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Case Laws

ITA No.7012/M/10
(Assessment Year:2007-08)

Li and Fung India Pvt. Ltd.
v.
Commissioner of Income Tax

ITA Nos. 368, 369, 370, 371 & 1206/Bang/2010
(Assessment Years : 2003-2004, 2004-2005, 2005-2006, 2006-2007 & 2007-2008) and ITA No. 248/Bang/2010
(Assessment Year : 2004-2005)

The C.I.T-II Ahmedabad, Gujarat
v.
M/s Mastek Ltd.

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Tax News

South African Employment Tax Incentive Signed into Law

US Treasury Inspector Reviews 2013 filing season

Austria's Faymann says tax reform is first priority

Merkel challenges EU on renewable energy tax break

French household tax burden to rise in 2014

Belgium's Q&A clarifies savings taxation plans

Irish revenue issues reminder on upcoming deadlines

Italian 2014 budget tries out new taxes

IRS finalizes intergovernmental FATCA data exchange format

Swiss industry seeks "Institutional Development" of EU accords

Tax evasion hits developing countries

Montoro confirms future Spanish tax cuts for lower incomes

Jersey adds a TIEA

Australian Carbon Tax Repeal in the Balance

Kind regards

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South Africa

South African Employment Tax Incentive Signed into Law

It has been announced that President Jacob Zuma has signed the Employment Tax Incentive (ETI) Act of 2013, which will take effect on January 1, 2014, and aims to reverse the high levels of youth unemployment by reducing the cost to employers of hiring employees between the ages of 18 and 29.

The Act will encourage private employers to employ young workers by providing a tax incentive to employers, with government sharing the costs of such employment. It is also intended that the initiative will be extended to support employers in the special economic zones, and may also, in the future, cover workers in certain approved industries.

The ETI will function by decreasing the amount of pay-as-you-earn tax that is payable to the South African Revenue Service (SARS) for every qualifying employee that is hired by the employer. There will be no change in the wages that the employee receives but the effective cost of hiring the employee will be lower, hopefully making it more attractive for firms to increase employment.

Employers can claim the ETI on a sliding scale for any employee between the ages of 18 and 29 who has been hired on or after October 1, 2013, who possesses a South African ID and is receiving a monthly salary that is above the relevant minimum wage and less than ZAR6,000 (USD575) per month. If there is no legal minimum wage applicable in a particular sector, the monthly salary must be greater than ZAR2,000. Domestic workers and employees connected or related to the employer are not eligible.

During the first year the ETI's value will be 50 percent of the monthly wage up to a maximum wage of ZAR2,000. For wages between ZAR2,000 and ZAR4,000 the value of the incentive will be ZAR1,000, and for wages between ZAR4,000 and ZAR6,000 the ETI's value will decrease linearly from ZAR1,000 to zero.

The value of the ETI will decrease by half during the second year. An employer may only claim the incentive for a two year period for each qualifying employee.

The Act also contains checks and balances that are designed to prevent abuse and ensure that employers do not discriminate against older workers in order to merely access the ETI. It has also been emphasized that the National Treasury and SARS will monitor the incentive closely in order to evaluate and explore what works and which design can make the best use of taxpayers' money.

Early in 2014, SARS will publish documentation that will provide further details to assist employers in both understanding how the ETI will work and how they can claim it in practice. – *Courtesy tax-news.com*

United States

US Treasury Inspector Reviews 2013 filing season

The Treasury Inspector General for Tax Administration (TIGTA) has issued his annual review of the United States Internal Revenue Service's (IRS) performance during the 2013 filing season, and, in particular, whether it processed individual paper and electronically filed tax returns accurately and on time.

The IRS announced it had to delay the start of the filing season to make the changes necessary to implement provisions of the American Taxpayer Relief Act, which became law on January 2, 2013. However, "despite the delays, the IRS timely processed the majority of tax returns, and tax refunds were issued within 45 days of the April 15 tax return due date," said J. Russell George, the TIGTA.

The TIGTA found that, as of May 4, 2013, the IRS received approximately 133.6m tax returns, down from the 134.6m returns filed during the same period in 2012. More than 113.5m (nearly 85 percent) of the returns were filed electronically, up from nearly 111.8m e-filed in 2012.

The TIGTA also found that the IRS issued more than 99.5m refunds totaling more than USD264bn, compared to nearly 101.2m refunds totaling more than USD274bn in 2012. The average refund decreased slightly to USD2,656 in 2013, compared with USD2,708 during the same period last year.

The IRS reported that it identified just over 579,000 tax returns with USD3.6bn claimed in fraudulent refunds during tax return processing and prevented the issuance of USD3.47bn (96.4 percent) of those refunds. "The IRS is continuing to expand its efforts to identify and prevent fraudulent tax returns from being processed," George noted.

However, the TIGTA's report also raised concerns about the potential misuse of the split refund option to direct multiple tax refunds to the same bank account. The TIGTA notified the IRS in February that it appeared some tax refunds were being incorrectly directed to tax preparers' accounts.

The TIGTA had identified 385,500 tax returns with direct deposits totaling more than USD150.8m made to almost 47,000 bank accounts that had three or more deposits from different taxpayers into these accounts. The TIGTA determined that 248,000 (64 percent) of these tax returns were prepared by a paid tax preparer.

In addition, it found that many paid tax return preparers continue to be non-compliant with Earned Income Tax Credit (EITC) due diligence requirements. As of March 2, the TIGTA identified over 122,100 paid tax return preparers filing 708,300 tax returns claiming USD2bn in EITC without the required checklist form attached to the tax return. This equates to more than USD354m in penalties that could potentially be assessed by the IRS. – *Courtesy tax-news.com*

Austria

Austria's Faymann says tax reform is first priority

Austrian Chancellor and Social Democrat (SPÖ) party leader Werner Faymann has made clear that his number one priority is to reform the country's tax system, as soon as there is scope to do so. Chancellor Faymann emphasized that he will push for the fiscal reform to be financed by wealth taxes.

In an interview with Salzburger Nachrichten, Chancellor Faymann pledged, as a first step, to reduce the entry rate of income tax in Austria, and in so doing lower the tax burden on the country's low- and middle-income earners.

Conceding that he had hoped to implement the tax reform in 2015, the Austrian Chancellor emphasized that the economic situation has since deteriorated and is currently worse than initially forecast. It would therefore be unrealistic to fix a date for the reform, he stressed, while underscoring his belief that changes will be made in this legislative period – and the sooner the better.

The Government will then be in a position to discuss whether or not there is leeway to introduce additional tax relief for families, as sought by the SPÖ's coalition partner, the Austrian People's Party (ÖVP), Chancellor Faymann explained. Furthermore, he noted that the negotiations would also focus on plans to introduce the so-called "millionaire's tax," which he has long since championed. Counter financing the fiscal reforms makes sense, to close the gap between rich and poor, thereby ensuring fairness in the tax system, he reiterated.

Highlighting the fact that plans for the 2014 Budget are well underway, Chancellor Faymann insisted that this would simply not have been possible, if the coalition Government had not reached an agreement on key revenue- and expenditure-based measures.

All too aware of opposition to plans to raise certain taxes, such as the tobacco tax and insurance tax, and to limit tax breaks for top managers, Faymann nevertheless maintained that in difficult times, tough choices have to be made. Unlike many other countries, including rich nations, the coalition Government has not opted to raise value-added tax (VAT), however, Chancellor Faymann underscored, arguing that raising VAT would merely hit families in Austria hard, with the most vulnerable the most affected. – *Courtesy tax-news.com*

Germany

Merkel challenges EU on renewable energy tax break

On a confrontation course with Brussels, German Chancellor Angela Merkel has pledged to defend the renewable energy tax (EEG-Umlage) rebate currently benefiting energy-intensive companies in Germany.

The European Commission has announced plans to launch an in-depth investigation to determine whether or not the EEG-Umlage reduction, granted to energy-intensive businesses, is compatible with European Union (EU) legislation. Opinion in Germany is divided. Critics insist that following a recent extension of the tax break, the measure now benefits companies even though they are not facing tough international competition.

The figures speak for themselves. This year, around 1,700 companies are due to take advantage of the rebate, soaring to approximately 2,800 next year.

Chancellor Merkel emphasized that both she and the German Energy and Economy Minister Sigmar Gabriel intend to make very clear to the European Commission that Germany wishes to remain a strong industrial location. Germany needs competitive companies, she argues.

Given that this issue concerns companies, it therefore also concerns jobs, Chancellor Merkel stressed. Although the German Government aims to work closely alongside the Commission, it will nevertheless underline at the same time that Europe will not be stronger if jobs are endangered in Germany.

Chancellor Merkel alluded to the fact the EU Energy Commissioner Oettinger is to submit a report to the European Council in February, listing all the subsidies that are currently accorded in Europe to compensate for electricity prices. She warned that as long as there are countries in Europe where power for industry is cheaper than in Germany, there is no reason to consider that Germany is "contributing to a distortion of competition."

Under the Renewable Energy Law, as amended in 2012 (EEG-Act 2012), energy-intensive industries are granted reductions on the EEG-surcharge.

The Commission also intends to investigate the reduction on the EEG-surcharge granted when a supplier sources 50 percent of his electricity portfolio from domestic renewable electricity ("green electricity privilege"). – *Courtesy tax-news.com*

France

French household tax burden to rise in 2014

While undoubtedly less ambitious than the 2013 Budget, France's 2014 Finance Act nevertheless profoundly modifies and raises taxation for households in France, impacting on their purchasing power in particular. Older measures will further hike tax bills in 2014.

