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Article

Artificial computation provisions – Unintended cross roads with anti-avoidance rules

By **S.Sriram**

In the law of Income-tax, the main principles are fairly simple – the whole difficulty arise in their application. The first question, what is income, is a dark cat in the bag of the income-tax code [1]. Over the years, the question has been more focussed, is it a black cat or a little mouse. Tax payers and professionals, when forced with their back to the corner, often find a way out of their situation by mis-reading the code and convincing the Courts of their interpretation. Thanks to the voluminous statute which leaves some way out for most of the situations. Such stray cases of tax avoidance provoke the legislator to fill-in the gap by introduction of innovative artificial Section, but many a time, such temporary solutions fail to synchronise with the larger scheme of the statute as a whole.

On the other side of the octagon, business houses expanded their horizon to various jurisdictions and the tax arbitrage being offered by operating in more than one country tempted them to adjust the prices at which they transact inter se, so as to park higher profits in jurisdictions which had lower tax costs. With the developed economies feeling the brunt of losing tax revenues due to such tax planning, provisions relating to Transfer Pricing were introduced to ensure economic value add in every jurisdiction is adequately compensated. India caught up with the rest of the developed world in 2002 by introducing elaborate Transfer Pricing regulations in the Income-tax Tax Act, 1961 ('the Act') and the Income-tax Rules, 1962 ('the Rules'). The Transfer Pricing regulations, briefly, require the value of any international transaction (i.e. any transaction between Associated Enterprises) to be determined at Arm's Length Price ('ALP'), as determined in the manner and method provided in the Rules.

Coming back to the amendments made to overcome mischiefs, the fact that they are short sighted and do not fit the larger structure of the Act, is proved time and again as the taxpayers who were earlier unaware of the loop hole, start making a business decision around certain gaps in the hurriedly introduced provisions. When the Supreme Court in the case of *PNB Finance* [2] held that a 'slump transfer' would not be chargeable to tax as the computation mechanism failed, the Act was emended to

[1] In introduction to the Law and Practice of Income-tax
[2] *PNB Finance Ltd.* v. *CIT,* [2008] 307 ITR 75 (SC)

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introduce an artificial mechanism by way of Section 50B to overcome the lacuna pointed out by the Supreme Court. A thoughtful legislator would have gone back to his drawing board to conceptualise all the problems that might arise from a situation of slump before bringing in an artificial computation mechanism. But the knee-jerk reaction, rather lack of time and skill, lead to other tax payers take advantage of the lacuna in the artificial mechanism, as in the case of *Bharat Bijlee* [3] where the taxpayer contended and succeeded that the artificial mechanism would not cover slump exchange.

The list of such Sections to overcome certain judicial rulings or unintended lacuna in the statute includes introduction of Section 55(2)(a) to overcome the judgment of Supreme Court in B.C. Srinivasa Shetty [4], Section 46(2) to overcome the judgment of Supreme Court in *Sunil Siddharth Bhai* [5], Section 50C/ 43C to overcome unaccounted sale consideration in case of transfer of land and building, introduction of Section 56(2)(viia)/ (viib) to curb introduction of unaccounted money by issue of shares at high premium, etc. These amendments too, like in the case of *Bharat Bijlee* (supra), are facing misuses.

The common thread between these sections is that they introduce a manner for computation of income in the specific fact situation covered therein. In the absence of the computation mechanism provided therein, the general provisions of computation of income would not be sufficient to bring the transactions to tax. These sections do not prima facie treat the consideration agreed to by the parties as the actual value of the transaction, but seek to provide their own mechanism for determining taxable profits. In the context of treating a notional lettable value as the income from house property in place of actual income that had accrued, the House of Lord in the case of *Salisbury House Estate* [6] observed that *"if the measure is an imperfect one and when applied does not ascertain the actual income derived from the property, so much the worse for the Revenue. Discrepancies one way or the other between actual income and statutory income for tax purposes are familiar features of Income-tax law….. if they part company one way or the other, the fault lies with the imperfection of the statutory machinery for ascertaining the income from landed property, and the Inland Revenue authorities are not entitled to resort to a different measure, designed for a different source of income, if the actual rent happen to exceed the annual value".*

[3] *CIT* v *Bharat Bijlee Ltd,* [2014] 365 ITR 258 (Bom)
[4] *CIT v. B.C. Srinivasa Shetty,* [1981] 128 ITR 294 (SC)
[5] *Sunil Siddharth Bhai* v *CIT,* [1986] 156 ITR 509 (SC)
[6] *Salisbury House Estate Ltd* v *Fry,* 15 TC 266 (HL)

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The core issue is now the interplay between the artificial provisions (like Section 50C, 45(2) etc.) which provide a statutory method for determination 'consideration' in a transaction and the transfer pricing regulations which require the consideration to be at ALP. As artificial rules seldom corresponds with the ALP, the debate always remains fresh as to which of them would apply over the other. Transfer pricing provisions, being specific to transactions between Associated Enterprises holds its fort from one perspective and the specific provisions, without which the whole levy would fail, stand as important charging Sections on their own ground. The judicial authorities in India have been called upon a few times to set this dispute to rest, but have only raised new questions while answering the facts in their own case.

