first by the assessee in its own right and then applying the amount for research activity of the Indian Company. Accordingly, the Bombay High Court upheld the decision of the Tribunal that there was no charge created by diversion of income at source by an overriding title. In our opinion, the preferential dividend received by the

[85] (1996) 219 ITR 39 (Mad.)
[86] (1998) 234 ITR 516 (Bom.)

assessee is rightly included at the hands of the assessee for the purposes of computing tax under the Act.

The Supreme Court has further observed in the case of *CIT v. Thakar Das Bhargava*[87]*.* In this case, the Advocate agreed to argue the case on a condition that his professional fees shall be paid in the name of his trust. On the facts of this case, the Supreme Court held that since there is application of fees and not diversion of income by overriding title, the fees are taxable in the hands of the Advocate as professional fees.

The rules for interpretation can be summarized here under:

Sl. no.	Rule	Citation
(i)	The true test in deciding the "diversion of income by overriding title" lies in the nature of obligation which is the decisive factor	CIT v. Sitaldas Tirathdas (supra).
(ii)	Discharge of self-created charge on asset not eligible for diversion of overriding title but is an application of income	S.B. Billimoria & Co. v. ACIT[88] Pondicherry Rly. Co. Ltd. v. CIT[89] CIT v. Travancore Sugars & Chemicals Ltd.[90]
(iii)	Property purchased with pre-existing charge / encumbrance	R. M. Arunachalam v. CIT[91] Navin R. Kamani (HUF) v. ITO[92]

87 (1960) 40 ITR 301 (SC)
88 (2009) 317 ITR 203 (Mum.)
89 AIR 1931 PC 165
90 (1973) 88 ITR 1 (SC)
91 (1997) 227 ITR 222 (SC)
92 (1991) 36 ITD 576 (Mum.)

	eligible for diversion by overriding title.	CIT v. Daksha Ramanlal[93]
(iv)	Obligation attached to an asset is a diversion by overriding title.	Matubhai C. Patel v. CIT[94] Udayan Chinubhai v. CIT[95]
(v)	Obligation attached to income is application of income	CIT v. Sunil J. Kinariwala[96]
(vi)	Amount paid to extinguish pre-existing rights is diversion by overriding title	CIT v. Pompei Tile Works[97]
(vii)	The receipt of amount directly by a payee from the source of assessee will not necessarily be treated as diversion of income by overriding title.	Perfect Thread Mills Ltd. v. DCIT *(discussed hereunder)*
(viii)	in case of private contracts, the actual intention of the parties should be verified in order to determine whether such contract were entered into for tax evasion.	PCIT v. M/s. Chamundi Winery and Distillery[98]
(ix)	What is important is whether income is diverted at source or it	P.C. Mullick and Another v. CIT[99]

[93] (1992) 197 ITR 123 (Guj.)
[94] (1982) 133 ITR 303 (Guj.)
[95] (1978) 111 ITR 584 (Guj.)
[96] (2003) 259 ITR 10 (SC)
[97] (1989) 175 ITR 1 (Karn.)
[98] (2018) 408 ITR402 (Kar. HC)
[99] (1938) 6 ITR 206 (SC)

	reaches the hands of the assessee first and then diverted.	
(x)	In the case of diversion of income, the obligation arises from a previous and independent title. Whereas, in case of application of income, the obligation is self-imposed or gratuitous.	Moti Lal Chhadami Lal Jain v. CIT[100]

Specific Case Law

Citation – *Perfect Thread Mills Ltd. v. DCIT*[101]

There was a difference of opinion between the two members in this decision rendered by Mumbai ITAT and the matter was referred to the Third Member. This decision is important because it highlights the different aspects of diversion of income by overriding title along with past precedence.

Facts –

During AY 2009-10, the assessee availed the facility of corporate loan from Bank for an amount of Rs.306 lacs. The loan was repayable in 36 monthly instalments. However, the assessee defaulted from August, 2009 onwards. The Bank classified the assessee’s account as NPA and invoked section 13(2) of the SARFAESI Act and took the possession of factory land of the assessee. The Bank thereafter sold the said land by dividing it in parcels and received a consideration of Rs.2.18 crores. The Bank adjusted Rs.1.48 crores against the principal segment and balance Rs.69 lacs against the interest segment of the loan.

[100] (1991) 190 ITR 1 (SC)
[101] ITA no. 4964/Mum/2013, order dt. 05/09/2019

The assessee claimed the interest of Rs.69 lacs as allowable expenditure in the books of account. In the return of income, the net amount of Rs.1.48 crores was also claimed as deductible u/s. 48 of the Act as under:

Total amount of sale consideration received from Bank	Rs.2,18,00,262/-
Less:	
(i) Indexed Cost of land and improvement	Rs.3,43,583/-
(ii) Amount adjusted by Bank against principal amount of loan	Rs.1,48,24,633/-
Long Term Capital Gain	Rs.66,26,046/-

In assessment, the assessee submitted that the possession of the land was with the bank and the sale consideration never reached the assessee as the bank adjusted the same against principal land and interest. Thus, there is diversion of income by overriding title and thus, the said sale consideration is not taxable in the hands of the assessee.

The AO held that the claim is not sustainable in law as the gains arose on the sale of the factory land of the assessee. Accordingly, the amount of Rs.1.48 crores was added back to the total income of the assessee. The CIT(A) held that there is no diversion of income and the amount cannot be claimed as deduction u/s. 48.

The Accountant Member held that in case of the borrower's failure to discharge the liability to the lender bank, the assessee's title of ownership is subjected to the rights of the Bank, conferred by the SARFAESI Act. Thus, the provisions of the Act provide to the lender bank an "overriding title" on the secured property.

The Judicial Member dissented and held that the obligation for payment of the loan and the interest was on the assessee. The Bank merely carried out recovery proceedings as permitted under the law. Such action under SARFAESI Act did not shift the obligation of the assessee to discharge the loan. Therefore, the recovery of money directly by the Bank by auctioning the property cannot be treated as diversion by overriding title.

Decision by Third Member –

The Third Member relied upon the decision of *R.M. Arunachalam v. CIT (supra)* and held that where the mortgage was created by the assessee itself, the clearing off such debt by it prior to transfer of property would not entitle him to claim deduction u/s. 48 because in such a case he did not acquire any interest in the property subsequent to his acquiring the same.

The Third Member further relied upon *CIT v. Attilli N. Rao*[102] and held that what was sold by the Bank at auction was the immovable property that belonged to the assessee and the price that was realized also belonged to the assessee. From the said price, the Bank deducted its dues. Therefore, the full price realized less admitted deduction was liable for tax. Accordingly, the Third Member concurred with the decision of the Judicial Member and held that there was no diversion of income by overriding title.

Further reference

(i) *Dy. CIT v. T. Jayachandran*[103]

(ii) *CIT v. Sunil J. Kinariwala*[104]

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[102] (2001) 252 ITR 880 (SC)
[103] (2018) 406 ITR 1 (SC)
[104] (2003) 259 ITR 10 (SC)

Author’s analysis

The concept of diversion of income by overriding title has its roots emanating from the concept of real income. A person ought not to be taxed on the income he never received. However, the fine line between income not received and application of income has made it a concept riddled with litigation. The concept of overriding title is still not really established even though nearly eight decades have passed. The conflict in judicial minds continues, based on the facts of each case.. The blurred nature of obligation in certain cases makes it difficult to plead that the obligation is attached to source or to income.

Chapter - VIII

Principles of Natural Justice

Natural Justice is a symbol or expression of usefulness, to prevent one person from harming or being harmed by another.

- Epicurus

Introduction

In the annals of legislative history, the principles of natural justice have been upheld by courts time and again. The courts have intervened whenever these principles have been violated by lower courts or authorities while passing any order adversely affecting any person. The Highest court has applied the concept of natural justice even in administrative orders, if such orders have caused prejudice to any person. In this chapter, we will study how the principles of natural justice are embodied in the Income Tax Act, 1961.

In General Law:

The term 'natural justice' is derived from the Roman word '*Jus Naturale*' which means principles of natural law, justice, equity and good conscience. Lord Evershed, Master of the Rolls in *Vionet v. Barrett*[105] remarked, Natural Justice is natural sense of what is right and what is wrong'. Principle of Natural Justice has been enshrined in the judicial systems since time immemorial. The term "natural justice" is synonymous with the concept of the general duty to do the right thing.

[105] 1985, 55LLJ QB, 39

The term ‘natural justice’ is not used anywhere in the Indian Constitution. The preamble of the Constitution of India includes the words “justice – social, economic and political”, “liberty of thoughts, expression, etc.” and “equality of status and opportunity”. All these phrases lead to compliance with the principles of natural justice in all the laws promulgated in the country. As per Article 14 of the Indian Constitution, the State cannot deny to any person ‘equality before law’. Article 21 confers on every person the fundamental right to life and personal liberty. The denial of equality and fundamental right to life would amount to violation of principles of natural justice. Similarly, Article 311 states that a civil servant cannot be removed or dismissed or reduced in rank except after inquiry and unless he is given a reasonable opportunity of being heard in respect of charges against him.

<u>Legal Maxims</u>

There are two legal maxims for principles of natural justice :

1. *nemo iudex in causa sua* – rule against bias or one cannot be a judge in his own cause. Thus before appointment in any judicial or administrative capacity, the appointee has to give a declaration of impartiality or lack of personal interest in the subject matter that he has to deal with e.g appointment of an arbitrator, a director not being allowed to vote upon a matter involving personal gain etc.

2. *audi alteram partem* - right to a fair hearing. This means that a person has a right to effectively present his case, before any adverse order can be passed against him.

Historical Background:

In the celebrated case of *Cooper v. Wandsworth Board of Works*[106], the Court observed that even God did not pass a sentence upon Adam, before he was called upon to make his defence. “Adam" says God, “ have you not eaten the fruit of the tree that I forbid you to eat?’ The Judge Byles further stated that although there are no positive words in the Act that require a party to be heard, yet common legislature will resolve the problem, the omission of the legislature.