From January 1, 2014, the standard rate of value-added tax (VAT) in France will rise from 19.6 percent currently to 20 percent. The intermediate rate of VAT, benefiting a number of sectors, including the hotel and catering industry, will also increase, from 7 percent to 10 percent. However, the reduced rate of VAT, applicable to basic goods such as foodstuffs, will be maintained at 5.5 percent.

A number of exceptions have been allowed. For social housing and renovation works undertaken on social housing in France, the VAT rate will be lowered from 10 percent to 5.5 percent. For the construction of "intermediate" housing, the VAT rate will be lowered from 20 percent to 10 percent. Furthermore, the VAT rate applicable for home energy improvement works, as well as for "induced" or associated ancillary works carried out, is to be cut from 10 percent to 5.5 percent. For cinema tickets, the reduced rate of 5.5 percent will apply.

A number of fiscal measures will impact heavily on families next year. For example, from 2014, the "family quotient" (quotient familial) income tax break is to be lowered to EUR1,500 (USD2,503), from EUR2,000. The tax advantage accorded to families with children in secondary or higher education is to be retained, however.

Significantly affecting tax bills, income from life insurance contracts will be included in the calculation of the wealth tax (ISF) cap next year, fixed at 75 percent. Social levies imposed on certain life insurance contracts will also rise. Additionally, capital gains derived from the sale of securities will be subject to the country's income tax scale, although reductions will be introduced. A 50 percent tax reduction will be accorded in cases where the holding period is greater than two years, rising to 65 percent for a holding period in excess of 8 years, and to 85 percent for individuals investing in a small- and medium-sized enterprise for a period of up to ten years.

Next year, the 10 percent pension supplement accorded to pensioners with three children or more will become subject to income tax. In addition, tax breaks will be capped at EUR10,000, albeit with a number of exceptions. For investment in French overseas departments and territories, taxpayers will benefit from tax credits rather than from a tax exemption. Following a two-year freeze, the country's individual income tax scale will finally be re-indexed in line with inflation.

The introduction of a "carbon tax" will serve to increase existing taxes levied on the consumption of fuels and combustibles (TIC), taking into account carbon emissions. As a result, tariffs for natural gas, heavy oil, and coal will rise slightly next year. In 2015, the tax increase will affect diesel, petrol, and domestic heating oil prices.

In 2014, the tax credit accorded for sustainable development (CIDD), allowing households to deduct part of renovation costs from tax, is to be limited to major works and limited to modest-income households. Tax deductions for solar panels will cease to apply.

To stimulate the housing market, an exceptional 25 percent tax reduction for capital gains realized following the sale of a property or rights relating to that property between September 1, 2013, and August 31, 2014 will be granted. Similarly, from September 1, 2013, total capital gains tax exemption will be granted after a twenty-two year holding period, compared to 30 years as is currently the case. Finally, the transfer tax imposed following the acquisition of a property is set to rise in 2014. Next year, French departments will be able to apply a maximum transfer tax of 4.5 percent, compared to 3.8 percent currently. – *Courtesy tax-news.com*

Belgium

Belgium's Q&A clarifies savings taxation plans

The Belgian Finance Ministry has published a series of questions and answers, clarifying Finance Minister Koen Geens's proposal to reform the taxation of savings in Belgium.

Taxpayers in Belgium are currently exempt from withholding tax for the first tranche of interest income earned from savings accounts, up to a maximum of EUR1,880 (USD2,572). However, this tax perk is only applicable to "classic" savings accounts, taxed at 15 percent, and not to other savings products.

In view of the fact that savers are not fully benefiting from the tax break at the moment, and given that traditional savings accounts do not serve the real economy, Finance Minister Geens has put forward the idea of extending the tax advantage to include other types of savings products, such as bonds and shares.

Income from these products is subject to withholding tax at a higher rate of 25 percent. The introduction of a tax-free allowance would be of significant benefit to these savers, representing a potential extra tax reduction, as well as benefiting the economy, the Ministry said.

According to the Finance Ministry, the National Bank and the International Monetary Fund (IMF) have both advocated that the scope of the tax shelter be expanded to include other products. Taxpayers would be able to opt to save in ways that would better finance the economy, on an equal tax footing, while at the same time taking advantage of greater tax relief, the Ministry explained.

Discussions on reform of savings taxation have been ongoing in Belgium for a number of years now, with the need to encourage savings widely recognized. Indeed, Finance Minister Geens has made clear that the plans should not be further delayed. On

December 16, the IMF underscored the importance of making progress on the issue.

Finance Minister Geens aims to ensure that the existing tax benefit remains in place, although extending to other savings products from 2015 (applicable from the 2016 tax year). For existing savings accounts, the tax advantage is retained at source, while for new products, the tax break will be recovered via the submission of a tax return.

Concluding, the Finance Ministry cited a number of examples, highlighting the benefits for those opting to save using alternative types of savings products. The EUR1,880 tax-free allowance would provide traditional savers with tax relief of EUR282 (15 percent tax), rising to EUR470 for alternative savings products (25 percent rate of tax), representing an additional saving of EUR188. – *Courtesy tax-news.com*

Ireland

Irish revenue issues reminder on upcoming deadlines

January 1 will be an important date for Irish taxpayers, the Revenue Authority has said, issuing a reminder of its new year deadlines.

A four-year time limit applies to claims for tax refunds. If taxpayers have a claim for the 2009 year, it must be received by Revenue before January 1, 2014. The quickest and easiest way to apply for a refund is to register as a pay-as-you-earn (PAYE) customer and use the service to view and update tax credits, incomes, and rate bands information.

Last year, Revenue refunded over EUR400m in respect of almost 1.1m (USD546.8m) PAYE employee reviews.

Also important to remember is that 2014 local property tax payments are due on or before January 1. The deadline for debit/credit card, cheque or full service provider payment is January 1, but Revenue will treat returns made on or before January 3 as “on time.”

If taxpayers wish to benefit from the concession of paying by Single Debit Authority on March 21, or from phased payments by Direct Debit or Deduction at Source, they will need to file a return immediately.

To date, returns have been filed in respect of over 1m properties. Approximately 89 percent have been completed online, and at end-November, EUR287m in LPT had been transferred from Revenue to the Exchequer.

Revenue is currently responding to just over 60,000 items of LPT-related correspondence. Any taxpayer who submitted a genuine query in respect of their 2014 obligations in advance of the November filing deadline will be treated as having complied with their requirements on time, once the query has been resolved and the return filed. – *Courtesy tax-news.com*

Italy

Italian 2014 budget tries out new taxes

On December 23, the Italian parliament approved a "maxi-amendment" which completely replaces the proposals originally made by the Government in its draft 2014 Budget in October, and introduces tax measures that may produce additional revenues to reduce individual tax burdens over the next year.

For the moment, the so-called 2014 "Stability Law" contains only restricted tax cuts, by way, for example, of deductions to individual income tax for employees earning up to EUR55,000 (USD75,300), an increase to the tax incentive for equity contributions from 3 percent to 4.75 percent by 2016, and a rise to 30 percent from 20 percent in the deductibility of local property tax (IMU) against both federal and local corporate income tax for one year.

The Budget has confirmed the restructuring of local taxes from January 1, 2014, whereby IMU is abolished for first non-luxury residences. A new "service tax" to fund all local services, to be called IUC (the unified local tax) will be formed of IMU (levied on the remainder of property owned, including luxury and second houses and commercial and industrial properties.), TASI (a new tax on general local services) and TARI (the current local tax on environmental and waste services).

Additional new measures include that a specific fund will be constituted to reduce tax burdens, to be divided equally between further individual income tax deductions and offsets available to businesses against the regional tax on production. The fund will be topped up with resources deriving from a further rationalization of public expenditure and by action to control tax evasion during the year – the amounts of which presently remain unknown.

However, the biggest innovation in the final version of the Stability Law is said to be the introduction of a “web tax” from January 1, 2014. While a first version of the measure which would have included within its ambit all goods traded over the internet, the approved legislation has been restricted to include an obligation for all purchases of online advertising or copyright in Italy to be effected through a business that is registered for Italian value added tax.

It is still hoped that the “web tax” will compel online multinationals, such as Google, which currently sell advertising through intermediary companies based in countries with lower taxes, to establish a fiscal domicile in Italy.

While it is believed to be the first such tax in the European Union, doubts have been raised that the new tax is compliant with the single market’s non-discrimination rules, and the Government is expected to have to negotiate with the European Commission to ensure its legitimacy. – *Courtesy tax-news.com*

United States

IRS finalizes intergovernmental FATCA data exchange format

The United States Internal Revenue Service (IRS) has finalized the format for automatically exchanging data collected under the Foreign Account Tax Compliance Act (FATCA) data with jurisdictions that have signed an intergovernmental agreement (IGA).

The IGA FATCA XML Schema, posted on the IRS website, is a standard format developed in close cooperation with the OECD, captures required information for reporting of FATCA data from both Foreign Financial Institutions (FFIs) and Host Country Tax Administrations (HCTAs), and will be used for automatic exchange with all FATCA jurisdictions.

The Schema uses elements from existing reporting schemas used by the OECD and the European Union to reduce the burden on reporting entities; uses XML to allow for easier modifications down the road in the event of legislative or regulatory changes in reporting rules; and will facilitate safe and secure electronic data transmission using the International Data Exchange Service (IDES).

