Residential Refresher Course

Brain Trust Issues

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Building a better working world

Q.No 1 – Depreciation on Finance Lease

Operating lease criteria
[ICDS Ltd - Supreme Court (SC) decision] (January 2013)

- ICDS (a non-banking finance company) was engaged in the business of leasing trucks
- ICDS claimed depreciation on leased trucks
- The lease agreement contained following features:
  - Lessor was the exclusive owner of the vehicle at all points of time
  - If the lessee committed a default, the lessor was empowered to re-possess the vehicle (and not merely recover money from the lessee)
  - At the conclusion of the lease period, the lessee was obliged to return the vehicle to the lessor and the lessor had the right to inspect the vehicle at all times
- The Hon'ble SC referred to the above terms of the agreement and held as under:
  - The lessor is in the business of leasing the trucks and the asset leased out is used for its own business purpose
  - Since the lessor was the owner of the asset at all points of time and the lessee was obliged to return the vehicle to the lessor at the end of the period; thus, the lessor was the owner of the asset and hence was entitled to claim depreciation
  - Irrespective of the nature of the lease (Finance Lease or Operating Lease), the lessor is entitled to depreciation and not the lessee as lessee is not the owner of the asset

Finance lease criteria
[Indusind Bank Limited – Mumbai ITAT (Special Bench) decision]

- This decision is pronounced in March 2012 ie prior to the SC decision of ICDS
- Indusind Bank Ltd ('IBL') entered into a agreement to lease a boiler
- The agreement provided that the leased asset has been pre-decided to be sold at the end of the lease term at certain percentage of the original cost to the lessee
- After considering various SC rulings (namely; Asea Brown Boveri Ltd and Association of Leasing & Financial Services Companies), ITAT held the lease arrangement as finance lease based on the following criteria. Also, we have mentioned below the criterias considered by the SC rulings referred in IBL decision:
  - The lease is for a non-cancellable fixed period and the period is decided by taking into consideration the economic life of the asset
  - The initial lease period is settled in such a way so as to fully recover the investment of the lessor together with interest thereon
  - Lessor is interested in the recoupment of his investment with interest in the shape of rentals over the period of lease and not the asset or its user
  - Lessee is responsible to bear all costs of all licenses, insurance, repairs and maintenance and other related costs and expenses for the leased equipment
  - It is the lessee who chooses the assets, takes delivery, enjoys the use of the asset, bears its wear and tear and risks of loss and damage
  - Lessee becomes the real owner of the asset

Finance lease criteria
[Indusind Bank Limited – Mumbai ITAT (Special Bench) decision]

- Lessee pays taxes, etc in relation to such asset
- Risks and rewards incidental to the ownership vest with the lessee
- Features of bailment are absent in such a lease
- Fixed obligation on the lessee for payment of lease money
- On terminated of the lease/ premature of the agreement by the lessee, the lessor is entitled to recover his investment with expected interest from the lessee
- Lessor simply holds the title of asset as his security till his investment and interest thereon is recouped
- The lessor is only symbolic owner during the period of lease and on the expiry of lease period, even such symbolic ownership also comes to an end
- Sale of the asset to the lessee at the end of the lease period at a pre-determined price

- Further, following criteria as emphasised in the decision with regards to the lease being an Operating Lease:
  - The lease period does not extend to the economic life of the asset
  - The lessor does not recover full cost of the asset along with interest in a single lease
  - The lessor bears risks and rewards of ownership of the asset

- ITAT has also stated that in case of a lease agreement which reflects features of both operating and finance lease, one should find out the 'pith and substance' of the transaction and characterize the transaction accordingly

Comparison of above judgements

ICDS Ltd (SC)	IBL (Mumbai SB, ITAT)	Match/ contradictory
-	Non cancellable, fixed period lease where lessor secures recovery of capital outgo	-
-	Lease period determined so that Present Value of minimum lease payments covers whole of Fair Value of leased asset	-
Lessor has the right to retain the legal title against the rest of the world	Lessor has only symbolic ownership right	Match
-	Lessor interested in recoupment of investment along with interest and not the asset	-
-	Lease period extends to the economic life of the asset	-
Obligation on lessee to return the asset at end of lease	Right of the lessee to purchase the asset at nominal value	Contradictory
-	Obligation of the lessee to obtain necessary licenses, insurances, maintenance	-
Lessor being the owner to claim depreciation	Lessee reserves the right to claim the depreciation	Contradictory
Asset should be utilized for the business purpose	-	-

Q.No 2 – Section 43A – Adjusting the cost of assets

Section 43A - Some thoughts

Whether capitalisation permitted?