Thus, undoubtedly, the principles of natural justice is a concept as old as time itself. It has been used interchangeably with divine law viz. “jus gentium”, the common law of England, “due process” of the U.S, “dharma” of India and “proportionality” of the civil law system.

Under Direct Tax Laws:

Under the Indian tax laws, a basic principle is that where any adverse presumption is to be drawn by an AO against an assessee, on the basis of information or material , the AO is duty bound to share the said information or material with the assessee and give him an opportunity to rebut such presumption or challenge the genuineness of such material, so as to avoid the adverse implication.

Natural justice recognizes three main principles:

1. *Nemo debet esse judex in propria causa* (No man can be a judge in his own cause): the person who is the judge or judges or an administrative authority, he should be impartial and free from any kind of bias. The principle is also more popularly known as the Doctrine of Bias
2. *Audi alteram partem* (No person shall be condemned unheard): means that both sides must be heard before passing any order.

[106] (1963) 143 ER 414

3. Speaking orders or reasoned decisions

In the case of *E. Vittal v. Appropriate Authority*[107], it was held that if in any proceedings, the result is based on the evidence held by one party then the affected party is entitled to receive the alleged document and an opportunity to rebut the same. The opportunity shall be effective and not merely a formality. The time limit is no obstacle to not giving adequate opportunity. The principle is inviolable. If an effective opportunity of being heard is not granted / denied, then in that case, the order passed is void ab initio and ought to be set aside.

Key Principles:

a) No party should be condemned unheard.
b) One cannot be a judge in his own case.
c) not only must justice be rendered but it must be perceived as such.
d) order should always be a speaking order to prevent any bias.
e) an unbiased hearing shall be extended to allow the accused person to present his / her case.

The Indian tax laws incorporate the principles of natural justice in the following forms:

1. <u>Right to receive notice :</u>

Whenever any return of income filed by the assessee is selected for assessment, the AO is duty bound to issue notice u/s. 143(2) of the Income Tax Act, 1961 thereby giving an assessee an opportunity of being heard. This opportunity allows the assessee to file evidence supporting and substantiating the claim in his return of income..

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[107] [1996] 221 ITR 760 (AP)

2. <u>Need for Show Cause Notice (SCN):</u>

The Income Tax Act mandates the issuance of a show cause notice before making any addition to the declared income. Thus, in all cases under assessment, where the Assessing Officer proposes to make additions or disallowances, the assessee would be given an opportunity to put up his defence against the proposed additions/disallowances in accordance with the principle of natural justice. CBDT has issued an *Instruction no. 20/2015 dated 29th December, 2015,* wherein at Para 4 it has been stated that in any case the AO proposes to make additions or disallowance, the AO ought to give a fair opportunity of being heard in accordance with principles of natural justice to the assessee to explain as to why such addition or disallowance shall not be made. For this purpose, the AO should issue a show cause notice indicating therein the reasons for the proposed addition . disallowance along with evidence in his possession. Before passing the final order, the AO is required to consider the submissions filed by the assessee in response to the show cause notice.

Accordingly,

a) The AO is duty bound to issue a show cause notice indicating reasons for proposed addition;
b) The AO has to consider the submission of the assessee and the evidence placed on record and then pass a reasoned order in case he decides to make an addition, rejecting the assessee's contention.

Under the newly introduced faceless regime of income assessment, this principle and process places an even greater burden on the officers to ensure that the orders are not passed arbitrarily. Therefore, the legislature has enacted section 144B / 144C of the Act which provides for the mechanism of carrying out the faceless assessment. The said enactment provides for making it mandatory to issue show cause notice before any variation can be made to the returned income. The enactment also provides for circulating the draft assessment order to the assessee calling for his objection before formally the final assessment order is passed.

Various High Courts have held that the orders passed in violation of the safeguards provided in the faceless assessment scheme are liable to be set aside. Some of the cases are as under:

(i) *RMSI Private Ltd. v. National E-Assessment Centre*[108] wherein the Court held that "*it is mandatory for the National E-Assessment Centre to provide an opportunity to the assessee, by serving a notice calling upon him to show cause as to why the variation proposed in the Draft Assessment Order, which is prejudicial to the interest of the assessee, be not made*."

(ii) *SHL (India) Private Limited v. UOI and others*[109], in para no. 27 held that the Assessing Officer has no power under the statute, as the provision clearly mandates the Assessing Officer to pass and furnish a draft Assessment Order in the first instance in such a case. The legislature has intended to give an important opportunity to Petitioner, who is an eligible assessee, which has been taken away. Failure to follow the procedure under Section 144C(1) would be a jurisdictional error and not merely procedural error or a mere irregularity. The Assessment Order has not been passed in accordance with the provisions of Section 144C of the Income Tax Act.

[108] W.P.(C) 6482/2021 (Delhi HC), order dated 14/07/2021
[109] W.P. (L) NO.11293 OF 2021 (Bombay HC), order dated 28/07/2021

3. Right to receive all documents:

   An assessment order passed without following principles of natural justice and without providing the necessary documents and details will be a nullity. The Supreme Court in the case of *Dhakeshwari Cotton Mills Ltd. v. CIT*[110] has observed that the Tribunal should not have upheld the order passed by AO wherein gross rate of profit was drawn on estimate of other similar business without providing the said information to the assessee and without giving an opportunity to rebut the said information.

   In the case of reassessment proceedings u/s. 147 of the Income Tax Act, the Delhi High Court in the case of *Sabh Infrastructure Ltd. v. ACIT*[111] held that the AO should disclose fully and truly the material facts to the assessee while communicating the reasons for reopening to the assessee. The Court has provided the detailed guidelines to be followed by the AO in case of reopening of assessment.

4. Right to Inspection of records:

   Where any information has been collected by the AO during the course of assessment proceedings, the assessee has the right to call for such information or request the AO to allow inspection of the file of assessment proceedings and make copies for his purposes.

   CBDT circular dated 28.06.1965 No. 17 (XL-36) provides for fees chargeable for inspection of records and certified copies of certain documents. This circular provides that the assessee or his authorised representative are entitled to inspect as well as obtain certified copies of assessment and other records so that the assessee is able to rebut the entire evidence.

[110] (1954) 26 ITR 775 (SC)
[111] (2017) 398 ITR 198 (Delhi HC)

5. <u>Provide reasons for reopening:</u>

Under section 148 of the Income Tax Act, the AO is required to provide the assessee the following details :

(i) Reasons recorded for reopening ;

(ii) Information on which the reasons are recorded ;

(iii) Satisfaction recorded by appropriate authority before grant of approval for reopening of assessment.

Keeping in mind the principles of natural justice, the Delhi High Court in the case of *Sabh Infrastructure Ltd. v. ACIT*[112] had laid down guidelines in the matter of reassessment as under:

(i) Along with reasons recorded, the AO should also provide a copy of approval obtained u/s. 151 of the Income Tax Act;

(ii) The reasons recorded should provide the reasons and ground available with the AO for reopening the impugned assessment especially where assessment u/s. 143(3) / 144 has already been done. Where the reopening is based on the report of the investigation wing, the AO should specify the enquiry conducted by him independent of such report of investigation wing.

(iii) Where the reasons refer to any evidence or document in possession of the AO and on which the reasons are recorded, such evidence / documents should be provided to the assessee;

(iv) The AO while disposing of the objection shall pass a speaking order. He should deal with each and every objection raised by the assessee and give proper reasons. However, no attempt shall be made to add to the reasons recorded beyond what has already been disclosed.

[112] 2017 (9) TMI 1589

Now w.e.f. 01/04/2021, a new section 148A has been introduced in the Income Tax Act, 1961 which has codified the principle of natural justice by providing that the AO has to carry out the following mandatory process of law and observe statutory safeguards before issuing notice for reopening of assessment:

a. the AO to conduct inquiry with prior approval of specified authority with respect to information which suggest that income chargeable to tax has escaped assessment;

b. mandates providing an opportunity of being heard to the assessee by serving upon him a show cause notice as to why notice u/s. 148 should not be issued on the basis of information which suggests that income chargeable to tax has escaped assessment and result of enquiry conducted;

c. consider the reply of assessee; and

d. pass a speaking order stating whether the said case is fit for issuance of notice u/s. 148 after considering the reply of the assessee and on the basis of material available on record.

In case, the above mandatory procedure has not been followed by the AO before issuance of notice u/s. 148 of the Act, then the entire reassessment proceedings are rendered invalid.

6. <u>Need for speaking orders:</u>

The AO is not only required to give the assessee an opportunity of being heard in any proceedings, but is also required to pass a speaking order, mentioning the reasons for making any addition.

To ensure that due process of law is followed,, the *CBDT vide Instruction no. 3/2013 [F.NO.225/76/2013/ITA.II], dated 05/07/2013* has directed that an order under section 154 of the Act must fulfil all the legal requirements, should be a speaking order and has to be invariably communicated to the taxpayer immediately after it is passed.

The CBDT has also issued *Instruction no. 20/2015 dated 29th December, 2015,* wherein at Para 4 directing the AOs to deal with the submission of the assessee and accordingly pass assessment orders.

7. <u>Cross-examination:</u>

Any statement given by a third party against the assessee cannot be treated as an evidence against the assessee in absence of an opportunity to the assessee to cross examine the third party. In the well known penny stock matters, the AOs routinely reopened assessments and made additions on the basis of statements of various directors, employees, etc. of the companies whose shares are treated as bogus and brokers who have provided service of trading. The courts have regularly held that before relying on the such statements, it is mandatory to provide assessee an opportunity to cross examine the statement givers, so that the fallacies, if any, may be brought to light and unfair additions may be avoided.