The Authority of Advance Ruling in *Canoro Resources* [7] observed that no transaction, whether covered by the normal computation mechanism or a special computation mechanism, can be kept outside the preview of transfer pricing and further held that the transfer pricing provisions would override the general computation provision contained in Section 45(2) of the Act. This position was duly followed by the Authority in the case of *Castleton Investment* [8] and a series of other judgments. However, the same Authority in *Amiantit International* [9] took a different view holding that the transfer pricing provisions are mechanisms to avoid shifting of tax base and would not apply to cases when there is no liability to tax in the first place.

When the taxable income is not based on the value of transaction determined by the parties, but computed based on a statutory mechanism or presumption, the question that begs an answer is, whether ALP can be substituted to such artificially determined income. Doing so might however render such section redundant in the cases of transactions between Associated Enterprises. As more and more artificial computation mechanisms are being introduced in the Act and as even domestic transactions now coming within the ambit of transfer pricing, this question would see a deeper examination by the Courts in the near future.

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[7] Canoro Resources Ltd., In re [2009] 313 ITR 2 (AAR)

[8] Castleton Investment Ltd., In re. AAR NO. 999 OF 2010

[9] Amiantit International Holding Ltd., In re. AAR NO. 817 OF 2009

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Notifications and Circulars

'Initial assessment year' to be chosen by the assessee for Sec. 80-IA

Under Section 80-IA assessees are allowed deduction in respect of profits from industrial undertakings or enterprises engaged in infrastructure development for a period of ten years chosen out of fifteen years (twenty years, in certain cases). A view has been adopted by certain assessing officers that the phrase, 'initial assessment year' pertains to the year of commencement of operations and thus assessees were denied the option of choosing when to start claiming the deduction. The CBDT has issued Circular No. 1/2016, dated 15-2-2016, clarifying that once an assessment year has been opted by the assessee as the 'initial assessment year', it shall be entitled to claim deduction under Section 80-IA for ten consecutive years beginning from the year in respect of which he has exercised such option, subject to the fulfilment of conditions prescribed in the section. However, the total number of years should not exceed the prescribed slab of fifteen or twenty years, as the case may be, and the period of claim should be availed in continuity.

FATCA and CRS - Clarifications on implementation

By letter F.No. 504/090/2007-FTD-1 dated 19-2-2016, certain clarifications have been issued as regards implementation of Foreign Account Tax Compliance Act (FATCA) and common reporting standards. Where no additional documentation are required for certain FD accounts, financial institution may treat the new FD account as pre-existing account provided certain conditions like the Savings bank account being opened before 30-6-2014 (FATCA) and 31-12-2015 (CRS) and linking of accounts are satisfied. The procedure for registration and submission of report under FATCA and CRS is under revision and will be released shortly.

Adhering to the time limit of 6 months for rectification sought by assessee or deductor

To ensure that the six-month time limit prescribed for passing orders in respect of application made by an assessee, deductor or collector to correct a mistake apparent on record, Instruction No.1/2016 dated 15-1-2016 has been issued which requires authorities to follow the time-limit strictly. Authorities will hence have to dispose the applications either by allowing the amendment sought or refuse the claim. The application cannot be allowed to lapse because no action was taken by authorities within prescribed time.

Rectification orders to be in writing

By Instruction No.2/2016 dated 15-2-2016, income tax authorities have been directed to pass rectification orders under Section 154 of Income Tax Act, 1961, in writing and duly serve a copy on the tax payer. This instruction seeks to address the grievance of taxpayers

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that such rectification orders were being passed only in the Assessment Information Systems (AST) without such information being shared with the taxpayer. This denied the taxpayer recourse to appeal or rectification as required.