- SC in case of CIT vs Tata Iron & Steel Co Ltd (231 ITR 285)(SC) has held that the cost of an asset cannot undergo change by the manner or mode of repayment of loan from which it was acquired
- Section 43A is an exception to the general principle that cost of asset cannot be altered
- However, section 43A applies only when assets are acquired from outside India. Same is also clarified by Circular 5P of dated 9 October 1967 which states that section 43A applies **only when capital asset is acquired from outside India**
- No specific provisions under the Act which state that forex gain/ loss on assets acquired **"in India"** should be adjusted in cost of asset

Section 43A - Some thoughts

Whether revenue or capital expenditure?

- Fundamental principles governing tax treatment of exchange fluctuation loss have been succinctly laid by the Supreme Court in the case of Sutlej Cotton Mills Ltd vs. CIT (116 ITR 1) as follows:

  "The law may, therefore, now be taken to be well settled that where profit or loss arises to an assessee on account of appreciation or depreciation in the value of foreign currency held by it, on conversion into another currency, such profit or loss would ordinarily be a trading profit or loss if the foreign currency is held by the assessee on revenue account or as a trading asset or as part of circulating capital embarked in the business. ***But, if on the other hand, the foreign currency is held as a capital asset or as fixed capital, such profit or loss would be of capital nature****."*

- Consistent view of the Courts that exchange fluctuation loss incurred on such loan is capital in nature and cannot be allowed as deduction in computation of total income:
  - CIT vs Sandoz (I) Ltd (206 ITR 599)(Bom)
  - CIT vs. Elgi Rubber Products Ltd (219 ITR 109)(Mad)
  - Union Carbide of India Ltd vs. CIT (130 ITR 351)(Cal)
- **Thus, gain could be non-chargeable capital receipt and loss could be non-deductible loss!**

Q.No 3 – Section 80IC

Section 80IC – Some thoughts

- Production commenced on 1 April 2006
- Deduction under section 80IC assuming no substantial expansion:

AY 2007-08 to AY 2011-12	100% of profits of undertaking
AY 2012-13 to AY 2016-17	30% of profits of undertaking

- Substantial expansion carried out in “September 2013”:
  - No additional benefit on account of this
  - Section 80IC(2)(b)(ii) requires substantial expansion to be undertaken before 1 April 2012
  - Thus, company will continue to get deduction @ 30% of its profits for AY 2014-15 irrespective of whether substantial expansion is carried out or not

Section 80IC – Some thoughts

- Let us assume that substantial expansion is carried out in September 2011

Deduction under section 80IC – 30% or 100%?

- **"Initial assessment year"** is defined under section 80IC(8)(v) to mean, inter-alia, the assessment year relevant to the previous year in which the undertaking completes substantial expansion
- Section 80IC(3)(ii) grants deduction @ 100% for 5 years **commencing with the initial assessment year** and 30% for next 5 years
- Can one argue that now AY 2012-13 has become the initial assessment year and hence deduction @ 100% should be allowed for AY 2012-13?
- Substantial expansion carried out in "September 2013":
  - No additional benefit on account of this
  - Section 80IC(2)(b)(ii) requires substantial expansion to be undertaken before 1 April 2012
  - Thus, company will continue to get deduction @ 30% of its profits for AY 2014-15 irrespective of whether substantial expansion is carried out or not

Section 80IC – Some thoughts

Whether segregation of profits is warranted so as to claim 100% only on those profits which arise out of substantial expansion and 30% in respect of remaining profits?

- Tax department may argue that profits relatable to pre-expanded unit should still be eligible for deduction @ 30% only (and not 100%)
- However, quantum of deduction granted by section 80IC is w.r.t. profit of "undertaking" and not w.r.t. "substantial expansion"
- Substantial expansion attaches itself to the existing undertaking and thus it should be the entire undertaking as a whole which should be eligible for 100% deduction
- Commercially, not possible to identify profits which related to pre-expanded unit and post-expanded unit
  - Issue becomes next to impossible if there are 2 or more substantial expansions over a period of time and thus contrary to legislative intent.