8. <u>Right to a legal representative:</u>

As per section 288(1), any person who is entitled or required to attend before the Income Tax authorities or Appellate Tribunal in connection with any proceedings under the Income Tax Act, can be represented by an authorised representative.
Thus, as per section 288(2), eight categories of individuals can serve as an authorised representative of an assessee. Representation could take place

due to various reasons if the assessee in question does not have proper legal knowledge, is critically ill, is of unsound mind, is travelling or residing outside India etc.

Scope/ Object

The Supreme Court in the case of *A.K. Kraipak v. UOI*[113], has laid down guidelines for observance of principles of natural justice. As per the Court :

(i) the rules of natural justice seek to ensure justice.

(ii) Rules of natural justice can only work in areas not covered by a valid legislature.

(iii) The rules of natural justice are not embodied rules. The rule of natural justice that should be applied in any given case would depend largely on the facts and circumstances of that case.

(iv) The rules of natural justice shall also apply to administrative enquiries.

(v) Whenever a complaint is filed before any court for lack of some principle of natural justice, in that case, the Court has to decide whether compliance with that rule was required to render a fair decision on the facts of this case.

(vi) The concept of natural justice has evolved a lot over period of time. Earlier there was mainly 2 concepts (i) no on shall be judge in his own case and (ii) an opportunity of being heard ought to be given to affected party before passing an order. Now the third rule

[113] (1969) 2 SCC 262

embedded is that quasi judicial enquiries must be held in good faith, free of bias and not in an arbitrary manner.

Interpretation Rules

There is no particular formula for application of the principles of natural justice or interpretation of the same. Even the Supreme Court in the case of *A.K. Kraipak v. UOI (supra)* held that the application of this rule will depend to a great extent on the facts and circumstances of that case. These principles are of vital importance in the judicial, quasi-judicial and administrative system to prevent such authorities from doing injustice and also to avoid unnecessary litigation Needless to state, consistent observance of such principles strengthens confidence in the administrative and judicial machinery of a nation that results in widespread wellbeing and ensures better compliance with the laws of the land.

Specific Case Law

Citation - *Sahara India (Firm) v. CIT*[114]

Facts -

The assessee-company was directed to get conducted a special audit of its accounts under section 142(2A). However, no opportunity of hearing was given to the assessee before passing such an order. The assessee challenged the said order on grounds of principles of natural justice. The assessee relied on the decision of Supreme Court in the case of *Rajesh Kumar v. DCIT*[115] and submitted that there has to be a pre-decisional hearing and an opportunity has to be granted to the assessee before any direction can be issued u/s. 142(2A) for special audit of accounts.

[114] (2008) 300 ITR 403 (SC)
[115] (2006) 157 taxman 168 (SC)

The two-Judge Bench were of view that the observation in *Rajesh Kumar's* case (*supra*) that in every case of order u/s 142(2A), the concept that assessee had to be heard before such order is passed was not correct in law. Therefore, the matter was thus referred to the larger bench.

Question before the Court -

Whether in view of the fact that the said provision section 142(2A) does not postulate the requirement of a hearing before an order for special audit is passed, a pre-decisional hearing is required to be given to the assessee?

Rule -

The question whether the principle *audi alteram partem* has to be applied or not is to be considered bearing in mind:

(i) The explicit language and basic regime of conferring provisions;

(ii) Power in the hands of the authorities;

(iii) nature of authority granted and purpose;

(iv) the final effect of the exercise of that power.

The application of said principle can be determined only after considering the above factors.

Supreme Court analysis -

In the case of Rajesh Kumar (supra) it was observed that before ordering special audit, the assessee ought to be given an opportunity of being heard to show that the accounts are proper and do not require appointment of special auditors. Because, the appointment of special auditor would require the assessee to undergo the process of further accounting despite the accounts being already audited by chartered accountant u/s. 44AB and he would be required to pay additional audit fees to the special auditor. Accordingly, the Supreme Court held that an order under section 142(2A) does entail civil consequences.

Held –

The Court held that the grant of opportunity of being heard is necessary before passing an order even if the provision does not specifically provide for grant of pre-decisional hearing.

Further Reference:

(i) *Moons Technologies Ltd. v. Union of India* [116]

(ii) *Assistant Commissioner of Income-tax v. Sushila Milk Specialities (P.) Ltd.*[117]

(iii) *Indian Aluminium Co. Ltd. v. Deputy Commissioner of Income-tax*[118]

Exceptions:

The principles of natural justice are applicable to a statutory body or tribunal whether administrative or quasi-judicial. However in certain situations, it may be considered proper to give them a go by. Some of these exceptions are where there is express statutory bar or where such disclosure could be against the public policy. Sometimes prompt action is required and hence the prior hearing is given a go by. A school of thought is that in purely administrative orders there is no requirement of prior hearing. However, this is not an absolute law and where the administrative orders adversely affect the person, then a prior hearing is a must. However, in all these cases of exception, in the event of a challenge the bonafide of the authority is to be established.

Authors' Analysis:

The Concept of Natural Justice is now codified under the Income Tax Law. With the advent of faceless assessment and faceless appeal, adequate and reasonable opportunity of hearing has become the norm and the Courts have taken a very serious view wherever this concept is violated. In fact

[116] [2017] 88 taxmann.com 67 (Bombay)
[117] [2010] 122 ITD 48 (Delhi) (SB)
[118] [2010] 329 ITR 550 (Calcutta)

certain Courts have gone on to hold that where the principle of natural justice was followed by AO but he did not issue the show cause notice and draft assessment order as required under section 144B and 144C of the Act, the said assessment was invalid.

The principle of natural justice does not stop only at the opportunity of hearing. It's not an empty formality. The AO is duty bound to consider and deal with the submission and details filed by the assessee before the assessment can be finalised. Mere granting of opportunity without dealing with the submission of assessee will defeat the very purpose of assessment. Recently, the Mumbai High Court has in the case of *Mantra Industries Limited*[119] come down heavily on the AO who passed an assessment order without dealing with the submissions of the assessee. The Court was so annoyed with the arbitrary assessment that it passed a stricture against the concerned AO.

The legislature has further ensured that each submission made by the assessee is further acknowledged through a number generated by the tax portal. This further ensures that the submissions made by the assessee are taken on record. Hence, the AO becomes duty bound to deal with such submissions. The use of technology has by the government will reduce the grievance of violation of principle of natural justice in income tax proceedings in a big way.

[119] WP No.1625 of 2021 order dated 11th October 2021

Chapter - IX

Burden of Proof

Introduction:

Like any other law, the taxing laws also involve the concept of Burden of Proof. Though the tax proceedings are not adversarial in nature, the tax department is mandated to collect the maximum possible revenue for the fiscal year. This often results in additions being made to the returned income on the basis of assumptions and presumptions. The department tries to place the onus on the assessee to prove that a particular receipt is not taxable or claim of expenditure is allowable or that the nature of transaction reflected in the books of accounts is genuine. On the other hand, the assessee shifts the burden on the department to prove that a particular receipt is taxable “income” or that the claim is disallowable or that the nature of the transaction as reflected in the books of accounts is non genuine. For instance, the department requires the assessee to prove the genuineness of unsecured loans shown in the balance sheet by leading evidence.

Under General Law:

Burden is a statutory obligation of a party to prove certain facts or absence thereof which that party pleads in support of the case. It is a liability on such parties to lead proof through evidence. The proof is a basket of the evidence led to prove the facts or law in support of the averments/ denials made in pleadings. Based upon the evidence led, the Courts decide whether the fact has been proved or unproved. The degree of proof may differ from proceedings to proceedings. In civil proceedings, preponderance of probability may be sufficient but in criminal proceedings the proof beyond reasonable doubt is required. The general principle of burden of proof is that it lies on that party whose contentions would be rejected, if no evidence is adduced before the Court.

Under Direct Tax Laws:

The Supreme Court has in the case of *Parimisetti Seetharamamma v. CIT*[120] laid down the proposition that the burden is on the Revenue to prove that the income sought to be taxed is within the taxing provisions and that the receipt is in fact income.

However, the onus of showing that particular item of income is exempt under any clauses is on the assessee. *CIT v. Ramakrishna Deo*[121].

In an earlier decision of *K.P. Varghese v. ITO*[122], the Supreme Court held that it is a settled law that the assessee cannot be asked to establish the negative i.e. he did not receive any consideration beyond that declared by him. The burden is always on the revenue to prove that conditions of taxability are fulfilled. The assessee cannot be compelled to prove the negative. Hence, the assessee cannot be asked to prove that he has not received taxable income. This rule is applicable because the assessee has not claimed any receipt anywhere in his return of income other than what is already declared as per the documents in his possession. The revenue has to prove with cogent evidence that the receipt is understated. Therefore in such cases the initial onus is on the revenue to prove the understatement.

In case of a claim for expense, the initial burden is on the assessee to prove the factum, i.e he has actually incurred an expenditure and further burden is on him to show that it was laid out or expended wholly and exclusively for the purposes of business. This is only because the assessee has claimed the expenditure while computing the income for the purpose of determining

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[120] (1965) 57 ITR 532 (SC)
[121] [1959] 35 ITR 312 (SC)
[122] (1981) 131 ITR 597 (SC)

the tax liability. Once this burden is discharged, then before any disallowance can be made such burden will shift on to the AO to show that such expense was either

(i) a capital expenditure or

(ii) a personal expenditure of the assessee or

(iii) a bogus expenditure.

As discussed earlier, the primary onus is on the assessee to prove the genuineness of loans in his books of accounts in regular assessment. Even in case of a search and seizure action u/s 132 of the Act, it is for the assessee to prove that the material found, if any, is not incriminating and does not reflect unaccounted income. However, where the department has reopened the assessment u/s 148 of the Act on the ground that the entries of loan in the books of accounts are bogus or fictitious then the burden to prove so will rest of the department and not the assessee. In the case of *CIT v. Sati Oil Udyog*[123] the Supreme Court has held that the burden of proving that the assessee has evaded tax is always on the Revenue. The Revenue has to discharge its burden by establishing facts and circumstances from which a reasonable inference can be drawn that assessee has evaded tax.