Ratio decidendi

Software purchase for sale by Value Added Reseller – TDS need not be deducted: The assessee entered into Value Added Reseller agreement with three (overseas) companies and did not deduct TDS on the payments made towards purchase of software. The revenue authorities argued that as per the agreement assessee had rights to use the software and hence the payment was towards royalty. The High Court concluded that what was transferred was not copyright or the right to use a copyright but a limited right to use the copyrighted material and that did not give rise to any royalty income. Thus, TDS was not required to be deducted on the same. [*P.CIT* v. *M Tech India Pvt Ltd*, ITA890/2015 Delhi HC judgement dated 19-1-2016]

Subsidy to reduce cost of acquisition of fixed assets is revenue in nature, and hence taxable: Observing that the scheme under which the assessee received subsidy was to facilitate the tea gardens/factories towards production of good quality of tea, the ITAT Bench, Kolkata held that the subsidy was revenue in nature and was liable to income tax. The Tribunal in this regard noted that the predominant purpose of the scheme was to ensure that tea manufacturers function more profitably, and that it was not for setting up of a new unit or expansion of the existing unit.

Further, the Tribunal was of the view that the amendment to Section 2(24)(xviii) of the Income Tax Act by Finance Act 2015 is prospective only. The first part of the amendment said that any subsidy whether it is capital or revenue will be regarded as "income", while the second part stated that if the value of the subsidy is reduced from the value of actual cost under section 43(1) for allowing depreciation, than the subsidy will not be taxed as "income". Noting that if the first part is to be considered retrospective, it would create a charge without the legislature specifically imposing the same, the Tribunal concluded that hence the amendment cannot be regarded as retrospective. ITAT hence also upheld the reduction of the subsidy from the actual cost of depreciable assets. [*Limtex Tea & Industries Ltd.* v. *Assistant Commissioner of Income-tax* - [2016] 65 taxmann.com 222 (Kolkata - Trib.)]

Settlement amount for giving up right to sue is not taxable: Relying on earlier Order, the Authority of Advance Rulings held that since the nature of settlement amount is of capital receipt, it cannot be categorized as income. It was also held that this amount received against surrender of right to sue cannot be considered

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for the purpose of capital gains under Section 45 of the Income-tax Act. The Authority was of the view that the settlement amounts were received not as part of business profit or to compensate the future income but as a result of surrender of the claim and that even in accordance with the principle of surrogatum such amount is not assessable as income because it does not replace any business income. The Settlement amount was paid by a company to its foreign investors after it was found that the company had manipulated its accounts and which ultimately lead to fall in price of shares of the company. The AAR in this regard also observed that the foreign investors were Foreign Institutional Investors (FIIs), not engaged in trading business and that the object of the investment was not to have business profit. [In Re: *Aberdeen Claims Administration Inc.* - [2016] 65 taxmann.com 246 (AAR - New Delhi)]

Claim for 50% balance of additional depreciation not allowed in previous year, allowable: The assessee, had acquired and installed new plant and machinery (during AY 2007-08) and claimed 50% of the additional 20% depreciation under Section 32(1)(iia) as new machinery was acquired after October 1, 2006. Revenue authorities denied the same stating that additional depreciation is allowed in the year of purchase and balance cannot be carried forward for the subsequent year since there was no such provision in the Act. However, the Karnataka High Court held that the assesse can claim balance of additional depreciation in the subsequent year since the statute uses the words 'shall be allowed'. [*CIT* v. *Rittal India Pvt. Ltd.* ITA No. 268/2014, Karnataka HC judgement dated 24-11-2015]

Data processing qualifies for exemption under Section 10A : Examining the assessee's argument that collection of data and processing the same would amount to IT enabled services, the ITAT held that it would qualify for exemption as customised electronic data was being exported. The revenue authorities contended that the assesse was merely collecting data and no software development took place and hence the assesse was not eligible for exemption for export of computer software. However, since the data was being used in the business activity of the assessee's customers, the ITAT held that it was not mere collection of data. [*CRISIL Limited* v. *DCIT,* ITA 951/Mds/2015, ITAT Chennai decision dated 14-1-2016]

Income earned prior to commencement of business, when not 'derived' from business: At issue was the treatment of interest earned by the assesse, (engaged in exploration and development of oil and gas fields) on funds deposited with the bank. The assesse claimed that the interest was income derived from business as it pertained to the funds of the joint venture wherein business had commenced. The revenue authorities advanced a view that this was income from other sources since the assesse

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had not commenced operations and there was no direct nexus between the interest income and the business of the assesse. The ITAT held that since not even trial production had commenced interest income is not incidental to the business activity and source of funds deposited was also not business funds, the interest income would be taxable as income from other sources. [*NIKO (Neco) Ltd* v. *DDIT*, ITA No. 5972/Mum/2013, ITAT Mumbai, decision dated 2-12-2015]

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