Food for thought

Will deduction be available only till AY 2016-17 or a fresh life of 10 years will be available from AY 2012-13 and onwards (i.e. claiming deduction till AY 2021-22?!!)

Q.No 4 – Payment of gratuity policy to LIC

Some thoughts

- As per section 36(1)(v), any sum paid by the assessee as an employer by way of contribution towards an **"approved gratuity fund"** created by him for the exclusive benefit of his employees under an irrevocable trust is allowed as a deduction

- As per section 2(5), approved gratuity fund means a gratuity fund **which has been and continues to be approved by the Chief Commissioner or Commissioner** in accordance with the rules contained in Part C of the Fourth Schedule

- As per section 40A(7), no deduction is allowed in respect of any "provision" made by the assessee for the payment of gratuity to his employees on their retirement or on termination of their employment for any reason except the following:

  - However, above will not apply in relation to any provision made by the assessee for the purpose of payment of a sum by way of any contribution towards an approved gratuity fund, or for the purpose of payment of any gratuity, that has become payable during the previous year

- Given the above and in view of specific requirement of section 36(1)(v), it could be debatable to contend that payment to LIC towards unapproved gratuity fund is allowable as a deduction even though it does not constitute a "provision"

Q.No 5 – “Individual” as an enterprise - Section 92A

Section 92A – Some thoughts

"Individual" is not intended to be covered within the ambit of the term "enterprise"

- No possibility of envisaging "individual" as one of the associated enterprise in the situations covered under section 92A(2)
- Legislature has used "enterprise" in section 92A(2)(a) and "person or enterprise" in section 92A(2)(b) despite the fact that definition of enterprise includes a person
- As per clause 92A(2)(j), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual
  - In the above case, term "enterprise" cannot include an individual as practically no individual can control another individual
- Provisions relating to domestic transfer pricing [Section 40A(2)(b)] specifically refer to individuals, relatives, etc as covered persons

Individual" is covered within the ambit of the term "enterprise"

- As per section 92F, "enterprise", inter-alia, means a person (including a permanent establishment of such person)
- As per section 2(31), person includes an 'individual'
- Thus, harmonious reading of above would suggest that enterprise includes an individual

Q.No 6 – Whether factoring charges represent "interest"?

Some thoughts

Delhi HC in case of Cargill Global Trading Pvt Ltd (2011-TII-20-HC-Del) and AAR in case of ABC International Inc (AAR no 840 of 2010 dated 3 May 2011) has held as under:

- Payment of 'interest' presupposes borrowing of money or incurring of debt. Discounting of BEs does not involve borrowing of money or incurring of debt
- The definition of 'interest' in the Interest Tax Act specifically includes discount on promissory notes and BEs drawn or made in India. Such extended coverage is absent in the Act and the DTAA
- Circular No. 65 dated 2 September 1971, issued CBDT clarified that, in cases of discounting of usance bill/BEs, the net payment made by the bank to the drawer of the BEs is in nature of a price paid for purchase of BEs. This circular clarified that discount amount cannot be regarded as 'interest' and, therefore, no tax is required to be deducted at source by the drawer
- On account of discounting on 'without recourse', the BEs are purchased by the company on its own behalf and it collects payment for itself on the due date and has no right to proceed against Cargill even if there is default by the debtor in future
- Thus, discounting charges are not in nature of interest paid

SC has also dismissed the SLP of the Income-tax Department against the above order of Delhi HC and have thus held that bill discounting charges are not taxable as interest income

Q.No 7 – Treatment of exchange differences

Treatment of exchange differences – Some thoughts

- Similar to Q no 2 discussed earlier
- Exchange difference pertaining to:

Loan borrowed in foreign currency which is utilised for purchase of assets from outside India	To be adjusted in cost of asset and depreciation to be claimed on the adjusted amount
Loan borrowed in foreign currency which is utilised for purchase of assets from within India	▸ Not allowed to be adjusted in cost of assets ▸ If it is a gain, it could be regarded as a non-chargegable capital receipt ▸ If it is a loss, it could be regarded as a non-deductible loss
Restatement of forex loan borrowed for any other purpose	▸ If it is a gain, it could be regarded as a non-chargegable capital receipt ▸ If it is a loss, it could be regarded as a non-deductible loss