The IRS is finalizing IDES to allow for FFIs and HCTAs to exchange FATCA data automatically with the US. It will also allow the US to make reciprocal exchanges where called for by an IGA that is in force.

It is said that IDES: is based on business requirements collected by a multilateral working group; serves as a single point of FATCA information delivery for both FFIs and HCTAs; may be used for automatic exchange with all FATCA jurisdictions; is based on readily-available mature technology; and requires both the file being sent (in the IGA FATCA XML Schema) and the transmission pathway to be encrypted, ensuring the security of tax data. – *Courtesy tax-news.com*

Switzerland

Swiss industry seeks "Institutional Development" of EU accords

Swiss business federation Economiesuisse has underlined the need for the further institutional development of bilateral agreements between Switzerland and the European Union (EU).

While making clear that this is a prerequisite for improving access for Swiss industry to the EU Single Market, the federation nevertheless warned that the Confederation must at the same time preserve its autonomy in certain key areas of economic policy, during the negotiations.

Alluding to the fact that 60 percent of Swiss exports flow to the EU, Economiesuisse emphasized that for Switzerland as an export nation, integration into the European Single Market is therefore very important. However, since 2008, talks on improving mutual market access have effectively been blocked, the federation noted.

This year, Switzerland and the EU have for the first time been able to draw up common solutions to the problem, and have recently adopted a corresponding negotiating position, the group explained.

Underlining its support for the negotiating stance of the Swiss Government, Economiesuisse nevertheless put forward its own recommendations. Economiesuisse stressed that above all Switzerland's autonomy, in particular its economic relations with third states and its tax and labor laws, must be maintained. Furthermore, the federation rejected the idea of direct monitoring by the European Commission.

Arbitration must be based on the law of the bilateral agreements in place, the body said. Although the principle of a uniform adoption of EU law in the bilateral treaties makes sense in most cases, the recognition of equivalent regulations in Switzerland is indicated in a number of areas, it said.

Concluding, Economiesuisse underscored that there are no advantages for Switzerland in waiting: current bilateral accords must swiftly be aligned with legislative developments in the EU, otherwise integration into the EU Single Market will only get progressively harder, the federation ended. – *Courtesy tax-news.com*

United States

Tax evasion hits developing countries

Illicit outflows from developing countries have increased by 10.2 percent a year since 2002, new research has claimed.

US-based research and advocacy organization Global Financial Integrity (GFI) has released its annual update on the funds flowing out of developing economies as a result of crime, corruption, and tax evasion. Around USD946.7bn was lost in this way in 2011, up 13.7 percent on the year before. In 2002, this figure stood at just USD270.3bn.

GFI Junior Economist Brian LeBlanc, one of the authors of the study, warned of the consequences. The money "haemorrhaged" from developing economies "could have been invested in local businesses, healthcare, education, or infrastructure."

He warned that "without concrete action, the drain on the developing world is only going to grow larger."

Among the policy solutions suggested in the report is that multinational corporations report, on a country-by-country basis, their sales, profits, and taxes paid. Governments are urged to press ahead with the automatic cross-border exchange of tax information, and reform customs and trade protocols to detect and curtail trade mis-invoicing.

Establishing the beneficial ownership of companies, foundations and trusts, is also regarded as vital. GIF recommends that governments demand that information on the true, human owner of all such entities be disclosed upon formation, and made available to law enforcement agencies, if not to the public.

Reflecting on the findings, GIF President Raymond Baker said that the study "underscores how important it is to quickly extend automatic tax information exchange to non-G20 developing countries. The G20 should include developing countries in the committee tasked with drafting the automatic exchange implementation treaty, ensuring that its terms are both beneficial to and implementable by developing countries." – *Courtesy tax-news.com*

Spain

Montoro confirms future Spanish tax cuts for lower incomes

In a recent interview with the Expansión newspaper, the Spanish Finance Minister Cristobal Montoro has disclosed that the Government intends to cut individual income taxation (IRPF) for those on lower incomes over the next three years, while higher-income taxpayers will continue to pay more.

Montoro also indicated that, while the IRPF reduction will be a key policy within future Spanish tax reform, the Government's main aim will also be to reduce the country's fiscal deficit. To do that, he said, it would be necessary to correct the shortcomings of the tax system, particularly in the insufficient amount of taxes collected.

However, while expanding the tax base and raising the tax take from companies, he confirmed that the Government would also look to provide further tax incentives for those businesses investing in productive capacity. Montoro has already stated that future fiscal reform should go as far as possible in encouraging economic growth, which would itself help to generate additional tax revenues.

It has been argued that economic conditions in Spain are now significantly different, even from a few months ago. With economic growth, even if only 1 percent, now forecast for 2014, it is felt that the time will be right for an announcement of tax reforms in mid-2014, which would enter into force in 2015.

While it is being said that tax burdens must be lowered after the large increases since 2012, the Government has also pledged that value-added tax is to remain fundamentally unchanged next year and in 2015. – *Courtesy tax-news.com*

United States

Jersey adds a TIEA

In October, Jersey signed a TIEA with Switzerland, and with the Slovenia TIEA now has 33 such agreements.

In principle, DTAs and TIEAs are equivalent instruments for concluding an administrative assistance clause in accordance with the international standard. Unlike DTAs, which are aimed primarily at avoiding double taxation and therefore contain other material provisions, TIEAs merely govern the exchange of information upon request.

Geoff Cook, Chief Executive of Jersey Finance, said about the Swiss agreement: "This latest agreement with Switzerland enhances our relationship with another major IFC, with whom Jersey already has a good and strong business relationship, particularly in the areas of wealth management and banking."

"With 32 such agreements now signed and a further dozen either initialed or where negotiations are well under way, Jersey continues to make great strides in extending its network of tax information exchange agreements and playing a key role in the global drive towards greater transparency and cooperation in tax matters."

One of the Vice Chairs of the OECD's Peer Review Group, Jersey has also recently given its full support to the G20 Action Plan, and agreed to join the Multilateral Convention on Mutual Administrative Assistance on Tax Matters, the European Union (EU) G5 project on automatic exchange of information based on the Foreign Account Tax Compliance Act (FATCA), and to automatic exchange of information under the EU Savings Directive. – *Courtesy tax-news.com*

Australia

Australian Carbon Tax Repeal In The Balance

While the Australian Senate ponders legislation intended to repeal the country's carbon tax law, the former chief executive of a greenhouse gas research centre has said that scrapping Australia's carbon tax is "the right thing to do at this time."

Peter J. Cook – who worked at the Cooperative Research Centre for Greenhouse Gas Technologies and on an Intergovernmental Panel on Climate Change – claimed in The Australian that the levy has "proved inefficient as a mechanism for decreasing emissions." Any reductions will have come from wind and solar and had "nothing whatsoever to do with a carbon tax and everything to do with the renewable energy target system."

Last week, the Senate was urged by the Australian Industry Group (Ai Group) to "spare business and households additional cost and uncertainty," and scrap the carbon tax. The Group warned of "great complications" should the Senate vote against the Government's proposals. It is thought that electricity pricing and contracting deals will bear the brunt of any extended delays.

Group Chief Executive Innes Willox recommended that both the Labor Opposition and Green parties no longer focus on less crucial elements of the Government's repeal package, such as the Clean Energy Finance Corporation and the Climate Change Authority. He stressed that resolving these issues was not urgent, because the two bodies do not impose any additional costs on energy. The Treasury should, therefore, "take the chance to repeal the core carbon pricing mechanism right away, giving energy users, generators and retailers the maximum chance to prepare."

Prime Minister Tony Abbott's Coalition does not have a majority in the Senate. Although the Senate's Environment and Communications Legislation Committee, which reviewed the repeal bills, is backing the Government on the issue, there does not yet appear to be a majority in favor of the repeal.. It found that the levy is "one of the highest and broadest carbon taxes in the world," and has "had a significant impact on costs for Australian businesses and families."

Willox says that Australians need "a sound policy basis for future investment." To provide this, the country must "clear away the carbon tax and to focus on the major task of designing the Direct Action approach to meet the emission reduction targets to which Australia has committed."

Cook suggests that for any price on carbon to have a positive impact, it would need be used "to directly support the research needed to develop and deploy emission-reducing technologies." However, the former Labor Government provided "no such linkage," with its carbon tax "targeted at broader budgetary issues and at social engineering rather than what its target should have been, namely clean energy engineering."

The recently elected Coalition Government came to power with pledges to scrap the carbon tax. The Labor party has refused to support Government legislation to this end when the alternative remains Prime Minister Tony Abbott's so-called "direct action plan." As part of the repeal package, an Emissions Reduction Fund will be created, based on a "market-based mechanism," and the Government will offer a series of positive incentives to reduce emissions.