The Supreme Court in the case of *Dr. K George Thomas v. CIT*[124] held that the burden lies on the revenue to prove that an income is revenue in nature. Though once established its revenue in nature, it falls under exemption or not is for the assessee to prove. Thus, the burden shifts to assessee once it's discharged by the department.

Where the AO proves that certain receipt is income, the assessee claims that it is exempt u/s. 10, the burden to so establish, rests on the assessee.

[123] (2015) 276 CTR 14 (SC)
[124] (1985) 156 ITR 412 (SC)

For example - In case of agricultural income, onus lies entirely on the assessee to prove that receipt of income was out of operations carried out on agricultural land by furnishing certificate of Tehsildar and other supporting material. Reference is invited to decisions of Madras High Court in the case of *B. Ramachandhiran v. CIT*[125] *and* Allahabad High Court in the case of *Smt. Prem Sundari v. CIT*[126].

Burden of Proof Vs Onus of Proof:

During the course of discharge of burden of proof in the income tax proceedings, the obligation to prove or disprove a fact swings like a pendulum between assessee and Revenue. Once the assessee has led evidence to prove its averments, the burden shifts on the Revenue to disprove the claim of the assessee by leading proof. Such shifting of burden is called “onus” and one party has to discharge the onus on it after which the said onus shifts back to the other party. It's like a tennis match where each party tries to put the ball in the court of the other party. Accordingly, though the burden of proof is constant and fixed, the onus keeps shifting.

In *A. Raghavamma and Another v. A. Chenchamma and Another*[127]*,* while making a distinction between burden of proof and onus of proof, a three-Judge Bench of Supreme court opined there is a difference between “burden of proof” and “onus of proof”. Burden of proof never shifts. It lies upon the person who has to prove a facts. Onus of proof keeps shifting and such shifting of onus is a continuous process in evaluation of evidence.

In cases such as unexplained cash credit u/s. 68 of the Income Tax Act, where the assessee discharges the initial onus of establishing the identity and creditworthiness of the credit provider and the genuineness of the

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[125] [2014] 43 taxmann.com 430 (Madras)
[126] [2014] 42 taxmann.com 178 (All.)
[127] AIR 1964 SC 136

transaction, be it one of loan or share capital subscription, the onus shifts to the Revenue to show the contrary. Where for instance, an assessee furnishes the complete details of the payer like its name and address of the Company, certificate of incorporation, CIN no., PAN, income tax returns, bank accounts, names and addresses of the directors and so on, the Courts have insisted that the AO make a proper enquiry before rejecting the material placed on record to make an addition/ disallowance such as issue summons u/s. 133(6) of the Income Tax Act. Where the AO fails to make such an inquiry, such an addition may be considered arbitrary and deleted.

Degree of Proof:

Degree of proof does not depend upon the volume of evidence adduced but its compelling nature. Thus, under income tax proceedings it's not sufficient to merely produce evidence in support of contention but to produce compelling and irrefutable evidence. Thus, to prove a cash credit in the books of accounts in the form of unsecured loans, the assessee is required to submit the confirmation of the lender to prove genuineness of transaction, his return of income for determining the creditworthiness and his PAN and address to prove the existence of the party. This would best be capped by the personal presence of the lender along with all his details.

Specific Case Law

Citation - *ITO v. Shreedham Constructions Pvt. Ltd*[128]

Facts -

The assessee company's assessment was reopened to verify the genuineness of the share subscription received by it. The department relied upon the statement of a third person who had in a search action initially stated that such transactions were mere accommodation entries and subsequently retracted his statement.

[128] 2017 (11) TMI 1764 - ITAT MUMBAI

The assessee company provided all details of investors like their confirmation, PAN, their return of income and other supporting documents. The investors also responded to the notices under section 133(6) issued by the AO though they did not appear personally. Hence the AO treated the investment as unexplained cash credit under section 68.

Held - The Mumbai ITAT held as under:

Under section 68, the initial burden of proof is on the assessee to explain the nature and source of any credit found in his books of accounts. Once the assessee discharges its initial burden by submitting identity and creditworthiness of the lender and genuineness of the transaction, the onus shifts on the Assessing Officer. If the AO still doubts the genuineness of the transaction, then he has to bring on record adequate material to prove the same, merely doubting or pointing out some discrepancy is not the foundation for discarding the evidence submitted by the assessee. Reliance was placed on judgment of the Hon'ble Supreme Court in the case of *CIT v. Gujarat Heavy Chemicals Ltd*.[129]

Hence, the addition made was deleted holding that though the assessee discharged the burden which lay upon it, the AO did not discharge the onus which was shifted upon him.

[129] (2002) 256 ITR 795 (SC)

Authors' Analysis

From the above discussion, the principles of burden of proof can be summarised as follows:

Item	Initial Burden on
Genuineness of entries in books of accounts like loans, claim of expenses.	Assessee
Charging a receipt as Income or treating it as revenue	Revenue
relating to claim of exemption and deduction	Assessee
Attempt to evade tax	Revenue
Unexplained Investment, Money, expenditure etc under section 69, 69A, 69B, 69C	Revenue
Proving genuineness of credits	Assessee
Conditions for levy of Penalty	Revenue
Claiming reasonable cause for mitigating penalty	Assessee
Prosecution for not filing return of income-claim that no wilful intention	Assessee

The assessees' and practitioners are advised to submit credible proof if called upon to do so and contest the additions/ disallowances made by the department without discharging their onus of proof.

The Government has enacted GAAR with effect from AY2018-19. The said provisions permit the Revenue to declare certain transactions as purely for the tax avoidance and accordingly treat the same for computing tax incidence. In the authors opinion the initial burden of proof lies on the department to show that the said transaction is not bonafide or only for the purpose of avoidance of tax. Having discharged their initial burden the onus shifts on the assessee to prove that commercial considerations were involved in the said transaction and it was carried out at arms length. The law of burden of proof is yet not not developed under GAAR. It will be interesting to see how the tax department and the courts decide this issue in the future.

Chapter X

Doctrine of Estoppel in Taxing Statutes

Introduction:

There is a prominent saying that “ignorance of law is no excuse”. Thus any person making a statement in ignorance of law cannot later plead such ignorance and resile from his commitment. He is barred under the estoppel from shifting his stand, except in case of statutory provisions. In this chapter we will be discussing how this doctrine of estoppel does not apply to taxing statutes. To put simply, any person who gives any statement as to an existence of the provision of a statute is not barred from contending that the provision is different from what he has previously stated. The other person who relies on such a representation cannot take a defence as to the estoppel pleading that a false representation was made by the first party regarding the provisions of law.

There are various judgments in relation to the topic, however we handpicked notable orders of the courts to study the various facets of the doctrine of estoppel as applicable to tax laws.

In General Law:

The term ‘Estoppel’ originated from a French term ‘Estoupail’ which means “stopper plug” referring to placing a brake on the imbalance of the situation. The foundation behind the estoppel is to prevent injustice owing to fraud or inconsistency.

In simpler form, Estoppel is when one person either by his act or omission, or by declaration, has made another person believe something to be true and persuaded that person to act upon it, then in that case, it precludes a person from denying or to negate anything to the contrary of that which has been constituted as truth in any suit or proceedings.

Thus estoppel means one cannot contradict, deny or declare a statement to be false which has been made by him previously in the court.

Doctrine of Estoppel in Indian Evidence Act:

The principles of doctrine of Estoppel with respect to evidence led are stated under section 115 of the Indian Evidence Act, 1892. Promissory estoppel is also a species of Estoppel being an 'equitable doctrine' and refers to a promise made by a party to another, from which he cannot rescind later.

However, the doctrine is applied in a limited manner under section 115, i.e. about representations made as to existing facts whereas the promissory estoppel deals with the future promises.

Such a promise is not supported in law on the basis of a contract in absence of 'consideration', but is governed only by the party's conduct. However, if a promise is made in situations involving legal rights and obligations it is appropriate that the parties should be enforced to do what they had promised. In cases, where the government is one of the parties, the court will balance the harm to the public interest by compelling the government to fulfil its promise in order to ensure that the government does not act capriciously. For example, if the government has offered a tax break and parties have entered into transactions on the strength of that promise, the government cannot be allowed to reverse the tax break, so as to alter the present position of a person prejudicially.

Historical Background:

The term 'Estoppel' is derived from the maxim, "*allegans contraria non est audiendus".* The said maxim means that if any person leads facts contrary to whatever he has said in the past, then he should not be heard. The said concept is also the species of *presumptio juris et de jure*, which means that certain facts are presumed to be true against the party stating the same unless the said person is able to rebut it with evidence.

Principle of Estoppel was established in the case of *Pickar v. Sears*[130] . The Court held that a person is precluded from altering his position if another person has acted on the word and conduct of such person. A party cannot gain advantage by misleading another party from his words or through his conduct. The doctrine recognized in this section is not only a rule of evidence but also a rule of equity applied in the Court of law.

In India the said doctrine can be traced to the case of *Ganges Manufacturing Co vs. Sourujmull*[131]*,* the Calcutta High Court held that the doctrine of estoppel had a larger scope in the jurisprudence and hence is not only limited to the law of evidence but is a part of equity..

Exceptions:

There are some limitations in the applicability of the doctrine of estoppel which are as follows-

(i) When both the parties have the entire knowledge of the things in their matter

(ii) Does not apply against the statutes and regulations. It cannot come in conflict with the statutes and regulations.

(iii) Where one party has exceeded his power while acting or taking a decision.

(iv) Against the sovereign acts of the government.

(v) Where it is against public interest.

(vi) Where there is a statutory prohibition from doing a particular act.

(vii) When there is no representation or promise made by the government or public authority.

(viii) Where there is any fraud or manifest injustice or collusion.