Q.No 8 – Depreciation on electrical fittings

Some thoughts

- As per New Appendix 1, furniture and fittings including electrical fittings are allowed to be depreciated @ 10%
- Further, Note 5 to the aforesaid appendix states that "Electrical fittings" include electrical wiring, switches, sockets, other fittings and fans, etc
- Also, machinery and plant are allowed to be depreciated @ 15%
- **Issue** – Would electrical fittings include transformers, control panels, tube lights so as to be eligible for depreciation @ 10% OR can they be characterised as “machinery and plant” and hence eligible for depreciation @ 15%?
- Not much clarity/ guidance/ judicial precedents on above issue
- Timing issue
- May be prudent to adopt a conservative view and claim depreciation @ 10% as control panels, transformers, etc support the functioning of electrical fittings

Q.No 9 – Interest on deposits in the name of Prothonotary and Court Master

Some thoughts

- Difficulty in complying with TDS obligation on account of uncertainty in identity of beneficial owner of interest income
- Harsh consequences for bank if TDS obligations not complied with
- However, CBDT Circular no 8 of 2011 (dated 14 October 2011) has provided guidance to assist banks in discharging their TDS obligation
  - Tax to be withheld in name of person who makes the deposit
  - Depositors to submit a prescribed declaration with the Court at the time of making deposit of amount ordered by the Court
  - Court to pass these information to the bank to ensure that tax withholding is made by the bank in name of depositors
- Other issues
  - Will income be taxable only at the time of final settlement of issue?
  - Assuming TDS is deducted in name of Mr A whereas the final outcome of appeal comes in favour of Mr B – Will Mr B be able to claim credit of TDS deducted and deposited in name of Mr A?

Q.No 10 – Sale of shares by bank

Some thoughts

View 1 – Bank to pay capital gains

- Upon invocation of pledge, legal and beneficial ownership of shares gets transferred to the bank
- Bank has invoked the pledge and recovered its dues
- Thus, ultimate sale of shares would trigger capital gains in hands of bank

View 2 – No capital gains tax liability on bank in absence of cost of acquisition

- Assuming legal and beneficial ownership of shares gets transferred to bank, still there may not be any capital gains tax liability in absence of cost of acquisition to the bank
- Thus, a view could be taken that as computation mechanism fails, no charge of capital gains should arise

View 3 – Borrower to pay capital gains tax

- Upon invocation of pledge, no “transfer” of legal or beneficial ownership can be said to have taken place
- Shares are ultimately sold by the bank on behalf of the borrower on account of his inability to pay the dues
- Thus, capital gains, if any, would be on account of the borrower

Q.No 11 – Rule 2BB – Cost of travel

Rule 2BB – Some thoughts

- As per Rule 2BB(1)(a), for the purposes of sub-clause (i) of clause (14) of section 10, prescribed allowances, by whatever name called, shall include any allowance granted to meet the cost of travel on tour or on transfer
- Explanation to Rule 2BB states that "allowance granted to meet the cost of travel on transfer" includes any sum paid in connection with transfer, packing and transportation of personal effects on such transfer
- Assuming employee gets transferred from Mumbai Branch of ICICI Bank to Chennai branch, allowance granted for cost of travel would be exempt as per Section 10(14) r.w. Rule 2BB
- However, it may be debatable to contend the above if the employment itself is shifted to another legal entity of the same employer, say, from ICICI Bank Ltd to ICICI Prudential Life Insurance Ltd
- Also debatable whether cost of travel will include travel expenses of dependent and other family members

Q.No 12 – Exemption under section 54

Section 54 – Some thoughts

- Section 54 grants capital gains exemption from sale of residential house provided the assessee has within a period of one year before or two years after the date on which the transfer took place purchased, ***or has within a period of three years after that date constructed***, a residential house
- No bar in the section on when the construction should "commence"
  - Only requirement seems to be that construction should be complete within a period of 3 years from date of original sale
- Following cases have held that exemption under section 54 should be allowed notwithstanding the fact that construction of new house had begun before sale of old house
  - CIT vs H.K. Kapoor (234 ITR 753)(All)
  - CIT vs Subramanyabhat (165 ITR 571)(Kar)