The Government intends for the tax to be removed by July, 2014; but this is starting to seem unlikely. One theory is that Abbott wants the Senate to reject his bill twice, which would allow him to call another election for both houses of parliament. – *Courtesy tax-news.com*

2013 TRI 2039 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
MUMBAI "E" BENCH, MUMBAI

D. Karunakara Rao, Accountant Member and Sanjay Garg, Judicial Member

FACTS/HELD

S. 41(1): Liability outstanding for long period of time is assessable as income (despite no write-back in A/cs) if assessee is unable to prove genuineness of liability

1. The assessee, engaged in the business of civil construction and labour contractor, had an amount of Rs. 86.25 lakhs shown as outstanding labour charges in his balance sheet that had remained unpaid for more than three years. The AO held that the fact that the amount was outstanding for so many years was abnormal. As the assessee was unable to give the addresses and labour bills of the labourers, he held that the assessee had failed to prove the genuineness of the liability and that it had ceased to exist. He therefore assessed the said sum as income u/s 41(1). On appeal, the CIT(A) reversed the AO on the ground that the fact that the amount was outstanding for a long period and that the assessee was unable to furnish confirmations did not mean that there was a remission or cessation of liability during the assessment year so as to attract s. 41(1). On appeal by the department to the Tribunal HELD allowing the appeal:

   It is very improbable that payments to labour can remain outstanding for more than three years. The assessee has not been able to produce the records relating to the name, addresses and bills of the labour etc to prove that the liability continues to exist. It is accordingly a case of cessation of liability. The assessee has just continued the entry of the same in his books of account without any intention to pay back the same. The view that such sums shown as liability is assessable to tax is sanctioned by Chipsoft Technology210 Taxman 173 (Del) (attached) where the view was taken that it would be illogical to say that a debtor or an employer, holding on to unpaid dues, should be given the benefit of his showing the amount as a liability, even though he would be entitled in law to say that a claim for its recovery is time barred, and continue to enjoy the amount. This view is not contrary to the view taken in Vardhaman Overseas Ltd 343 ITR 408 (Del) where the law was laid down that s. 41(1) does not apply if the amount of liability is not written back in the accounts. If both judgements are read in harmony, it can be observed that the assessee cannot be allowed to show an amount as a liability even though he has no intention to pay it back but to enjoy the same for an unlimited period without being added to his income only on the excuse that he has not written off the same in his books of accounts. However, if the facts of the case establish that the liability has been genuinely shown by the assessee and his subsequent conduct shows that he has paid back the said credits and his intention was not to enjoy the amount for unlimited period without any intention to pay back the same, then it cannot be said to be a case of cessation of liability. On facts, not only is the existence of outstanding liability of labour charges for so many years improbable in the normal course of business but the assessee has also failed to give any evidence regarding the identity & genuineness of the creditors. Accordingly it is a case of cessation of liability and s. 41(1) applies (Yusuf R. Tanwar vs. ITO followed (attached)).

Appeals allowed.

ITA No.7012/M/10 (Assessment Year:2007-08).

Heard on: 22nd November, 2013.

Decided on: 11th December, 2013.

Present at hearing: Pitambar Das, for Appellant. Yogesh A. Thar, for Respondent.

JUDGMENT

Per Sanjay Garg:– (Judicial Member)

The present appeal has been filed by the Revenue against the order of the CIT(A) dated 16.07.10 relevant to assessment year 2007-08. The Revenue has taken following grounds of appeal:

"(i) On the facts and in the circumstances of the case and in law, the Ld. CIT(A) erred in directing the addition u/s. 41(1) of

Rs.86,25,651/- without appreciating the fact that the assessee failed to prove the genuineness of the liability.

(ii) On the facts and in the circumstances of the case and in law, the Ld. CIT(A) erred in deleting the addition u/s. 41(1) of Rs.86,25,651/- without giving an opportunity to the A.O. for further verification.

(iii) The appellant prays that the order of the ld. CIT(A) on the above grounds to be set aside and that of the A.O. be restored."

2. Brief facts of the case are that the assessee is an individual engaged in the business of civil construction and labour contractor under the name & style of M/s. Engarc Construction. The assessee filed his return of income for the relevant year admitting total income of Rs.16,76,266/-. However, the Assessing Officer (herein further referred to as AO) observed that the assessee's balance sheet as on 31.03.2007 showed an amount of Rs.1,89,03,822/- as sundry creditors and creditors for expenses. On being called for the grouping of the sundry creditors, the assessee filed the details wherein AO found that out of the total creditors of Rs.1,89,03,822/- an amount of Rs.86,25,651/- was shown as outstanding labour charges that had remained unpaid by the assessee for more than three years. Before the AO, the assessee submitted that earlier the assessee was a partner in the M/s. Engarc Construction till 31.3.2006. During the relevant year, the firm was dissolved and the assessee took over the said firm as its proprietor. There was an outstanding liability of labour charges payable in the balance sheet of the firm amounting to Rs.91,25,901/-. There was a dispute between the partners of the firm regarding payment of outstanding liability and as the dispute was not settled, hence the labour charges were not paid. However, the AO did not accept the contention of the assessee and observed that liability of labour charges outstanding for more than three years was something abnormal as generally the labour charges do not remain outstanding for such a long period. He further observed that despite being asked for, the assessee had not filed the addresses and labour bills of such labourers. The assessee had failed to prove the genuineness of such liability and the same had ceased to exist. He therefore added the same into the income of the assessee under section 41(1) of the Income Tax Act.

3. Before the ld. CIT(A) the assessee submitted that as per the dissolution deed, the assessee was to take over only the assets of the firm and not its liabilities, hence, the assessee had disowned himself of the labour liability of Rs.86,25,651/- and there was no question of remission of the same under section 41(1). However, the ld. CIT(A) observed that as per the dissolution deed not only the assets of the firm but also its liabilities were intended to be taken over by the assessee. Even the assessee after the take-over had shown the liability in its books of account; hence, the stand of disowning of the same could not be accepted as per records.

4. However, he further observed that unless the AO would have proved that there was a remission or cessation of liability during the assessment year under consideration, the same could not have been taxed under section 41(1) merely because the liability was outstanding for more than three years or that the assessee was not able to furnish confirmation. There was neither remission nor cessation of liability during the assessment year under consideration. He therefore deleted the addition made by the AO under this head.

5. We have considered the submissions of the ld. representatives of both the parties and have also gone through the records.

6. The ld. D.R. before us has relied upon a recent authority of the Hon'ble Delhi High Court styled as "*CIT vs. Chipsoft Technology (P) Ltd.*" 210 Taxman 173 (Del), wherein it has been held that in the case of an employer, omission to pay the dues/liability to employee over a period of time and the resultant benefit derived by the employer/assessee would qualify as a cessation of liability, albeit by operation of law and that a debtor or an employer, holding on to unpaid dues, should not be given the benefit of his showing the amount as a liability, even though he would be entitled in law to say that a claim for its recovery is time barred, and continue to enjoy the same. The relevant para of the above said judgment of the Hon'ble Delhi High court is reproduced as under:

> *"9. Two aspects are to be noticed in this context. The first is that the view that liability does not cease as long as it is reflected in the books, and that mere lapse of time given to the creditor or the workman, to recover the amounts due, does not efface the liability, though it bars the remedy. This view, with respect is an abstract and theoretical one, and does not ground itself in reality. Interpretation of laws, particularly fiscal and commercial legislation is increasingly based on pragmatic realities, which means that even though the law, permits the debtor to take all defences, and successfully avoid liability, for abstract juristic purposes, he would be shown as a debtor. In other words, would be illogical to say that a debtor or an employer, holding on to unpaid dues, should be given the benefit of his showing the amount as a liability, even though he would be entitled in law to say that a claim for its recovery is time barred, and continue to enjoy the amount. The second reason why the assessee's contention is unacceptable is because with effect from 1-4-1997 by virtue of Finance Act, 1996 (No.2), an Explanation was added to Section 41 which spells out that "loss or expenditure or some benefit in respect of any such trading liability by way of remission or cessation thereof" shall include the remission or cessation of any liability by an unilateral act by the first mentioned person under clause". The expression "include" is significant; Parliament did not use the expression*

> *"means". Necessarily, even omission to pay, over a period of time, and the resultant benefit derived by the employer/assessee would therefore qualify as a cessation of liability, albeit by operation of law."*

7. On the other hand the ld. A.R. of the assessee has submitted before us that the assessee had not written off the accounts of the sundry creditors into profit and loss account. The liability had regularly been shown in the balance sheet. The assessee's liability to the creditors thus subsisted and had not ceased even. The limitation act bars the remedy to recover through legal course of action but does not extinguish the debt. He has pressed that the amount is not thus assessable u/s. 41(1) of the Income Tax Act. He has strongly relied upon the authority of the Hon'ble Delhi High Court styled as "*CIT vs. Shri Vardhaman Overseas Ltd.*" (2012) 343 ITR 408 (Del). Apart from the said authority, to stress this point, he has also relied upon the following decisions:

> *1. "CIT v. Bharat Iron & Steel Industries" [(1993) 70 Taxman 353 (Guj.)]/[(1993) 199 ITR 67 (Guj.)]/ [(1992) 105 CTR 331 (Guj.)]*
>
> *2. "DSA Engineers (Bombay) v. ITO" [2009] 30 SOT 31 (Mum.)(ITAT)*
>
> *3. "CIT v. Indian Rayon & Industries Ltd." 2010-(IT2)-GJX-0688-BOM*
>
> *4. "CIT v. J.K. Chemicals Ltd." [1996] 62 ITR 34 (Bom.)*
>
> *5. "CIT v. Sugauli Sugar Works (P.) Ltd." [1999] 102 Taxman 713 (SC)/[1999] 236 ITR 518 (SC)/[1999] 152 CTR 46 (SC)*
>
> *6. "Cit vs. Silver Cotton Mills Co. Ltd." 170CTR 377 (Guj)*
>
> *7. "CIT v. Miraa Processors (P) Ltd." (2012)22taxmann.com 120(Guj)*