[130] (1837) 6 Ad & El 469, 474

[131] (1880) 5 Cal 669,678

(ix) If the public authority suffers to its detriment for compelling the performance of the promise.

However, the scope and the limit of this principle is not legally settled. Hence the principle can be applied if equity and justice so demand..

Under Direct Tax Laws:

No Estoppel Against Statute:

Although estoppel is a doctrine of equity, it cannot be stretched to include estoppel against the law. A person who made a statement under belief of existence of a particular law may at a later date contend that such statement was made in ignorance of correct legal position. The Courts have held that such a situation is not adversely affected under equity since the other party relying on a former incorrect statement has a duty to ensure correct position of law before placing reliance on the former incorrect statement.

The Law is supreme and even the estoppel with the colour of equity cannot override it. Therefore, a person cannot take recourse to the defence of estoppel to plead that a false representation has been made regarding the provisions of a statute or law. The principles of estoppel cannot supersede the provisions of a statute. Where a statute imposes a duty by positive act, estoppel cannot avert it.

The Supreme Court in the case of *CIT Vs. Mr. P. Firm*[132] held that if a particular income is not taxable under the Act, it cannot be taxed on the basis of estoppel or any other equitable doctrine.

[132] (1965) 56 ITR 67 (SC)

In the case of *Maynak Poddar vs. Wealth Tax Officer*[133], the assessee had erroneously included the buildings used for commercial purposes in his return of wealth. Such buildings were not subjected to wealth tax during that time. The court held that there cannot be any estoppel against statute. If in law an item is not taxable, no amount of admission or misapprehension can make it taxable. The taxability or the authority to impose tax is independent of admission. Neither there can be any waiver of the right by the assessee. The department cannot tax an item on the basis of an admission or misapprehension of the taxpayer, if that item is not otherwise taxable.

In *Spice Entertainment vs. Commissioner of Service Tax*[134], a Division Bench of the Delhi High Court held that a proceedings against the amalgamated company was null and void since the said company did not exist at the time when the assessment was carried out. The participation of such amalgamated company did not result in validating an assessment which was otherwise a dead letter. Consent of the asssessee also did not confer jurisdiction to the revenue to assess the amalgamated company. It was not merely a procedural defect. The participation by the amalgamated company would have no effect since there could be no estoppel against law.

In the case of *The Kashmir House v. The Deputy Commissioner of Commercial Taxes and Or,* the Hyderabad General Sales Tax Act imposed a duty on every dealer to pay tax on the goods sold or purchased by him as required by the provisions of the Act. That being so, the dealer was under a liability to pay tax on his turnover and it was not competent for any official of the department to offer a release from payment of such tax. Such a release would be null and void and cannot be relied upon by any dealer to evade payment of tax. The High Court of Andhra Pradesh held that there

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133 (2003) 262 ITR 633 (Cal)
134 ITA No. 475 of 2011

can be no estoppel against a statute. If the law requires that a certain tax be collected, it cannot be given up, and any assurance that it would not be collected would not be binding.

In *Anant Mills Ltd. v. Commissioner of Income Tax*[135]*,* the Gujarat High Court brought in a new rule for applying the rule of estoppel. The Court held that the admissions or statements made by the assessee is applicable only for that particular assessment and cannot be held against the assessee in any other assessment year. Thus the Court held that the doctrine of estoppel does not apply to the case of subsequent assessments.This is also borne out of the fact that the principles of res judicata are not applicable to the income tax proceedings and the assessee / revenue both are entitled to plead that the facts are different in other assessment years and hence different consequences would ensue.

In the case of *HCL Technologies v. ACIT*[136], the appellant public limited company claimed a deduction under section 10A of the Income Tax Act which was not claimed in the earlier years. engaged in providing software development services. The said deduction was disallowed on the grounds that the units were set up in the earlier years were mere expansion of the existing units and secondly, the issue of units set up were independent and separate was raised belatedly which could not be gone into at this late stage. The Delhi High Court held that if, on an application of the statutory provision, the party is entitled to the benefits under the Act, the mere circumstance that for the past several years, it did not claim such benefit would not preclude it from availing it in the assessment year in question. It held that estoppel does not apply against a statute.

[135] (1994) 206 ITR 582 (Guj)
[136] ITA 46/2015

In *Balmukund Acharya v. DCIT*[137] the assessee offered Long Term Capital gains on sale of godown to tax. However, before CIT(A), the assessee contended that the sale of godown was not taxable. CIT(A) did not decide the claim of the assessee. ITAT confirmed the order of CIT(A). Order of ITAT was set-aside by the High Court holding that:

> "*Having said so, we must observe that the Apex Court and the various High Courts have ruled that the authorities under the Act are under an obligation to act in accordance with law. Tax can be collected only as provided under the Act. If any assessee, under a mistake, misconceptions or on not being properly instructed is over assessed, the authorities under the Act are required to assist him and ensure that only legitimate taxes due are collected*.

The Bombay High Court in the case of *Nirmala L. Mehta v. CIT*[138] relied upon Article 265 of the Constitution of India and held that the said Article in unmistakable terms provides that no tax shall be levied or collected except by authority of law. Consent of assessee cannot take away the right of the assessee to claim relief where the tax is levied or collected without authority of law. In fact, it was obligatory on the part of the AO to apply his mind to the facts disclosed in the return and levy tax in accordance with statute only.

Fresh Claim without revising original return of income:

A question arises as to whether the assessee can resile from earlier return of income only on the basis of Doctrine of Estoppel without actually filing a revised return of income. The Supreme Court in the case of *Goetze (India)Ltd v. CIT*[139] held that a new claim cannot be considered unless a revised return is filed within the time frame allowed under the law.

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[137] [2009] 310 ITR 310 (Bom)(HC)
[138] [2004] 269 ITR I (Bom)
[139] (2006) 284 ITR 323 (SC)

Gujarat High Court in *Pr. CIT v. UTI Bank Ltd.*[140] had the occasion to deal with the decision of the *Goetze (India) Ltd, v. CIT (supra)*. The Court held that the purpose of income tax assessment is to tax real income. The decision of the Supreme Court in the case of Goetze laid down the procedure of making fresh claim before the AO which is statutorily provided in the form of provision of belated return. Such procedure cannot take away the right of the assessee to raise a fresh claim as per law. Thus the decision of the supreme court is applicable only to the powers of the Assessing Officer and not to the power of the Appellate Commissioner or the Tribunal.

Thus the higher forums are entitled to admit and entertain a new ground or a legal contention. Thus the court recognized the powers of the Appellate Commissioner and the Tribunal to entertain a new claim for the first time though not made before the Assessing Officer. A similar view is also taken in *CIT v. Pruthvi Brokers & Shareholders*[141] by Bombay High Court.

Assessed Income below Returned Income:

The other issue raised by the Department was that the assessed income cannot go below the returned income even if a new claim is made. The Department relied upon the *CBDT Circular No. 549, dated 31-10-1989*. However, the said circular has been judicially struck down by various courts. The Hon'ble Andhra Pradesh High Court in the case of *CIT v. Bakelite Hylam Ltd.*[142] as well as Gujarat High Court in the case of *Gujarat Gas Co. Ltd. v. Jt. CIT*[143] have considered the said circular and held that assessed income can fall below the returned income. In *CIT v Bakelite Hylam Ltd (Supra)* it was held as under :

[140] [2017] 398 ITR 514 (Guj. HC)
[141] [2012] 349 ITR 336 (Bom.)
[142] [1999] 237 ITR 392(AP HC)
[143] [2000] 245 ITR 84(Guj. HC)

> *".........we are inclined to hold that the assessing authority is entitled to determine the quantum of refund also in a regular assessment made under section 143(3)."*

Similarly held by Gujarat High Court in Milton Laminates Ltd. against which the Department's SLP is dismissed as reported in 354 ITR St. Pg. 101.

The decision of Hon'ble Gujarat High Court in the case of *Pr. CIT v. UTI Bank Ltd.*[144] and decision of ITAT, Mumbai in the case of *Rupee Finance and Management (P.) Ltd. v. Dy. CIT*[145] can be further referred for the said purpose.

Specific Case Law

Citation - *Sajjan India Ltd. v ACIT*[146]

The ITAT was dealing with an issue that whether disallowance u/s 14A can fall below the amount of disallowance voluntarily made by the assessee in the return of income filed with the Revenue. The assessee contended that the disallowance u/s 14A can fall below the voluntary disallowance made in the return of income filed. The assessee relied upon the decision of Gujarat High Court in the case of *Pr. CIT v. UTI Bank Ltd.*[147] and decision of ITAT, Mumbai in the case of *Rupee Finance and Management (P.) Ltd. v. Dy. CIT*[148].

The ITAT held that once the Tribunal has adjudicated the matter in assessee's favour then complete effect of the said decision be given to arrive at assessed income. Such income cannot be artificially controlled or restricted merely because disallowance was made in return of income under a wrong belief by the assessee. The mandate of the 1961 Act is to tax real income. The department cannot take advantage of the assessee's mistake

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[144] [2017] 398 ITR 514 (Guj. HC)
[145] [2017] 81 taxmann.com 249 (Mum.)
[146] [2018] 89 taxmann.com 21(Mum)
[147] [2017] 398 ITR 514 (Guj. HC)
[148] [2017] 81 taxmann.com 249 (Mum.)

and try to enrich itself unjustly. The Hon'ble Andhra Pradesh High Court in the case of *CIT v. Bakelite Hylam Ltd.*[149] as well as hon'ble Gujarat High Court in the case of *Gujarat Gas Co. Ltd. v. Jt. CIT*[150] have taken a similar view, after considering *CBDT circular No. 549 dated 31-10-1989 (1990) 182 ITR (st) 1* and holding that assessed income can fall below returned income in proceedings u/s 143(3) r.w.s. 143(2)."

