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Contents

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Article

Retention money - Is recognition as contract revenue sufficient to tax it early?

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The Central Government, in exercise of its powers conferred under the Income tax law[1] notified[2], in September 2016, Income Computation and Disclosure Standards (shortly, 'ICDS') that would govern computation of income of an assessee (interchangeably used in this article with 'taxpayer') under the head *'profits or gains from business or profession'* and *'income from other sources'.* The introduction of these standards necessitated a taxpayer to take a fresh look at certain issues that were accepted as settled long ago. The subsequent move by the taxpayer to knock the doors of a Writ Court was surely anyone's foretelling and equally prophetic was the taxman's response in amending the Income Tax Act, 1961 (shortly, IT Act) to bestow a fresh lease of life to the notified ICDS[3] after the ruling of the Hon'ble Delhi High Court[4]. This article takes a look at one such issue, *viz*., taxability of retention monies *aka* retentions, that was considered settled and so would it have remained but for the amendment in the IT Act read together with the ICDS.

Retentions, in common parlance, are contractual amounts withheld by a contractee from a contractor, to be paid in future to such contractor only on completion/'satisfactory' completion of work undertaken. The general rule of taxability is to tax incomes as and when they 'accrue' or 'arise' or as and when they are received unless there existed an artificial fiction created under the law deeming such accrual or receipt to have taken place[5]. As per Sampath Iyengar's *'Law of Income Tax'*[6], the two words i.e, accrue and arise, *together mean 'to become a present and enforceable right'* and *'to become a present right of demand'* and that *'both words are used in contra distinction to the word receive and indicate a right to receive'.* The Courts also have uniformly opined that for an income, to be considered to have 'accrued' in the hands of the assessee, such assessee must have the right to receive the income[7]. In other words, there must be a debt owed by somebody to the assessee and until such a debt is created, it cannot be said that the assessee acquired right to receive the income.[8] Further, merely because entry is made in the books of account would not in itself, lead to a conclusion that any income had accrued to assessee[9]. Applying these principles to the case of taxing retention monies, the Courts held that the same was not taxable until an assessee had the right to receive the same from the contractee[10].

This settled position of taxing retention monies had to be revisited in the wake of introduction of ICDS. Standard III of ICDS deals with construction contracts. The said ICDS provides that contract revenue shall be recognized when there is *reasonable certainty* of its ultimate collection[11] and that the contract

[1] Section 145(2) of the Income Tax Act, 1961
[2] S.O.3079 (E) dated 29th September, 2016
[3] Certain amendments were made vide Finance Act, 2018 to address the findings of the Hon'ble Delhi High Court.
[4] Chamber of Tax Consultants v. UoI [2017] 299 CTR 137 (Del)
[5] CIT v. A. Ganapathi Raju [1964] 53 ITR 114 (SC)
[6] Sampath Iyengar's Law of Income Tax, 11th Edition
[7] CIT v. Govind Prasad Babu Nath [1987] 35 Taxman 513 (Cal)
[8] Anup Engineering v CIT [2013] 33 taxmann.com 139 (Guj)
[9] CIT v. Shoorji Vallabhdas & Co [1962] 46 ITR 144 (SC), Godhra Electric Company Limited v. CIT [1997] 139 CTR 564 (SC)
[10] CIT v. Simplex Concrete Piles India P Ltd [1989] 45 Taxman 370 (Cal) Anup Engineering v CIT [2013] 33 taxmann.com 139 (Guj)
[11] Paragraph 9 of ICDS III on Construction Contracts.

revenue shall comprise retentions as well[12]. Retentions are defined in the Standard to mean '*amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified'.* The Standard advocates use of percentage completion method for recognizing contract costs and revenues[13] and contract revenue as such is to be recognized when there is a reasonable certainty of its ultimate collection. This inclusion of retention money under contract revenue under ICDS – III was challenged before the Hon'ble Delhi High Court on the ground that such an inclusion was contrary to position taken by Courts in this regard. In its ruling, the Hon'ble High Court held that Paragraph 10 of ICDS – III could not be interpreted in a manner seeking to tax retention monies at an earliest possible stage when the receipt of such sum is uncertain or unconditional. Paragraph 10 of ICDS - III, the Hon'ble High Court did not state the stage at which the retentions need to be aggregated with contract revenue and thus, the settled principles of accrual would still prevail and only upon such retentions accruing to a taxpayer, should they be considered as part of contract revenue.