8. The facts of the case in hand reveal that the outstanding liability has been shown towards pending labour charges. It is a commonly known factor that labourer class, which is generally consists of economically weak/poor persons, generally demands the payment for their labour work done immediately. It is very improbable that a labourer would not claim his remuneration for the labour work done by him for more than three years. When called for by the AO to produce the records relating to name, addresses and bills of the labour etc; the assessee failed to provide the same. The assessee just provided the names of alleged labourers which did not prove any identity of such persons. Even, as per the case of the assessee, the liability had been taken over by the assessee from the previous partnership firm. When no identity of alleged labourers is available with the assessee, then the possibility of subsequent payment of such amount to the alleged labourers does not arise at all. Even we have specifically asked the ld. A.R. that as to whether the alleged labour

charges have been paid now, to that the ld. A.R. showed his ignorance. However, subsequently a paper book was filed by the ld. A.R. which has been taken on record and the opportunity of hearing on the said documents has also been given to the ld. DR also. After going through the newly filed documents, it reveals that the assessee had no evidence of the payment of such labour charges even till date. The assessee vide affidavit letter dated 28.10.13 has deposed that in fact he had given a comprehensive power of attorney to his earlier partner Mr. Abdul Qadir to look into the affairs of his proprietary concern M/s. Engarc Contractors. The said Mr. Abdul Qadir has not provided him any accounts in connection with the assessee concern despite several reminders. However, during the financial year 2007-08 and financial year 2008-09, he had received an amount of Rs.80,70,000/- and Rs.7,00,000/- respectively from the proprietary concern of Mr. Abdul Qadir namely M/s. Engarc Contractors. After deducting the credit balance of Rs.77,80,629/- from Mr. Abdul Qadir, the remaining amount of Rs.2,89,371/- has been offered for tax by the assessee for the assessment year 2008-09 and full amount of Rs.7,00,000/- as taxable income for the assessment year 2009-10. Thereafter the assessee has not received any money from Mr. Abdul qadir and the assessee has reasons to believe that Mr. Abdul Qadir has paid of all the concerned creditors. This statement of the Mr. Shailesh D. Shah proprietor of the assessee concern in our view is not sufficient to hold that the assessee has paid of all the labour charges. Rather it supports the contention of the Revenue that the said amount has not been paid till date to any labourer and thus it is a case of cessation of liability. The explanation of the assessee that he had given a comprehensive power of attorney to his earlier partner and the said partner has not provided any accounts to him is of no help to the assessee. It is a matter between the assessee and his power of attorney and the assessee can not escape from the burden to prove that the said liability has not ceased to exist. Even the nature of the liability i.e. labour charges outstanding for so many years themselves prove that neither there is any identity of any labourer nor there seems any probability of the assessee to pay any such amount to any such person at this stage. The assessee has just continued the entry of the same in his books of account without any intention to pay back the same. Even as observed above when the identity of any such labourer is not known the question of payment of such amount to such person does not arise.

9. As observed by the co-ordinate bench of the Tribunal in the case of "*Yusuf R. Tanwar, vs. ITO*" (ITA No.8408/Mum/2010) decided on 28.02.13 that the proposition of law laid down by the Hon'ble Delhi High Court in "Chipsoft Technology (P) Ltd." (supra) is not contrary to that of laid down by the Hon'ble Delhi High Court in the case of "Shri Vardhaman Overseas Ltd." (supra). The proposition of law laid down in "Chipsoft Technology (P) Ltd." (supra) supplements but not supplants the proposition of law laid down by the Hon'ble Delhi High Court in "Shri Vardhaman Overseas Ltd."

(supra). When we read both the authorities in harmony with each other, then it can be observed that the assessee cannot be allowed to show an amount as a liability even though he has no intention to pay it back but to enjoy the same for unlimited period without being added to his income only on the excuse that he has not written off the same in his books of accounts. However, if the facts of the case establish that the liability has been genuinely shown by the assessee and his subsequent conduct shows that he has paid back the said credits and his intention was not to enjoy the amount for unlimited period without any intention to pay back the same, then it cannot be said to be a case of cessation of liability.

10. However, from the facts of the case it reveals that not only the existence of outstanding liability of labour charges for so many years is improbable in the normal course of business but the assessee has also failed to give any evidence regarding the genuineness of the creditors, identity of the creditors or any payment of the liability subsequently till date, despite specific query by us on this point. Under such circumstances it is held to be a case of cessation of liability. Accordingly, the appeal of the Revenue is hereby allowed and the action of the AO in adding the said labour charges into the income of the assessee is upheld.

11. In the result the appeal of the Revenue is allowed.

Order pronounced in the open court on 11.12.2013.

INCOME TAX APPELLATE TRIBUNAL
MUMBAI "F" BENCH, MUMBAI

P.M. Jagtap, Accountant Member and Sanjay Garg, Judicial Member

Appeal partly allowed.

ITA No.: 8408/Mum/2010 (Assessment Year: 2007-08)

Heard on: 22nd January, 2013.

Decided on: 28th February, 2013.

Present at hearing: Prakash Pandit, for Appellant. O.P. Meena, for Respondent.

JUDGMENT

Per Sanjay Garg:– (Judicial Member)

The present appeal has been preferred by the assessee against the order of the CIT(A) dated 14.10.2010, vide which he confirmed the additions of Rs.48,89,025 to the income of the assessee made by the Assessing Officer vide assessment order dated 27.11.2009 u/s. 143(3) of the Income Tax Act relevant to A.Y. 2007-08 holding the cessation of liability of sundry creditors, invoking provisions of section 41(1) of the Income Tax Act.

2. The brief facts of the case are that the assessee, an individual, was engaged in the business of civil contract, filed his return of income declaring the income at Rs.2,10,060. The Assessing Officer during the assessment proceedings found that the assessee had shown an amount of Rs.48,89,025.96 as current liabilities towards sundry creditors. The Assessing Officer asked the assessee to give details of the said sundry creditors along with their name address and also confirmation of the same. The assessee failed to supply the requisite information and, hence, the Assessing Officer treated the said liabilities as income of the assessee and added this amount to the total income of the assessee. Aggrieved by the order of the Assessing Officer, the assessee filed appeal before the learned CIT(A). The learned CIT(A) also did not find any infirmity in the order of the Assessing Officer and, hence, confirmed the additions made by him. The assessee is thus in appeal before this Tribunal.

3. We have heard the learned representative of the parties and have also gone through the material on record. The Assessing Officer when called for the details such as the name, addresses and confirmations of the sundry creditors from the assessee, the assessee vide his letter dated 08.05.2009 claimed that all the credits pertain to the assessment year prior to A.Y. 2002-03 and that it would not be proper and prudent on the part of the assessee to give confirmation letters from the sundry creditors as by doing so, the period of limitation would start. The assessee also failed to provide the addresses and other details of the creditors. However, at the same time, the assessee claimed before the Assessing Officer that though the limitation period for claiming the amount by the creditor had expired, he had not extinguished the debt so as to prevent the creditors from enforcing the debts against the assessee. He further stressed that only the right to recovery had ceased but not the liability. Hence, he has rightly shown the amount of Rs.48,89,025 as current liability on account of sundry creditors. The Assessing Officer after considering the submissions of the assessee in para 5.4 i of the assessment order has observed as under:

> *"i. After repetitive opportunities during the course of assessment proceedings, the representative for the assessee vide order sheet noting dated 3.11.2009 submitted that the assessee is not able to provide addresses of sundry creditors. The assessee is claiming that these liabilities pertain to period prior to A Y 2002-03 and are due to expenses claimed by her at that time. The statute does not permit to assessee to claim certain business liabilities in its balance sheet ad, at the same, does not disclose details of these business liabilities in the name of limitation act or any other reason. The primary details were privileged knowledge of the assessee and therefore, the assessee had to prove that these trade*

> *liabilities were genuine and in existence and not settled in some other manner or by some other arrangement. In the decision of Kesoram Industries & Cotton Mills Ltd (1992) (196 ITR 845 (Cal) the hon'ble High court held that whether the liability of the assessee has been fully discharged is within special knowledge of the assessee. He has to prove that in fact the liability subsists. Where the conduct and surrounding circumstances demonstrate that the amount has been remitted or foregone or the sum has ceased to be claimable against the assessee it would be a clear case of remission or cessation of the liability of the assessee."*

4. The authorized representative citing various authorities has submitted before us that the assessee has not written back the accounts of the sundry creditors into profit and loss account. The liability has regularly been shown in the balance sheet. The assessee's liability to the creditors thus subsists and has not ceased, whatever is ceased is the right of the creditors under law to recover the same being barred by limitation in view of the provisions of the Limitation Act 1963. He has pressed that the amount is not thus assessable u/s. 41(1) of the Income Tax Act. He has strongly relied upon the authority of the Hon'ble Delhi High Court styled as "*CIT vs. Shri Vardhaman Overseas Ltd.*" (2012) 343 ITR 408 (Del). Apart from the said authority he has relied upon the following decisions:

"*CIT vs. T V Sundaram Iyengar & Sons Ltd.*" 222 ITR 344 (SC)

"*DCIT vs. Hotel Excelsior Ltd.*" 141 TTJ 248 (Del)

"*ACIT Circle -1 vs. Samrat Rice Mills (P) Ltd.*" 54 SOT 1 (Del)

"*ITO vs. Bhavesh Prints (P.) Ltd.*" 46 SOT 268 (Ahd)