Further Reference

1. *Narayandas Kishandutt v. CIT*[151]
2. *The Peerless General Finance and Investment Company Ltd. v. Commissioner of Income Tax*[152]
3. *Commissioner of Income Tax v. Sabarkantha Zilla Kharid Vechan Sangh Ltd.*[153]
4. *A. Razzak v. Commissioner Income Tax, West Bengal*[154]
5. *Tide Water Oil Co. (India) Ltd. v. CIT*[155]
6. *Commissioner of Income Tax v. GEI Engineering Ltd.*[156]
7. *S.R. Kosti v. CIT*[157]
8. *CPA Yoosuf v. ITO*[158]
9. *CIT v. Bharat General Reinsurance Co. Ltd.*[159]
10. *CIT v. Archana R. Dhanwatey*[160]
11. *Dy. CST v. Sreeni Printers*[161]

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[149] [1999] 237 ITR 392 (AP HC)
[150] [2000] 245 ITR 84 (Guj. HC)
[151] [1984] 149 ITR 636 (MP)

[152] [2019] 416 ITR 1 (SC)
[153] [1977] 107 ITR 447 (Guj)
[154] [1963] 48 ITR 276 (Cal)
[155] [2013] 353 ITR 300 (Cal)
[156] [2009] 310 ITR 112 (MP)
[157] [2005] 276 ITR 165 (Guj.)
[158] [1970] 77 ITR 237 (Ker.)
[159] [1971] 81 ITR 303 (Delhi)
[160] [1982] 136 ITR 355(Bom.)
[161] [1987] 67 SCC 279

Authors' Analysis:

In a taxing statute it is a trite law that one has to look at the clear provisions of law. There is no room for any intendment. There is no equity about a tax. There is no supposition as to a tax. Nothing is to be read in, and similarly nothing should be implied. Therefore an income which is not otherwise taxable, cannot become taxable because of wrong understanding of law by the assessee.. Neither there can be any waiver of the right by the assessee. The Department cannot rely upon any such mis-admission or waiver to wrongly tax an item.

Even the raising of fresh claims cannot be estopped as there cannot be estoppel against law. Therefore, even if the return of income cannot be revised for any reason for making a new claim, yet the assessee will not be precluded from raising such claim before the appellate authorities which the authorities are duty bound to consider. So the non-application of doctrine of estoppel in taxing statutes is based upon justice and acts as a shield against any capriciousness by the taxing authorities.

Chapter - XI

Charging Sections vs. Machinery Provisions

Introduction:

The charging sections are statutory provisions in legislation which directly affect the rights of any person. On the other hand, the machinery provisions lay down for the procedures and safeguards for enforcement of the rights and the duties.

Under the tax laws the liability for payment of tax or any other sum is fastened by the charging section, the words of which are required to be absolutely clear. Such provisions are strictly construed and a person cannot be charged only on the basis of intendment. Thus, the maxim - A*bsoluta sententia expositore non indigent"* applies to charging provisions which means plain language does not need an interpreter. Thus, the charging provisions provide for the competence and the jurisdiction of the Department to treat any receipt as income for the purpose of levying income tax.

The machinery provisions, on the other hand relate to the procedure adapted for determining the liability which is calculated as per the charging provisions. Thus, the procedure for carrying out assessment and appeals etc are machinery provisions. These machinery provisions have the following two important functions:

(a) They lay down the process and the procedure for calculation of the tax liability, like issuance of notice, granting opportunity of hearing, etc.; and

(b) They provide for the process for to be adopted for collection and recovery of taxes by the Department.

In *Halsbury's Law of England* (Fourth Edn., Vol. 23, para 29), it has been observed that it is important to distinguish between “charging provisions”, which impose the charge of tax, and “machinery provisions”, which lay down the mechanism for the quantification of the tax and its levying and collection. Machinery provisions do not impose, extend or restrict a charge that has been created.

Under General Law

Under General Law, the “Charging Provisions” are also referred as “Substantive Laws” and the “Machinery Provisions” are also referred as “Procedural Laws”.

As per *Black's Law Dictionary as a General Rule:*

Substantive Laws: are laws which fix duties, established rights and responsibilities among and for persons, natural or otherwise,

Procedural Laws: are those which prescribe the manner in which such rights and responsibilities may be exercised and enforced in a Court.

Historical Background

The interpretation of the charging provision goes way back in 1929-1932. In *W.H. Cockerline & Co.* v. *The Commissioner of Inland Revenue*[162], Lord Hanworth quoted with approval a following passage from the judgment of Sargent, L.J.:

> *"The liability is imposed by the charging section, namely, section 38, the words of which are clear. The subsequent provisions as to assessment and so on are machinery only. They enable the liability*

[162] 16 TC 1 at 19

> *to be quantified and when quantified to be enforced against the subject, but the liability is definitely and finally created by the charging section and all the materials for ascertaining it are available immediately."*

Under Direct Tax Law

The distinction between the charging and machinery provisions is required since different rules apply to them for enforcing such provisions. A case in the point is the decision of Supreme Court in the case of *Associated Cement Co. Ltd.* v. *CTO*[163], wherein the Supreme Court laid down that:

(i) Charging Provisions are to be construed strictly; whereas; machinery provisions are to be applied liberally.

(ii) The Machinery Provisions are to be applied in the manner so that the charging provisions do not fail.

The Income Tax Act broadly breaks the charging and machinery provisions in the following manner:

1. Section 2 to Section 115 are charging sections which contain the various heads of income and manner of computation of the Gross total income after allowing for various deductions under Chapter VI of the Act. Moreover Section 270 to section 280D are penalty provisions which too are in the nature of charging provisions - The liability to pay the tax, interest and penalties arises by operation of these “charging sections”.

2. Section 116 to 269UP and section 281 to 298 are mainly machinery provisions which provide the mechanism to determine the quantum of tax on income and collection and recovery etc.

[163] 48 STC 466

Under the Income Tax Act, 1961, the liability to pay the tax arises by virtue of section 4 -which is a charging section. As per section 4 of the Act, income tax shall be charged in respect of the "total income" for any assessment year at the rate and in accordance with and subject to the provisions of the Act. The term "income" is defined under section 2(24) and has been interpreted in various ways by courts over the years.

Some instances of the charging and its corresponding machinery provisions are discussed as follows:

1. Section 45 Capital Gain: Section 45 brings to charge the profits or gains arising from the transfer of a capital asset to income-tax under the head "Capital Gain". In absence of such charge of tax on income from transfer of capital asset, the gain would escape any tax liability.

   Thus, section 45 is a charging section. Once the transaction falls within the charging section 45 of the Act, the manner of computation of capital gain i.e. the principal basis for quantifying the income chargeable under the head "Capital gains" is provided in section 48 which provides that the income chargeable under that head shall be computed by deducting from the full value of the consideration received or accruing as a result of a transfer of the capital asset (*ii*) the cost of acquisition of the capital asset. Thus Section 48 is a machinery section. The Supreme court has held in the case of *CIT v. B.C. Srinivas Shetty*[164] that where the computation provision fails, even the charging section fails. In that case the Cost of Acquisition could not be determined and hence the computation under section 48 could not be made. Thus, the Supreme Court held:

   > "All transactions encompassed by section 45 must fall under the governance of its computation provisions. A transaction to which

[164] (1981) 128 ITR 294 (SC)

> those provisions cannot be applied must be regarded as never intended by section 45 to be the subject of the charge. This inference flows from the general arrangement of the provisions in the Income-tax Act, whereunder each head of income the charging provision is accompanied by a set of provisions for computing the income subject to that charge. The character of the computation provisions in each case bears a relationship to the nature of the charge. Thus, the charging section and the computation provisions together constitute an integrated code. When there is a case to which the computation provisions cannot apply at all, it is evident that such a case was not intended to fall within the charging section. Otherwise one would be driven to conclude that while a certain income seems to fall within the charging section, there is no scheme of computation for quantifying it. The legislative pattern discernible in the Act is against such a conclusion. It must be borne in mind that the legislative intent is presumed to run uniformly through the entire conspectus of provisions pertaining to each head of income. No doubt there is a qualitative difference between the charging provision and a computation provision. And ordinarily the operation of the charging provision cannot be affected by the construction of a particular computation provision. But the question here is whether it is possible to apply the computation provision at all if a certain interpretation is pressed on the charging provision. That pertains to the fundamental integrity of the statutory scheme provided for each head."

The Authors have chosen not to supply their own language to the above thesis of the court as it would result in violence to the words used by the Supreme Court in laying down an important concept.

2. <u>Section 50CA</u>: As per section 50CA where the consideration received or accruing as a result of the transfer by an assessee of a capital asset, being share of a company other than a quoted share, is less than the fair market value of such share determined in prescribed manner , the value so determined shall, for the purpose of section 48, be deemed to be the full value of consideration received or accruing as a result of such transfer. The said section 50CA is a charging provision. Section 48 under which the capital gain

is calculated and Rule 11UAA being the procedure for computation of FMV are machinery provisions.

3. Income from House Property:

The Finance Bill 2017 amended section 23 of the Income Tax Act with effect from 1st April, 2018 which lays down the determination of annual value in case of house property for the purpose of calculating the income under the head “House Property” particularly in case of deemed let out property.

The legislature has inserted subsection (5) in section 23 which reads as under:

> *“(5) Where the property consisting of any building or land appurtenant thereto is held as stock in trade and the property or any part of the property is not let during the whole or any part of the previous year, the annual value of such property or part of the property, for the period up to two years from the end of the financial year in which the certificate of completion of construction of the property is obtained from the competent authority shall be taken to be nil.”*

Section 23 is not a charging provision; it is a provision which provides for determination of the annual value of the house property. The charging provision is section 22 and no amendment has been made in that section to give effect to the amendment in section 23. Now, section 22 itself indicates that merely because a person is the owner of the property it does not follow that the income therefrom should be assessed under the head "Income from house property”. Thus, the proposed amendment in section 23 becomes otiose in absence of any amendment in section 22 which is the charging provision.