In an attempt to make the notified ICDS effective even after the Delhi High Court's ruling, the Finance Act, 2018 made certain amendments in the IT Act which included insertion of a new section that dealt with computation of income from construction and service contracts[14]. The Memorandum explaining the amendments proposed by the Finance Bill, 2018 suggested that these amendments were being made '*in order to bring certainty in the wake of recent judicial pronouncements on the issue of applicability of ICDS*'. Apart from reiterating that percentage completion method was to be followed, the new section also specified that *contract revenue shall include retention money.* Whether such an amendment is sufficient to tax retention monies even prior to their accrual to the taxpayer is the moot question here.

Neither the Standard nor the IT Act has deemed the time of accrual of retention monies to be in the year in which the related work is completed, notwithstanding the fact that such retentions may be payable at a future date. It is nobody's dispute that contract revenue would include retention monies. However, the subtle aspect, as the Hon'ble High Court had rightly pointed out is whether such retention money has acquired the character of income and if it so did, only then it would be included as part of contract revenue and not otherwise. In other words, if retentions can be said to be accruing to taxpayer, the extent of such retentions would be added to contract revenue and if there is no such accrual, the retention money component would be zero. The amendment made in the IT Act has merely stated what was already provided in the ICDS-III but interpreting that to tax retentions at a stage anterior to such accrual appears to be contrary to the scope of taxation under the IT Act. Be that as it may, even under ICDS – III, contract revenue shall be recognized as and when there is *reasonable certainty* of its ultimate collection. While the term *reasonable certainty* is not defined in the ICDS, in the context of retention monies, one may argue that there exists a complete uncertainty as to whether a taxpayer would at all be eligible to receive either whole or part of the sum and hence taxing such retentions would therefore tantamount to taxing hypothetical income which is not permissible[15], absent a legal fiction to tax the same. Thus, depending on the terms of the contract and surrounding facts and circumstances of the case, it may be possible to

[12] Paragraph 10 of ICDS III on Construction Contracts.
[13] Paragraph 16 and 17 of ICDS III on Construction Contracts.
[14] Section 43CB of the Income Tax Act, 1961

[15] CIT v. Excel Industries Limited [2013] 358 ITR 295 (SC); CIT v. Bokaro Steel Limited [1999] 151 CTR 276 (SC)

argue that even after the amendment *vide* Finance Act, 2018 the retention money does not accrue until the time of its receipt.

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Ratio Decidendi

TDS deposit time – Amendment in Section 40(a)(ia) applicable retrospectively

The Assessing Officer disallowed the export commission charges paid by the assessee, stating that the Tax Deducted at Source (TDS) on such commission amount ought to have been deposited by the assessee before the end of the previous year (31-3-2005) to get the commission amount deducted from the total income in terms of the provisions of Section 40(a)(ia) of the IT Act as it stood then. The TDS was deposited on 1-8-2005. The Supreme Court, however, held that the assessee was allowed to claim deduction for TDS paid in previous year in which tax was deducted as the amendment made by Finance Act, 2010 in Section 40(a)(ia) is effective retrospectively, i.e. from date when said provision was inserted, providing additional time to deposit TDS. The Apex Court observed that intention of the legislature was not to punish the assessee but only to ensure the tax compliance and to remove hardships faced by *bona fide* assessees. Relying upon the Supreme Court decision in *Allied Motors*, it was stated that said provision must be interpreted liberally as the amendment was curative in nature. [*CIT* v. *Calcutta Export Company* – Judgement dated 24-4-2018 in Civil Appeal Nos. 4339-4340 of 2018, Supreme Court]