"*Kaps Advertising vs. ITO*" 48 SOT 63 (Del)

"*CCIT vs. Kesari Tea Co. Ltd.*" 254 ITR 434 (SC)

"*CIT vs. Sugauli Sugar Works (P.) Ltd.*" 236 ITR 518 (SC)

5. On the other hand, the learned DR has relied upon a recent authority of the Hon'ble Delhi High Court styled as "*CIT vs. Chipsoft Technology (P.) Ltd.*" 210 Taxman 173 (Del), wherein it has been held as under:

> *"9. Two aspects are to be noticed in this context. The first is that the view that liability does not cease as long as it is reflected in the books, and that mere lapse of time given to the creditor or the workman, to recover the amounts due, does not efface the liability, though it bars the remedy. This view, with respect is an abstract and theoretical one, and does not ground itself in reality. Interpretation of laws, particularly fiscal and commercial legislation is increasingly based on pragmatic realities, which means that even though the law, permits the debtor to take all defences, and successfully avoid liability, for*

abstract juristic purposes, he would be shown as a debtor. In other words, would be illogical to say that a debtor or an employer, holding on to unpaid dues, should be given the benefit of his showing the amount as a liability, even though he would be entitled in law to say that a claim for its recovery is time barred, and continue to enjoy the amount. The second reason why the assessee's contention is unacceptable is because with effect from 1-4-1997 by virtue of Finance Act, 1996 (No.2), an Explanation was added to Section 41 which spells out that "loss or expenditure or some benefit in respect of any such trading liability by way of remission or cessation thereof" shall include the remission or cessation of any liability by an unilateral act by the first mentioned person under clause". The expression "include" is significant; Parliament did not use the expression "means". Necessarily, even omission to pay, over a period of time, and the resultant benefit derived by the employer/assessee would therefore qualify as a cessation of liability, albeit by operation of law."

6. We may observe that one of the Hon'ble Judges of the High Court of Delhi was part of the Division Bench as in both the authorities i.e. " Shri Vardhaman Overseas Ltd." (supra), and "Chipsoft Technology (P.) Ltd." (supra). Under such circumstances, it cannot be said that both the authorities are contradictory to each other, rather the law laid down by the authority in the case of "Chipsoft Technology (P.) Ltd." (supra), supplements but not supplants the law laid down by the Hon'ble Delhi High Court in the case of "Shri Vardhaman Overseas Ltd." (supra). In the case of "Chipsoft Technology (P.) Ltd.", the Hon'ble High Court has categorically held that it would be illogical to say that a debtor or an employer, holding on to unpaid dues, should be given the benefit of his showing the amount as a liability, even though he would be entitled in law to say that a claim for its recovery is time barred, and continue to enjoy the amount. The facts of the present case are also squarely covered by the law laid down by the Hon'ble Delhi High Court in the case of "Chipsoft Technology (P.) Ltd.", (supra). In the case in hand also the assessee on one had is continuously for the last so many years showing the amount in question as his liability towards sundry creditors and at the same time when the Assessing Officer asked for the details of the creditors he refused to provide the same saying that it would amount to acknowledgement of the debt and the creditors may sue him for recovery of the amount. He even failed to provide the addresses of the creditors, prove the genuineness or the creditworthiness of the creditors. Under law, the assessee cannot be allowed to approbate and reprobate at the same time. On one hand he wants to avoid the liability to pay the tax saying that the amount is legally payable by him as a liability but on the other hand he does not want to pay the said amount to the creditors but enjoy the same without being added to his income. The assessee is

blowing hot and cold in the same breath, which in our view is not permissible under law. So far as the authorities relied upon by the assessee are concerned, with due respect it is submitted that in those authorities, it was not established that the assessee had no intention to pay back the debts but in the case in hand, the assessee has refused to divulge the details of creditors because of his intention not to pay back the loan amount as was claimed by him in his reply to the Assessing Officer. Hence, the authorities relied upon by the assessee, as detailed above, are quite distinguishable on their own facts.

7. The case was heard on merits on 22nd Jan 2013 and the judgment was reserved. Now, the assessee vide letter dated 28th Jan 2013 has submitted a statement showing the details of sundry credits from the year 2000 to 2012. It has been further claimed that the amount which was outstanding at Rs.69,32,307 in the year 2000 has been reduced to Rs.19,32,372 at the end of the A.Y. 2012-13. Through this letter the assessee wants to bring into the knowledge of this Tribunal that the liability has not ceased, rather he has been repaying the amount to his creditors. The outstanding amount is now a sum of Rs.19,32,372 only against the amount of 48,89,025 relating to A.Y. 2007-08, which has been added by the Assessing Officer to his total income.

8. In view of the newly developed facts, it would be in the interest of justice to remand the issue back to the Assessing Officer for verifying the genuineness of repayment of loans as claimed by the assessee. We may observe that in the list submitted by the assessee, he has shown to have made certain payments during the A.Ys. 2009-10 and 2010-11. However, neither this fact was brought into the knowledge of the Assessing Officer before completion of the assessment on 27.11.2009 nor this plea or this fact of repayment was brought into the notice of the learned CIT(A) during the pendency of the appeal or till date of order on 14.10.2010. No such plea was taken by the assessee in the grounds of appeal before the Tribunal. It is only after the completion of the arguments that the assessee has come with a new fact that he has been regularly repaying the loan amount to the creditors as detailed in the list. This type of explanation given by the assessee at this stage seems to be suspicious. However, the interest of justice demands that this explanation, though suspicious, is required to be verified. If the assessee has really repaid the amount to the creditors then it will be injustice to him, if the amount is added to his income. Under such circumstances, we remand this case back to the file of the Assessing Officer for fresh assessment in accordance with law and with direction to scrutinize, verify and make necessary investigations regarding the genuineness of the assessee's claim of repayment to the sundry creditors

9. In the result, the appeal is partly allowed.

Order pronounced in the open court on this 28th day of February 2013.

HIGH COURT OF NEW DELHI

S. Ravindra Bhat and R.V. Easwar, JJ.

CIT
v.
Chipsoft Technology Pvt Ltd.

Appeal allowed.

ITA No. 598 of 2011

Heard on: 16th July, 2012.

Decided on: 20th July, 2012.

Present at hearing: Sanjeev Rajpal, Advocate., for Appellant. Parag Chawla, Advocate., for Respondent.

JUDGMENT

S. Ravindra Bhat, J.–

1. The present appeal by the revenue is directed against a judgment of the Income Tax Appellate Tribunal (ITAT) dated 17-10-2101, in ITA 2108/Del/2010.

2. Admit. The following question of law arises for consideration:

> "Did the Tribunal fall into error of law, in its impugned judgment in setting aside the disallowance of Rs. 32,28,724/- towards unpaid liability claimed in respect of salaries of the assesse for the assessment year 2006-07?"

With consent of counsel for parties the appeal was heard finally.

3. The brief facts of the case are that the assesse filed its return declaring nil income, on 31-11-2006. The Assessing Officer (AO) noticed that the assesse had shown unpaid liability to an extent of Rs. 38,51,893/- on account of its employees' dues. Of this, an amount of Rs. 6,23,000/- pertained to salary for the year 2005-06 and the balance pertained to the previous years; some extending to as far back in period as 2000-01. The AO called upon the assesse to furnish details and confirmation from the employees. The assesse furnished particulars and confirmation only in respect of 3 employees, out of 170 whose dues it claimed were outstanding. The assesse provided correspondence through e-mail with employees, without giving particulars such as address, etc of such employees. According to the assesse, it was struggling to survive due to a downturn in business. The AO was unconvinced with the explanation, and held that there was a cessation of the assesse's liability and that it had obtained benefit in respect of the said amounts; he invoked Section 41(1) of the Income Tax Act, and added the same to its assessable income.

The assesse appealed to the CIT (A), who directed deletion of the amounts, holding that the liability was outstanding in its books and therefore, did not amount to cessation of liability. The revenue appealed to the ITAT, which endorsed the reasoning of the CIT (Appeals).

4. It is argued by Mr. Rajpal, that the ITAT fell into error in overlooking the fact that the amount due to 170 employees remained unchanged and static for about 6-7 years and no payment was made during the intervening period. Furthermore, the assesse did not reveal that its employees were actively pursuing their claims, and had taken any steps at all to recover their dues. The assesse did not file any correspondence with its employees, to substantiate its argument; even in the assessment proceedings it was unable to furnish particulars about its employees. The liability therefore, had ceased. It was urged that even if it were assumed that at some point the liability existed, the lapse of time, and the resultant defences available to the assesse under the Limitation Act, justified the AO's inclusion of the said amounts, on the ground of cessation of liability. It was underlined that the ITAT erred in not holding that benefit had accrued to the assesse by virtue of the wage liability becoming time barred. The revenue relied on *Kesoram Industries and Cotton Mills Ltd. v. Commissioner of Income-tax* 196 ITR 845 (Cal).

5. It was argued by Mr. Parag Chawla, on behalf of the assesse that in the absence of any action altering the treatment of wage liability in the books, or any other such act, the revenue cannot arbitrarily treat what is a liability as a profit. It was submitted that in order to attract Section 41(1) there should be some overt objective act, or act of the creditor leading to the inference that the liability ceases in law. It was submitted that the employees or workmen can always approach the court, or authorities under the Industrial Dispute Act, and claim the unpaid wages. In such event, the assesse would be remediless.