The assessment procedures to be followed by the assessee and the AO for determination of the taxable income and consequent liability are machinery provisions. Failure to follow such machinery provisions makes the assessment order bad in law. Example: As per section 144B of the Income Tax Act, 1961, the National Faceless Assessment Centre, Delhi has to provide a copy of draft assessment order to the assessee before passing the final assessment order as explained in detail in another chapter. Failure to so provide the draft order, renders the assessment a nullity on account of violation of machinery provisions.

Interpretation by Courts

Charging Provision:

The charging section which fixes the liability enjoins strict application of rules of construction. The first and the primary rule of construction of the charging section is that the intention of the legislation must be found in the words used by the legislature itself.

A Constitution Bench of five Judges of the Supreme Court in *R.S. Nayak v A.R. Antulay*[165], has held that the Court must give effect to the words of statute in a natural manner unless there is an ambiguity. Further, in the case of *CIT v. Motors & General Stores*[166], the Supreme Court held that no tax can be imposed on the subject merely on intendment. The statutory words must clearly impose a tax burden before a subject can be charged with tax.

Machinery Provision:

Machinery provisions being handmaiden to the charging sections, have to be applied so as to facilitate the charging sections, as observed by the Supreme Court in the case of *India United Mills Lid.* v. *Commissioner of Excess Profits Tax*[167].

[165] 1984 AIR 684
[166] 66 ITR 692 (SC)
[167] (1955) 27 ITR 20 (SC)

In the case of *Maxwell* v. *Murphy*[168], Dixon, Chief Justice said: *"No suitor has any vested interest in the course of procedure, nor any right to complain, if during the litigation the procedure is changed, provided, of course, that no injustice is done."*

Specific Case Law

Citation – *CIT v. Ellis Bridge Gymkhana*[169]

Facts- The assessee club filed its wealth tax return under protest upon notice from the Department. The assessee contended that it was not covered under the Wealth Tax Act, 1957. The Department rejected the claim of the assessee on the ground that the club was not a company and hence, will be assessed as individual.
In appeal, the assessee got relief from the AAC, Tribunal and the High Court on the basis of the Gujarat High Court in the case of *Orion club v. WTO*[170].

Before the Supreme Court the assessee submitted that it was an “AOP” which was not covered in charging section 3. If the Legislative intent was to tax the wealth of an AOP, then the Legislature would have expressly so provided, as under the Income Tax Act. The Supreme Court relied upon the rule that charging section are to be construed strictly and there can be no chargeability by implication. The assessee must fall clearly under the charging section. The charging section of a Wealth Tax Act, 1957 does not impose a charge on AOP or firm. This is clarified by the explanatory notes on the provision relating to direct taxes issued by the Board on 29/06/1981 clarifying the Finance Bill, 1981.

[168] [1957] 96 CLR 261
[169] (1998) 229 ITR 1 (SC)
[170] (1980) 123 ITR 395 (Guj. HC)

Held - The charge on the wealth tax was on individual and HUF and could not be extended to ' body of individuals or AOP.

Further Reference

a) *Bangalore Club v. CIT*[171];

b) Travel & Tourism Association of Goa v. UOI[172]*;*

c) DCIT v. Regent Automobiles (P.) Ltd.[173]

Authors' Analysis

The charging and machinery provisions go hand in hand but are quite distinct in scope and application regarding enforceability and interpretation. The charging section creates a liability which is enforced via the machinery provisions. In the absence of machinery provisions, no tax can be collected even if there is a corresponding charging section.

The charging sections are to be construed strictly. If the language of the charging sections are clear then in that case there can be no assumptions and presumptions while applying the same. In a taxing Act, one has to look at the intention with which the charging section was enacted and introduced in the statute. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in and nothing is to be implied, into the provisions which has not been provided by the legislature. The Machinery provisions are enacted to give effect to the manifest purpose of the charging provisions and have to be read as to render them effective.

[171] (2020) 119 taxmann.com 103 (SC)
[172] (2020) 116 taxmann.com 791 (Mum.)
[173] (2011) 12 taxman.com 153 (Delhi)

Chapter - XII

Binding Nature of Circulars Issued By CBDT

Introduction

Circulars governing the working of the income tax department are issued by the Central Board of Direct Taxes (“*CBDT*”) u/s. 119 of the Income Tax Act, 1961. The said circulars serve to clarify or interpret any provisions or relax any condition. The circulars help in the proper administration of the Act and are required to be followed by the income tax authorities as provided u/s.116 of the Act.

In this chapter we will study whether the power u/s. 119 comes with any restriction and whether the circulars issued by CBDT are binding on assessee.

In General Law

Notifications, instructions, circulars or administrative orders or FAQs are necessary for the working of an administrative wing of government or day to day implementation of a statute.

The term “Notification” has been defined by the Supreme Court in the case of *Subhash Ramkumar Bind v. State of Maharashtra*[174] to mean and imply a formal announcement of a legally relevant fact and in the event of a statute, speaking of a notification, it has to refer to a notification published in the Official Gazette of the Central or State Government as the case may be. It is a formal declaration and its publication shall have to be in accordance with the official mechanism for it to be deemed applicable..

[174] AIR 2003 SCC 269

Historical Background

Under section 119 of the Income Tax Act, CBDT has powers to issue orders, instructions or directions for proper administration of the Income Tax Act. The Supreme Court in the case of *UCO Bank v. CIT*[175] has observed the purpose of such power u/s. 119 is just, proper and efficient management of the work of assessment and in public interest. It is a beneficial power given to the Board for proper administration of fiscal law so that undue hardship may not be caused to the assessee and the fiscal laws may be correctly applied.

Under Direct Tax Laws

Section 119(1) of the Income Tax Act, 1961 empowers the CBDT to issue orders, instructions / directions from time to time to income tax authorities for proper administration of the Act and such authorities and all other persons employed in the execution of this Act shall observe and follow such others, instruction or directions of the Board.

As per sub-section (2) to section 119, order or instruction or direction in the form of circular can be issued in the following cases :

(i) for laying down procedures to be followed by the Income Tax authorities in works related to assessment and collection of revenue or imposition of penalty or such order necessary for public interest – example: the CBDT issued Circular no. 68 dated 17/11/1971 wherein it advised that a mistake arising as a result of subsequent interpretation of law by the Supreme Court would constitute "mistake apparent from the records" and rectificatory action u/s. 154 of the Income Tax Act, 1961 would be in order. Therefore, where an assessee moves any application in this regard, the authorities have to act upon it. It further stated that where any such application has already been rejected, fresh application shall be filed by assessee and appeal pending on this point as issue be withdrawn.

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[175] (1999) 237 ITR 889 (SC)

(ii) to avoid genuine hardship authorise authorities [other than CIT(A)] to admit an application, deduction, refund or relief after expiry of period specified under the Act – example : Central Board of Revenue ("***CBR***") *issued Circular no. 14 (XL-35) of 1955 dated 11/04/1955* stating in para no. 3 that the officers of the department must not take advantage of ignorance of an assessee as to his rights. The officer should (a) draw their attention to any refunds or reliefs to which the assessee appear to be clearly entitled but they have omitted to claim for some reasons or other (b) freely advise the assessee when approached by them as to their rights and liabilities and as to procedure to be adopted for claiming refunds and relief.

(iii) to avoid genuine hardship and relax any requirements in provisions of Chapter IV and VIA where the assessee has failed to comply with any requirement where :

- Default was due to conditions beyond the control of assessee ; and
- Assessee has complied with such requirement before the completion of assessment in relation to previous year in which such deduction is claimed.

Restrictions on issuance of Circulars

Such powers come with a restriction as per Proviso to section 119(1) i.e. no order or instruction or direction shall be issued :

(i) Requiring any authority to make a particular assessment or to dispose of a particular case in a particular manner.

(ii) Interfering with the discretion of the CIT(A) in exercise of his appellate authorities.

Example : Recently, in 2018, the CBDT had framed plan / guidelines for AY 2018-19 for setting out targets of tax collection, disposal of cases by income tax authorities and for awarding points for such disposal. In

Chapter III – Litigation Plans, the CBDT provided for additional credit of 2 units to CIT(A) for passing quality orders. The terms quality cases was defined conclude cases where :

- Enhancement has been made ;
- Impugned order has been strengthened in opinion of CCIT ; or
- Penalty u/s. 271(1)(c) has been levied by CIT(A).

The said plan / guidelines were challenged in Bombay High Court in *PIL no. 144 of 2018* in the case of *Acelegal and others v. UOI and others* and in *WP no. 3343 of 2018* in the case of *The Chamber of Tax Consultants and others v. CBDT and others*.

In these cases, the hon'ble Bombay High Court held that as per proviso to section 119(1), the CBDT cannot issue instructions or directions to any authorities to make a particular assessment or to dispose of a case in a particular manner. The said guidelines were accordingly withdrawn by CBDT.

Interpretation Rules :

(i) <u>Beneficial for the assessee :</u>

In respect of *Circular No. 14 (XL-35) dated 11-4-1955* issued by CBR, the Bombay High Court in the case of *Dattatraya Gopal Shette v. CIT*[176] held that a benevolent circular giving some benefit to the assessee has to be given effect to even if it is strictly not following the law. The Court has held that the officers of the department are duty bound to give effect to the circulars and cannot ignore the same by deciding at their own end that the said circular is a violation of law. The said decision is in line with the

[176] (1984) 150 ITR 460 (Bom.)

earlier decision of the Supreme Court in the case of *Ellerman Lines Ltd v. CIT*[177].

Later, the hon'ble Supreme Court in the case of *Catholic Syrian Bank Ltd. v. CIT*[178] expounded the nature of the Circulars. It held that the said circulars are issued for:

a) to explain a specific provision of law or procedure
b) or tone down the rigors of law
c) to ensure fair enforcement of the provisions
d) to mitigate the rigour of a particular provisions to the benefit of the assessee in certain specific circumstances.