Section 54 – Some thoughts

Open issues

- Consider an extreme situation that construction was started 10 years back and only some minor work got completed post date of transfer – Will exemption under section 54 still be available?
- Will proportionate exemption be available? (i.e. only the amount invested on construction post the date of sale shall be eligible for exemption)

Q.No 13 – Section 43B – Tax paid under protest

Section 43B – Some thoughts

- *Notwithstanding anything contained in any other provision of this Act, a deduction otherwise allowable under this Act in respect of—*

  (a) any sum payable by the assessee by way of tax, duty, cess or fee, by whatever name called, under any law for the time being in force,…….. shall be allowed ***(irrespective of the previous year in which the liability to pay such sum was incurred by the assessee*** *according to the method of accounting regularly employed by him) only in computing the income referred to in section 28 of that previous year in which such sum is actually paid by him*

  [Explanation 2.—For the purposes of clause (a), as in force at all material times, ***"any sum payable" means a sum for which the assessee incurred liability*** *in the previous year even though such sum might not have been payable within that year under the relevant law*

Section 43B – Some thoughts

- Deduction under section 43B allowed on payment of custom duty made under protest
  - DCIT vs Silicon Graphics Systems (I) Ltd (ITA No 574/Del/2009)
- Special Bench decision in the case of DCIT vs Glaxo Smithkline Consumer Healthcare Ltd (110 TTJ 183)(Chd)(SB) is also relevant which has held the following:
  - **For claiming deduction under section 43B, it is <u>not necessary</u> that liability to pay tax/ duty must first be incurred**
  - Explanation is always governed by main provisions of section and it cannot override them
  - Wordings of Explanation 2 contradicts the main section, which provides, *"irrespective of the previous year in which the liability to pay such sum was incurred"*
  - Very purpose of section 43B is to allow the deduction in the year in which the amount is actually paid
  - If Explanation 2 is read literally, it can lead to absurd results and hardships and in some case might become unworkable

Q.No 14 – Deduction under section 80JJAA

Section 80JJAA – Some thoughts

View 1 – Computation to be done for each undertaking separately

- As per section 80JJAA, deduction is provided for profits of eligible undertaking
- As per section 80A(4), deduction in respect of undertaking cannot exceed profits of each qualifying undertaking
- Section 80JJAA(2) excludes from consideration certain categories of undertakings. Section 80JJAA(1) limits itself to profits and gains from eligible undertaking. These two sub-sections read with Section 80A(4) appear to support the view that the deduction cannot exceed the total amount of profit from eligible undertaking as included in the gross total income

View 2 – Computation to be done w.r.t. aggregate profits from all eligible undertakings

- Section 80A(4) applies only when any amount of profits and gains of undertaking is claimed and allowed as deduction. This is not a case where 'profits' and 'gains' of undertaking are claimed as a deduction; rather it is the qualifying expenditure in respect of which partial deduction is granted
- Section does not appear to stipulate that deduction should be from the eligible profits of that very undertaking to which additional wages of NRW belong to
- Section 80JJAA is an expenditure linked deduction whereas part 'C' of Chapter VIA to which section 80A(4) refers should apply to sections which grant incentive in respect of certain incomes. This further strengthens the argument that section 80A(4) may not apply to a deduction claimed under section 80JJAA

Section 80JJAA – Some thoughts

What constitutes “wages”?

- No clear or definitive guidance/ judicial precedents as to what constitutes “wages” for the purpose of deduction under section 80JJAA of the Act
- Act as well as Rules contains different definitions of ‘salary’ in varied context
- Going by the intent of the section which is to encourage employers to create new employment opportunities, one may choose to adopt a “cost to company” basis for computing the quantum of wages eligible for deduction
- Appropriate disclosures need to be made in the tax audit report, Form 10DA, etc.

Deduction @ 30% for each of 3 years or 10% each year for 3 years?