6. Section 41 (1) of the Income Tax Act reads as follows:

> ***"Profits chargeable to tax.***
>
> ***41.*** *(1) Where an allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee (hereinafter referred to as the first-mentioned person) and subsequently during any previous year,–*
>
> > *(a) the first-mentioned person has obtained, whether in cash or in any other manner whatsoever, any amount in respect of such loss or expenditure or some benefit in respect of such trading liability by way of remission or cessation thereof, the amount obtained by such person or the value of benefit accruing to him shall be deemed to be profits and gains of business or profession and accordingly chargeable to income-tax as the income of that previous year, whether the business*

> *or profession in respect of which the allowance or deduction has been made is in existence in that year or not; or*
>
> *(b) the successor in business has obtained, whether in cash or in any other manner whatsoever, any amount in respect of which loss or expenditure was incurred by the first-mentioned person or some benefit in respect of the trading liability referred to in clause (a) by way of remission or cessation thereof, the amount obtained by the successor in business or the value of benefit accruing to the successor in business shall be deemed to be profits and gains of the business or profession, and accordingly chargeable to income-tax as the income of that previous year.*
>
> *[Explanation 1.—For the purposes of this sub-section, the expression "loss or expenditure or some benefit in respect of any such trading liability by way of remission or cessation thereof" shall include the remission or cessation of any liability by a unilateral act by the first mentioned person under clause (a) or the successor in business under clause (b) of that sub-section by way of writing off such liability in his accounts."*

In Kesoram (supra), the Calcutta High Court held that the liability in such cases had to be added back:

> *"Whether the liability of the assessee has been fully discharged is within the special knowledge of the assessee. He has to prove that in fact the liability subsists. When the assessee itself comes to the conclusion that the amount in question would not be claimed by the concerned persons and, thereafter, it proceeds to forfeit such amount and does not take such amount to a reserve account but writes it back in the profit and loss account, the reasonable inference that will follow from these facts and circumstances and the conduct of the assessee is that the amount which was provided for was in fact not necessary and it was an excess provision. No longer was there any liability. It is always possible that a creditor, if he so chooses, may agree to accept a smaller amount in full discharge of the whole amount due to him. An employee, casual or regular, who is entitled to wages or salary, will not allow his claim to remain unsatisfied. If the employer does not pay, he can move the authorities under the Payment of Wages Act. In his own interest, he will not permit the employer to withhold the wages, if it is due to him. When an assessee has obtained a benefit of deduction of a trading liability, it is for the assessee to establish whether such trading liability has been fully discharged or not. This court has laid down in CIT v. Agarpara Co. Ltd. [1986] 158 ITR 78, that if there be any excess over the requirement of the assessee in respect of liability claimed and allowed, such liability must be deemed to have ceased. It has also been laid down that it*

> *may be inferred from the surrounding circumstances that there has been a cessation or remission of the liability of the assessee. It has also been laid down that if unclaimed bonus being a portion of the bonus allowed as deduction in computing the income of the assessee is carried forward from year to year and thereafter written back in the account and no tax is levied thereon, the assessee would be getting a benefit to which it was not entitled."*

The court in the above decision was concerned with a fact situation where the assesse had unilaterally altered the liability in its books. This aspect was sought to be highlighted as a point of distinction, by the assesse in this case, to say that here, no such change in situation had occurred and that the liability continued to be reflected in the books.

7. There is some authority in favour the assesse's position that there is neither remission nor cessation of its trading liability in such cases, since there is neither any unilateral act of the creditor amounting to remission nor any bilateral act of the parties resulting in the liability ceasing to exist in law, merely because the recovery of the same has become time-barred. (*J.K. Chemicals Ltd. v. CIT* [1966] 62 ITR 34 (Bom), *CIT v. Sadabhakti Prakashan Printing Press (P.) Ltd.* [1980] 125 ITR 326 (Bom), *CIT v. V.T. Kuttappu & Sons* [1974] 96 ITR 327 (Ker), *Liquidator, Mysore Agencies Pvt. Ltd. v. CIT* [1978] 114 ITR 853 (Kar), and *Bhagwat Prasad & Co. v. CIT* [1975] 99 ITR 111 (All). It was also held in those judgments that the mere fact that the assessee did not show the amount as his trading liability in his account books did not affect the consequence since such unilateral act of the assessee was neither remission nor cessation of his trading liability.

8. On the other hand, this Court has considered Kesoram (supra) which upholds a view that favours the revenue. A similar view was spelt out in *Commissioner of Income Tax v Agarpara Co. Ltd* 1986 158 ITR 78:

> *"26. Whether a trading liability that was once incurred ceases to exist for the purpose of Section 41(1) has to be decided in the light of the provisions of the Income-tax Act, 1961, and the statute, if any, governing such liability. The assessee who maintains his accounts on the mercantile basis would be entitled to a deduction in respect of bonus in the year in which a liability arises under the statute, or the employees' claim for bonus is admitted by the assessee or is settled by an agreement between the parties or is adjudicated upon by an award. Under Section 36(1)(ii) of the Income-tax Act, 1961, payment of bonus to the employees is an allowable deduction. Under the Payment of Bonus Act, 1965, liability to pay bonus has become a statutory obligation imposed upon the employer covered by the said Act. Under the Bonus Act bonus is payable within a period of eight months from the close of the accounting year unless there is a dispute regarding such payment, in which case it is payable within a month from the date*

> *of the award becoming enforceable. Contravention of any of the provisions of the Bonus Act or the Rules made thereunder is punishable with imprisonment for a term which may extend to six months or with fine which may extend to Rs. 1,000 or with both. As the liability for bonus became a statutory one, a provision made therefor or even where no provision is made, in the mercantile accounting, the amount payable is allowable if the same is in accordance with the law about the payment of bonus. Any provision over and above that payable under the Bonus Act shall not be allowable to the extent of such excess. It is not the case of the assessee before us that time to pay bonus was extended or any dispute as regards payment of bonus has been raised. The assessee has provided for bonus for its employees but a part of the bonus so provided for three several years remained unclaimed. Once bonus has been offered by the employer, but remains undrawn, it cannot be said that the liability subsists even after the expiry of the time prescribed by the statute, particularly when there is no dispute pending regarding the payment of bonus. In the context of such facts and circumstances, it may be inferred that unclaimed or unpaid bonus is an excess of the requirement of the assessee and, therefore, to that extent, in any event, the liability has ceased."*

9. Two aspects are to be noticed in this context. The first is that the view that liability does not cease as long as it is reflected in the books, and that mere lapse of the time given to the creditor or the workman, to recover the amounts due, does not efface the liability, though it bars the remedy. This view, with respect is an abstract and theoretical one, and does not ground itself in reality. Interpretation of laws, particularly fiscal and commercial legislation is increasingly based on pragmatic realities, which means that even though the law permits the debtor to take all defences, and successfully avoid liability, for abstract juristic purposes, he would be shown as a debtor. In other words, would be illogical to say that a debtor or an employer, holding on to unpaid dues, should be given the benefit of his showing the amount as a liability, even though he would be entitled in law to say that a claim for its recovery is time barred, and continue to enjoy the amount. The second reason why the assesse's contention is unacceptable is because with effect from 1-4-1997 by virtue of Finance Act, 1996 (No.2), an Explanation was added to Section 41 which spells out that "*loss or expenditure or some benefit in respect of any such trading liability by way of remission or cessation thereof*" *shall include the remission or cessation of any liability by a unilateral act by the first mentioned person under clause*". The expression "include" is significant; Parliament did not use the expression "means". Necessarily, even omission to pay, over a period of time, and the resultant benefit derived by the employer/assesse would therefore qualify as a cessation of liability, albeit by operation of law.

10. The submission of the assesse that no period of limitation is provided for under the Industrial Disputes Act, as a result of which it is exposed to liability at any time, is insubstantial and unpersuasive. This is because in *The Nedungadi Bank Ltd. vs K.P. Madhavankutty* AIR 2000 SC 839 the Supreme Court held that even though under the Act no period of limitation has been prescribed, a stale dispute one where the employee approaches the forum under the Act after an inordinate delay cannot be entertained and adjudicated.

11. In view of the foregoing reasons, the question of law is answered in the affirmative, in favour of the revenue, and against the assesse; consequently the orders of the Commissioner (Appeals) and the impugned order of the ITAT are hereby set aside. The order of the Assessing Officer is hereby restored. The appeal is allowed in the above terms without any order on costs.