Encashment of bank guarantee is revenue expenditure qualifying deduction

The assessee entered into an agreement (concession agreement) with Delhi transport Corporation (DTC) for setting up bus queue shelters under the build operate and transfer basis, and was required to pay DTC monthly revenue in respect of fees for shelters and was free to earn revenue through advertisement, etc. to be displayed on those shelters. According to the agreement the assessee was to give performance security to DTC. The assessee company defaulted in performing the obligation and therefore Delhi transport Corporation requested for invocation of the bank guarantee. Loss/expenditure suffered or incurred as a result of encashment of bank guarantee as security was disallowed. ITAT however held that encashment of bank guarantee by DTC for non-fulfilment of awarded work, was an allowable deduction under Section 28 of the Income Tax Act, 1961. It noted that the expenditure is to be considered as revenue and not capital expenditure. The Tribunal also observed that liability of assessee cannot be said to have not been crystallized on basis of pending arbitration proceeding. It was noted that if during the arbitration proceedings an award comes and assessee is entitled to the benefit, same would be chargeable to tax under Section 41(1) of Income Tax Act. [*Green Delhi BQS* v. *ACIT* – Order dated 7-5-2018 in ITA No. 2939/Del/2014, ITAT (Delhi)]

Assessment of total income under Section 143 can be completed below returned income

Assessee inadvertently offered entire redemption value of the UTI Mutual fund/tax free ARS Bonds to tax instead of profit resulted in a higher sum being offered to tax by the assessee in her return of income for the AY 2011-12. When this error was noticed by the assessee during assessment proceedings, a revised computation of income along with revised P&L Account were filed by the assessee before the AO. The revenue contended that assessment cannot be completed below the returned income and that admitted tax cannot be refunded as there is no revised return of income. Considering the legislative history of Section 143(3) of IT Act, the ITAT observed that by Finance Act, 1998 power to determine 'sum refundable' to assessee by AO was re-instated by legislature. Thus, it was held that assessment can be completed below the returned income. The Tribunal noted that AO is empowered to provide for determination of sum payable by assessee as well as refund of any amount due to him and relief sought cannot be denied on ground of its omission. Reliance was placed upon Apex Court decision in *Anchor Pressings*. [*Asst. CIT* v. *Sharmila Kumar* – Order dated 14-5-2018 in I.T.A. No. 679/Kol/2016, ITAT (Kolkata)]

Section 10AA deduction on trading, warehousing and consultancy income – Provisions of SEZ Act override Income Tax laws

The assessee, engaged in business of import and export of tobacco products, C&F agency, and trading of all types of FMCG products, had claimed deduction under Section 10AA of the Income Tax Act in respect of trading, warehousing and consultancy income. The Assessing Officer, however, rejected deductions observing that (i) that provisions provide for deduction only on manufacturing activities or provision of services and not on trading, (ii) warehousing activities were not for storing goods on behalf of some other person but was for storing assessee's own goods and hence not a service but a trading activity. The ITAT, however, held that deduction was allowable on all the three incomes as definition of service as given in Rule 76 of the SEZ Rules, 2006, expressly included trading (to the extent of import for the purposes of re-export) and warehousing activities. Since, the consultancy services were in the form of market support, which were intrinsically linked with import-export trading activity, it was held to be covered under "other business services" as provided in the definition of service in Rule 76. Further, the Tribunal observed that as per Section 51(1) of the SEZ Act, 2005, the SEZ Act has overriding effect on all other laws, and thus it will also override the provisions of Income Tax law. [*Midas DFS (P) Ltd.* v. *ITO* - TS-292-ITAT-2018 (Kol.)]