Therefore these circulars are binding on the Revenue authorities.

(ii) Binding on the income tax authorities : As stated above as per section 119(1), the circulars issued by the Board are binding on the Income Tax Authorities. In the case of *Navnit Lal C. Javeri v. K. K. Sen*[179], the Supreme Court observed that a circular issued by CBDT are binding on all officers and persons employed in execution of Act.

Further, the authorities are required to follow only the instructions or orders or directions issued u/s. 119 and not any orders or instructions issued under any other law. It has been observed by the Karnataka High Court in the case of *Stummp, Schuele & Somappa Ltd. v. CIT*[180] that only the circulars issued by the department and that too by the authorised authorities are binding on the assessing authorities and other adjudicating authorities not

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[177] 1972 AIR 524 SC
[178] (2012) 343 ITR 270 (SC)
[179] (1965) 56 ITR 198 (SC)
[180] (1991) 190 ITR 152 (Karn.)

circulars or instructions issued by the authorities other than those empowered to issue directions u/s. 119.

(iii) <u>Circulars cannot be referred to where the section is clear :</u> Where the section itself is clear, assistance of circulars in regard to its interpretation cannot be taken as held by Karnataka High Court in the case of *CBDT v. HMT Ltd.*[181]

(iv) <u>Withdrawal of circulars :</u> Withdrawal of circulars will operate prospectively and not retrospectively. The Bombay High Court in the case of *Unit Trust of India v. P K Unny (2001) 249 ITR 612 (Bom.)* held that the circulars issued u/s. 119 does not constitute law. They are in the nature of instructions and / or guidelines. Thus, the circulars will operate prospectively and not retrospectively.

(v) <u>Circular issued subsequently :</u> The later circular could not be given retrospective effect once the classification dispute for the relevant period had been settled by the earlier circular. CBDT vide a recent Circular no. 3/2018 dated 11 July, 2018 prescribed the revised monetary limits, for appeal filing by the tax department before the Tribunals, HCs, and SLP before the SC. It also mentioned that all the existing departmental appeals having tax effect below the prescribed monetary limits should be pursued for dismissal as withdrawn/ not pressed. Thus, this circular is applicable with retrospective effect since the aim of the Government is to reduce litigation. This circular is binding on appellate authorities as well.

[181] (1991) 188 ITR 457 (Karnataka)

(vi) Assessee can challenge : As stated above the CBDT plan for FY 2018-19 was challenged before the Bombay High Court and the court directed CBDT to withdraw the said plan. Thus, the assessee has the right to contest the validity or legality of orders, instructions or directions issued by CBDT. However, the department cannot take a stand contrary to the said orders or instructions or directions issued by the Board. The Supreme Court in the case of *Collector of Central Excise, Patna v. Usha Martin Industries and Ors.*[182] held that the assessee can contest the validity or legality of a departmental instruction and also the appellate authority is not bound by the interpretation given by the Board but the assessing officer cannot take a view contrary to the Board's interpretation.

(vii) Circulars cannot bind appellate authorities : The circulars are not law. Thus, they cannot bind appellate authorities even when it is binding on administrative income tax authorities. In the case of *CIT v. M/s. Hero Cycles Pvt. Ltd.*[183]*,* the Court has observed that it is a well settled law that the circulars can bind the Income Tax Officer but will not bind the appellate authority or the Tribunal or the Court or even the assessee.

(viii) Circulars cannot control judicial powers of the income tax authorities : The Supreme Court in the case of *Sirpur Paper Mills Ltd. v. Commissioner of Wealth-tax*[184], held that the orders, instructions and directions of the Board might control the exercise

[182] AIR 1997 SC 871
[183] (1997) 228 ITR 463 (SC)
[184] 1970 AIR 1520 (SC)

of the power of the officers of the department in matters administrative but not quasi-judicial.

Specific Case Law :

Citation – *UCO Bank v. CIT (supra)*

Facts – For AY 1981-82, the assessee bank had credited interest to the suspense account since such interest was not recovered in three previous years and accordingly, the assessee excluded it while computing its total income. The AO completed the assessment at returned income accepting the contention of the assessee on the basis of *Board's Circular No.F.201/21/84 TTA-II, dated 09/10/1984*. Vide order u/s. 263, the CIT reversed the order of the AO and treated the said amount as income of the assessee. Included the said amount in the total income of the assessee. ITAT allowed the appeal of the assessee. However, the High Court ruled in the favour of Revenue upholding the stand of the CIT.

Question before the Supreme Court – Whether the doubtful interest on a loan can be treated as income of the assessee in light of Circular no. 41 dated 06/10/1952 withdrawn vide Circular dated 20/06/1978 read with Circular dated 09/10/1984?

Rule –

CBDT Circular No. 41(V-6)D of 1952, dated 06/10/1952 which inter alia states that if the Assessing Officer is satisfied that there is very little probability that the interest accruing to the lender held in suspense account is recoverable then in such case, the interest amount need not form part of taxable income of the assessee. The said principle is also applicable to Banks.

The said circular was in force till 20/06/1978 when the CBDT issued a circular, withdrawing the earlier circular of 6-10-1952. The said circular was withdrawn for the reason that in case of mercantile system of accounting, interest is chargeable even if it is credited to the suspense account.

Subsequently, the Board issued another circular dated 09/10/1984, wherein it stated that the interest in the suspense account will be taxable. However, where there is no recovery for three consecutive years, interest charged to such an account will not be chargeable to tax. If there is recovery in the fourth year or later, then the amount recovered will be chargeable to tax in the year of receipt.

Analysis –

(i) The assessee is following a mercantile system of accounting. The assessee's method of accounting transferring the doubtful debt to an interest suspense account and not treating it as profit until actually received, is in accordance with accounting practice [Spicer and Pegler's *Practical Auditing, page no. 186-187* and *State Bank of Travancore v. CIT*[185]].

(ii) The circulars issued u/s. 119 cannot be adverse to the assessee. Thus, the authority which wields the power for its own advantage under the Act is given the right to forego the advantage when it considers just, by relaxing the rigour of the law or in other permissible manners as laid down in section 119.

(iii) The power is given for the benefit of the assessee and for the purpose of just, proper and efficient administration of fiscal laws and to avoid any undue hardship to the assessee. Thus, in certain

[185] (1986) 158 ITR 102 (SC)

specific categories of cases, the benefit of relaxation of law can be given by issuing circulars that are binding on the income tax authorities.

(iv) If the Board has considered it necessary to lay down a general test for deciding what is a doubtful debt, and directed that all ITOs should treat such amounts as not forming part of the income of the assessee until realised, this direction by way of a circular cannot be considered as travelling beyond the powers of the Board under section 119. Such a circular is binding under section 119.

Held – There is no inconsistency or contradiction between the circular so issued and section 145. The Circular is not contrary to section 145 as it clarifies the treatment of any amount as per the accounting principles followed by the lender. The Circular is validly issued u/s. 119 as it provides uniformity in administration of law and the provisions to be followed by the income tax officers in a specific situation.

Key Principles –

(i) Circulars cannot be adverse to assessee.

(ii) Circulars are to be in line with law.

(iii) Circulars are for proper administration of fiscal laws.

Further Reference –

(i) CIT v. Anjum M.H. Ghaswala[186]

(ii) American Express International Banking Corpn. V. CIT[187]

(iii) Mercantile Bank Ltd. v. CIT[188]

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186 [2001] 119 Taxman 352 (SC)
187 [2002] 125 Taxman 488 (Bombay)
188 [2006] 153 Taxman 97 (SC)

(iv) Union of India v. Tata Chemicals Ltd.[189]

Authors' Analysis :

Any law to be implemented must be clear and certain to not only the law implementing agencies but also the citizen of a country. This is more so important in the case of tax laws. The taxpayer must know how the complex provisions of law will be interpreted and enforced by the tax department. Therefore, any circular issued by the CBDT granting any relief to a taxpayer has to be implemented as such by the tax authorities. They are bound by such circulars since they are subordinate to the Board.

Under section 119 of the Income Tax Act, 1961, CBDT has the power to issue orders, directions or instructions in the form of circulars or notifications to render clarification or mitigate any hardship or for any just and proper reasons. The circulars are drafted for the purpose of providing guidance to the Income Tax Department. The circulars are primarily for creating uniformity in functioning of the entire income tax department on any issue.

The power to issue circular is not unfettered. The exceptions are:

a) Circulars cannot be referred to where the statutory provisions are clear.

b) The Circulars cannot be issued to direct the assessing authorities to assess a particular case in a particular manner.

c) The circulars cannot prevail over law. In the case of *State Bank of Travancore v. CIT*[190], the Supreme Court held that the circulars are executive in nature and thus cannot alter the provisions of income tax Act.

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[189] [2014] 43 taxmann.com 240 (SC)

[190] [1986] 158 ITR 102 (SC)

d) The circulars can be drawn only prospectively and not retrospectively.

e) the circulars are not binding on the assessee or appellate authorities. The said circulars are for administrative purpose and cannot control judicial powers of authorities. In the case *Keshavji Ravji & Co. v. CIT*[191], the Supreme Court held that the circulars don't bind the Courts.

f) the circulars, even if withdrawn later, are binding on the income tax department for the period the said circulars were in operation. In the case of *Harshendu Upendra Kaka v. ITO*[192], the Bombay High Court the withdrawal will operate prospectively and not retrospectively

Of late, the legislature has been codifying law under the garb of issuing circulars and notifications. Such circulars and notifications often go against the enacted law and hence are in variance with the statute which has been passed by the legislature. The Authors' are of the view that such circulars and notifications which override the provisions of law will be illegal and vulnerable to the challenge in the court of law unless it can be shown that the said circular is issued as a benefit or relief to an assessee.

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[191] [1990] 180 ITR (SC)
[192] [2001] 249 ITR 612 (Bom.)