- Language of section seems to be clear and it grants deduction @ 30% of additional wages paid by assessee in the previous year
- Had the intent been to restrict deduction to 30%, the language of the section would have been categorical to indicate the same by either providing that deduction is 10% for each of the 3 years or alternatively that the deduction is in aggregate restricted to 30%
- As qualifying wage is a varying amount, it would not be possible to restrict it to 30% in aggregate. The deduction calculated at 30% in year 1 can be different compared to the deduction calculated in year 2

Section 80JJAA – Some thoughts

Employment of 101 workmen – Deduction available for all 101 workmen or only for 1 workmen?

- Additional wages is defined to mean as wages paid to NRW in excess of 100 workmen employed during the previous year
- In case of "new" undertaking – Deduction is available provided more than 100 workman are employed
- In case of "existing" undertaking – Deduction is available if NRW are more than 10% of existing workmen. However, the number of existing workmen should be atleast 100
- Relevant extract of CBDT Circular No 772 dated 23/12/1998 explaining the intent of section 80JJAA

  In case of a new undertaking, the number of such workmen must be at least one hundred. The benefit of the aforesaid deduction shall be available only in respect of wages paid to workmen ***over and above that number*** *both in case of new as well as existing undertakings*

- Relevant extracts from Notes to Form 10DA

Description of requirement on form 10A	Newly setup unit
Additional wages paid to new regular workman by the assessee company	In case of new undertaking, it is wages paid to the regular workmen in excess of one hundred workmen employed, during the previous year

Section 80JJAA – Some thoughts

Deduction in a scenario where 500 permanent employees are recruited in July 2013

View 1 – Employee does not qualify as NRW as in year of employment, he is employed for less than 300 days. Once he is not NRW, his salary does not qualify for deduction either in FY 13-14 or in subsequent years

- Section 80JJAA of the Act grants deduction of 30% of additional wages which are paid to new regular workmen.
- Regular workman is defined inter alia as not including workman employed for a period of less than three hundred days during the previous year.
- A plain reading of the section implies that employment of not less than 300 days should continue during the previous year.
- The section language is unambiguous and requires determination of (i) new (ii) regular workman to be employed. A person is regarded as newly employed if during the previous year he is employed for 300 or more days.
- The deduction is thereafter granted for the year of employment and the subsequent two years.
- If the person does not satisfy the condition of being a regular workman as defined in the Explanation to section in the year of employment, he does not have ability to satisfy the condition in year 2 as in year 2 he is an “existing” employee who was employed in year 1 and not a “new” employee

Section 80JJAA – Some thoughts

Deduction in a scenario where 500 permanent employees are recruited in July 2013

View 2 – The employee becomes regular workmen from FY 14-15 if period of employment exceeds 300 days during FY 14-15. His salary for FY 14-15 and the two subsequent years (viz. FY 15-16 and 16-17) in which he is employed for > 300 days would qualify for deduction under section 80JJAA

- It would not be correct to say that the person is not new in Year 2 merely because he is employed after 4th June in the earlier year
- In respect of workmen who are employed towards the end of the year, it should not be that the deduction is either not available or that the deduction is available for a period of < 3 years even if the employee continues to be in employment all through
- Once the workmen is employed on a long term basis, he remains 'new' to the assessee for a period of 3 years in the context of section 80JJAA
- Deduction under S.80JJA as per this view can be tabulated as under:

FY	Deduction u/s 80JJA
13-14	Nil
14-15	12 Months
15-16	12 Months
16-17	12 Months

Section 80JJAA – Some thoughts

Deduction in a scenario where 500 permanent employees are recruited in July 2013

View 3 – A person employed in July 2013 qualifies to be NRW if he completes 300 days over a period of two years. If a person remains with the organization, his salary will be taken into account for the purpose of section 80JJAA deduction starting from the period July 2013 and ending on 31.3.2014 such that effectively deduction granted over 3 year term captures deduction for 9 months in Year 1

- Definition of NRW is understood as referring to a person who is employed during the previous year as a new workmen and who is expected to remain with the organization under normal circumstances for a period of more than 300 days
- So long as a person completes employment of more than 300 days on a continuing basis, he should be entitled to the deduction
- Deduction under section 80JJAA though theoretically available for 3 years may like other Chapter VI-A deductions get curtailed to a shorter period depending on the point of time the qualifying activity starts. Deduction under S.80JJA as per this alternative can be tabulated as under

FY	Deduction u/s 80JJA
13-14	9 months
14-15	12 Months
15-16	12 Months

Thank You

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