Taxability of inland haulage charges under India-France DTAA

The assessee a tax resident of France was engaged in shipping business in international water, and carried out its business activities in India through its agent. During assessment proceedings, it was noticed that assessee had not offered to tax Inland Haulage Charges (IHC), service tax in relation to IHC and feeder vessel charges. The assessee explained that these charges are not taxable as they are income forming part of the operation of ships in international traffic which are exempted under Article 9 of India-France Double Taxation Avoidance Agreement (DTAA). The assessing officer however proceeded to frame the draft assessment order considering that IHC was earned from the activity of inland transportation and not from international transport and thus taxable in India under Section 44B of the Income Tax Act, 1961. Observing that IHC being part of the income derived from the operation of shipping in international traffic, ITAT has held that IHC for AY 2013-14 is not taxable in India under Section 44B of Income Tax Act as the same is exempt under Article 9 of India-France DTAA. The Tribunal followed the decision of its co-ordinate bench dealing with identical issue involving same assessee for preceding assessment year. DRP's contention that expression 'any other activity connected with such transportation' was absent in DTAA, was rejected. [*Delmas* v. *Dy. CIT* – Judgement dated 13-6-2018 in ITA No.2187/Pn./2017, ITAT (Mumbai)]

Deduction under Section 80-IC triggers from initial year of substantial expansion

The activity undertaken by the assessee, an industrial undertaking, qualified for exemption under Section 80-IA of the Income Tax Act. The exemption was availed from assessment year 1998-99. Substantial expansion was carried out in the AY 2006-07 and exemption claimed under Section 80-IC of the Act for AY 2006-07 onwards. Deductions for the year 2006-07 and 2007-08 were allowed but deductions for AY 2008-09 and AY 2009-2010 were rejected on the ground that this was 11th and 12th year of deduction and as per Section 80-IC(6), total deductions under Section 80-IC and Section 80-IB cannot exceed the total period of ten years. The Supreme Court, however, held that period of ten years for area-based deductions allowed under Section 80-IC of Income Tax Act is to be calculated without counting deductions availed under Section 80-IA and 80-IB. It was noted that purport behind deductions under these provisions are different from each other. The Apex Court allowed deductions for AY 2008-09 and 2009-10, finding substantial expansion of the unit in 2006-07. It was observed that assessee became entitled to deductions only from initial assessment year of completion of substantial expansion. [*Mahabir Industries* v. *Pr. CIT* – Judgement dated 18-5-2018 in Civil Appeal Nos. 4765-4766 of 2018, Supreme Court]

Service of notice to security guard is valid

Delhi High Court has held that the service of notice, at the factory premises of the assessee, to the security guard by the Income tax inspector was a proper service under Section 282(2) of the Income Tax Act. The department had sent the notice under Section 148 through a registered post and also served the notice at the factory premises of the assessee which was duly received by the security guard posted there. The Tribunal in this case had allowed assessee's appeal holding that, as the service of notice was not on any director or any person authorised to receive such notice, notice was invalid and reassessment proceedings was bad in law. The High Court, however, held that the use of the word 'may' as used in Section 282 provides that service of notice to the principal officer of the company, is permissive and not mandatory.

The High Court also held that the plea regarding service of notice before the Tribunal for the first time was not acceptable as the same was not objected before the assessing officer or the appellate authority. It observed that there was no occasion to object as the director of the company had appeared before the assessing officer and was also given the copy of the said notice. The Court also observed that since the company was a juristic and a legal person, service could not be in person on the company *per se*, and had to be affected by sending the notice to the registered office or at the place of business. Also, the purpose of service of notice was to inform and make the company aware that proceedings under section 147/148 had been initiated. The matter was remanded back to the Tribunal for decision on merits. [*CIT* v. *Sudev Industries Limited* –

Judgement dated 31-5-2018 in ITA N0. 805/2005, Delhi High Court]

No business profit where principle of mutuality satisfied and service not restricted to specific members

Authority for Advance Ruling has held that where principle of mutuality is satisfied, and the services are not restricted to specific set of members but were provided to all members, then the income cannot be taxed as business profits under Section 28(iii) of the Income Tax Act. The Applicant was registered as Non-Profit Association (NPO) in Brussels and engaged in creating awareness about the key end uses of zinc in human health, crop nutrition and fertilizers. The question before the AAR was whether membership fees/ contributions received from Indian members by the Liaison Office (LO) in India was liable to income tax in India read with the relevant DTAA?

The AAR held that services were not special services as their utility was not restricted to few or specific set of members but, available to all members in the ordinary course of its activities. It was also observed that subscription from non-members was an isolated incidence and cannot be said to be a deviation from the dominant object of the applicant, moreover as the subscription received from non-members was with prior approval of the RBI. It was noted that there were no profits from such receipts because the entire funds were spent on organizing it. It observed that fact that the surplus was to be distributed to other NPO on dissolution did not adversely affect the principle of mutuality as the right of disposal was mutually agreed between the members. Lastly, it was held that since the applicant worked on principle of mutuality and was not an enterprise set up for the purpose of doing business or earning profit, the question of PE did not arise. The LO in India as well as the membership fee and contribution from members were hence not liable to tax in India under Income Tax Act or the India-Belgium DTAA. [*International Zinc Association* - TS-284-AAR-2018]

Permanent establishment in respect of hotel business – AAR has power to look at entire contract not just part of it

The applicant, being a company within the FRHI Group, was incorporated in Luxembourg and engaged in providing services in connection with hotel management including all services that are necessary for hotel operations. The question before the Advance Ruling Authority was in respect of Global Reservation Services (GRS), i.e., whether the same was chargeable to tax in India as FTS or royalty read with the relevant DTAA.

While adjudicating the issue, AAR sought documents pertaining to entire contracts and not just limited to GRS. The Authority referred to Rule 12 of the Authority for Advance Rulings (Procedure) Rules 1996 and held that Authority has not only the power but the duty to look at all aspects of the questions set forth which would enable it to pronounce a ruling on the substance of the questions posed for its consideration.

Subsequently, relying on the tests for fixed place PE as laid by the Apex Court in the case of *Formula One World Championship Ltd*. it was held that availability of fixed place was met as the hotel was at the disposal of the applicant for all purposes in India. AAR in this regard placed reliance on the covenants of the agreements and observed that some of the important aspects like operations and management of the hotel rested with the Applicant along with no right of interference by the hotel owner. It noted that the hotel owner was even barred from contacting directly any of the hotel staff appointed by the applicant. Accordingly, it was held that there was presence of fixed place PE of the applicant in

India. On the issue pertaining to the categorisation of income as royalty or FTS or not, the Authority held that since the applicant has a PE in India, the same will be taxable as business income. [*FRS Hotel Group (Lux) S.a.r.l* - [2018] 94 taxmann.com 23(AAR-New Delhi)]

News Nuggets

Amendment proposed to Rule 10B on computation of interest pursuant to secondary adjustment

Section 92CE empowers the CBDT to prescribe the time limit within which the excess money available with an associated enterprise (AE) of an assessee as a result of a primary adjustment to transfer price, shall be repatriated to India and a limit of 90 days has been prescribed in Rule 10CB. The time limit of 90 days may commence from various dates depending on how the adjustment is effected like suo motu adjustment, adjustment in exercise of safe harbour and so on. Changes have been proposed to commencement of time limit as regards adjustments in case of advance pricing agreement and mutual agreement procedure. The limit of 90 days is proposed to be calculated from date of entering into the advance pricing agreement and from the date of giving effect to resolution under MAP when the primary adjustment to transfer price is determined by such resolution. Presently for both these instances, the 90 days period is counted from due date of filing return.

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