2013 TRI 2055 (H.C. Del.)

HIGH COURT OF NEW DELHI

S. Ravindra Bhat and R.V. Easwar, JJ.

Li and Fung India Pvt. Ltd.
v.
Commissioner of Income Tax

FACTS/HELD

Transfer Pricing: TNMM under Rule 10B(1)(e) contemplates ALP determination with reference to the relevant factors (cost, assets, sales etc.) of the assessee and not those of the AE or third party. Assessee's study report cannot be discarded without showing how it is wrong. Finding that assessee is a risk bearing entity should be based on tangible material

1. The assessee, a wholly owned subsidiary in India of Li & Fung (South Asia) Ltd., Mauritius, was set up as a captive offshore sourcing provider. It entered into an agreement with Li & Fung (Trading), Hong Kong, an associated enterprise, for rendering "sourcing support services" for the supply of high volume & time sensitive consumer goods. The assessee was entitled to receive cost plus a mark up of 5% for the services rendered to the AE. The assessee claimed that it was a low risk captive sourcing service provider performing limited functions with

minimal risk. It adopted the TNMM and computed the PLI at operating profit margin/total cost. Since the operating profit margin at 5.17% exceeded the weighted average operating margin of 26 other comparable companies, the assessee claimed that its remuneration was at arms' length. The TPO did not dispute the TNMM or the comparables but held that the assessee ought to have received 5% on the FOB value of the goods sourced through the assessee (i.e. the exports made by the Indian manufacturers to overseas third party customers). He also held that the assessee was a risk bearing entity and an independent entrepreneur and it could not be said that the assessee is a risk-free entity. The DRP upheld the TPO's order though it reduced the mark up to 3% of FOB value of exports. On appeal by the assessee, the Tribunal (143 TTJ 201) upheld the stand of the TPO. On further appeal by the assessee HELD by the High Court reversing the Tribunal:

(i) The assessee's compensation model is based on functions performed by it and the operating costs incurred by it and not on the cost of goods sourced from third party vendors in India. Allotting a margin of the value of goods sourced by third party customers from Indian exporters/vendors to compute the assessee's profit is unjustified. To apply the TNMM, the assessee's net profit margin realized from international transactions had to be calculated only with reference to cost incurred by it, and not by any other entity, either third party vendors or the AE. Rule 10B(1)(e) does not enable consideration or imputation of cost incurred by third parties or unrelated enterprises to compute the assessee's net profit margin for application of the TNMM. Rule 10B(1)(e) contemplates a determination of ALP with reference to the relevant factors (cost, assets, sales etc.) of the enterprise in question, i.e. the assessee, as opposed to the AE or any third party. The approach of the TPO in essence imputes notional adjustment/income in the assessee's hands on the basis of a fixed percentage of the FOB value of export made by unrelated party venders;

(ii) The finding that the assessee assumed substantial risk is not based on any material. The assessee made no investment in the plant, inventory, working capital, etc., nor did it bear the enterprise risk for manufacture and export of garments. It merely rendered support services in relation to the exports which were manufactured independently. Thus, attributing the costs of such third party manufacture when the assessee did not engage in that activity and when those costs were clearly not the assessee's costs, but those of third parties, is clearly impermissible. A contrary conclusion would amount to treating the assessee as the vendor/ exporters' partner in their manufacturing business – a completely unwarranted inference;

(iii) Tax authorities should base their conclusions that the assessee bears "significant" risks on specific facts, and not on vague generalities, such as "significant risk", "functional risk", "enterprise risk" etc. without any material on record to establish such findings. If such findings are warranted, they should be supported by demonstrable reason, based on objective facts and the relative evaluation of their weight and significance;

(iv) Also, as the TPO did not discard the exercise conducted by the assessee of comparing its operating profit margin with that of the comparable companies, and it was not shown that the profit margin and cost plus model adopted by the assessee was distorted, he could not have proceeded to his own determination and calculations. The TPO must first reject the assessment carried out by the assessee before making further alterations. Where all elements of a proper TNMM are detailed and disclosed in the assessee's study reports, care should be taken by the tax administrators and authorities to analyze them in detail and then proceed to record reasons why some or all of them

Appeal allowed.

ITA No. 306 of 2012.

Heard on: 8th July, 2013.

Decided on: 16th December, 2013.

Present at hearing: Porus Kaka, Sr. Advocate with Neeraj Jain, Manish Kanth and Ramit Katyal, Advocates, for Appellant. N.P. Sahni, Sr. Standing Counsel and Ruchesh Sinha, Advocate, for Respondent.

JUDGMENT

S. Ravindra Bhat, J.–

1. The present appeal under Section 260A of the Income Tax Act, 1961 (hereafter 'the IT Act') impugns the order dated 30.09.2011 of the Income Tax Appellate Tribunal, Delhi Branch 'D', New Delhi (hereafter 'the Tribunal') in ITA No. 5156/Del/2010, for the assessment year 2006-07. The present appeal concerns the alleged apportioning of consideration between the Appellant (i.e. the assessee, M/s Li Fung (India) Pvt. Ltd, hereinafter 'LFIL') and its Associated Enterprise (hereinafter 'AE') in order to arrive at the arm's length price for the transactions between the two entities, using the Transactional Net Margin Method (TNMM). The following questions of law arise from the appeal:

a. Whether the assessment of the Revenue of arm's length price applying the TNMM method was contrary to the transfer pricing provisions under the IT Act and Rules?

b. Whether the Transfer Pricing Officer's (TPO's) apportionment by considering the cost plus mark up of 5% on FOB value of goods between third party enterprises, sourced through the appellant is in compliance with the law?

2. The facts that give rise to these questions of law are as follows. LFIL is a wholly owned subsidiary of Li & Fung (South Asia) Ltd., a company incorporated in Mauritius as a captive offshore sourcing provider. Li & Fung (Trading)(the AE),is a group company incorporated in Hong Kong, which enters into contracts with customers viz. retail chains overseas, for rendering sourcing support services for the supply of high volume, time sensitive consumer goods. The appellant entered into an agreement dated 4.12.1997 with the AE, whereby the contract for rendering sourcing services is outsourced or subcontracted to LFIL, for which it is remunerated at cost plus a mark up of 5% for services rendered to the AE, and ultimately, the AE's customers.

3. LFIL previously received buying support services fees amounting to Rs. 47, 69, 83, 904 from the AE, which ought to be considered as an international transaction of rendering buying support services to AE under the Transfer Pricing provisions under Sections 92 to 92F of the IT Act. To justify that the transaction was at arm's length, LFIL applied the Transactional Net Margin Method (TNMM) as the most appropriate, considering Operating Profit Margin divided by Total cost as the Profit level indicator. Since the operating profit margin at 5.17% exceeded the

weighted average operating margin of 26 other comparable companies at 4.07%, LFIL contended that such a transaction of rendering of sourcing services was at arm's length on an application of the TNMM method. 4. During the course of the Transfer Pricing assessment, LFIL contended that it was a low risk captive sourcing service provider performing limited functions with minimal risk as an offshore provider and substantial functions relating to buying services was performed by the AE, which also assumed various enterprise risks. Thus, the compensation paid to the appellant at cost plus 5% as remuneration was to be considered at arm's length while applying the TNMM. Alternatively, the AE entered into contracts with unrelated third parties for rendering buying services @ 4% to 5% of the FOB value of exports. LFIL had in turn received service fee of Rs.47.69 crores which is equivalent to nearly 4% of the FOB value of the export (by the vendors) from the AE, which constituted 80% of the consideration received by the AE, which, in LFIL's opinion ought to have been considered at arm's length.

5. The Transfer Pricing Officer by an order dated 28.10.09 under Section 92CA(3) of the IT Act did not dispute the selection of the comparable companies for application of TNMM by LFIL. However, he held that the cost plus compensation @ 5% of cost of incurred by LFIL was not at arm's length and applied a mark up of 5% on the FOB value of export of Rs. 1202.96 crores made by the Indian manufacturer to overseas third party customers.

6. The reasons given by the TPO were that:

a) LFIL was performing all the critical functions, assumed significant risks and used both tangible and unique intangibles developed by it over a period of time;

b) there was no evidence that the AE had either technical capacity or manpower to assist LFIL and that in the absence of any credible evidence, the involvement of the AE could not be accepted;

c) LFIL had developed several unique intangibles which had given an advantage to the AE in the form of low cost of the product, quality of the product and enhanced the profitability of the AE, though the cost for development and use of intangibles was not taken for computation of routine mark up of 5% considered by LFIL;

d) LFIL had crucially developed supply chain management which provided the link between the suppliers and customer to achieve strategic and pricing advantage;

e) LFIL owned human capital intangible, developed at their own cost with all related risks in creation and maintenance of such intangible;

f) the AE recognised that India offers both cost and operational advantage such as lower salaries for the employees, low cost material and low cost manufacture. LFIL had neither quantified this locational saving nor had the AE attributed any part of the additional profit on account of locational saving to LFIL.

7. The TPO did not, as stated earlier, dispute the analysis undertaken by LFIL, but for the above reasons applied the 5% mark up to FOB value of exports made by Indian manufacturer to overseas third party customers, amounting to Rs 1202.96 crores and accordingly computed an addition of Rs 57, 65, 61, 186/- to the appellant's income on account of the alleged difference in calculation of the arm's length price of the above transactions. Thus, the Assessing officer in the draft assessment order passed under section 144C(1) of the Act made an addition, *inter alia*, on account of transfer pricing adjustment of Rs. 57,65,61,186 on the basis of the order passed by the TPO. The reasoning of the TPO is as follows:

> *"5.2.5 The compensation model of the assessee does not include the profit attributable to the assessee on account of location saving:*
>
> *Globalization and continuous search for lower cost has resulted in transfer of manufacturing and procurement activities from high cost economy like European Union, Japan, UK and United States, to lower cost economies like India to stay competitive and to increase profits. In this case, the AE has recognized that India offers both cost and operational advantage such as tower salaries for the employees, low cost material and low cost manufacture. Accordingly, it has established a trading company in India for procurement of goods. Location savings generally emerge when companies transfer their operation site from high cost economy to economies with low cost. That is, they take advantage of price differences in the factors for production or procurement across the countries. In many cases, the location saving arise from differences of low labour cost, low raw material and finished goods cost, low logistic cost and lower quality control cost. The net location saving represent saving from moving to low cost economy. In this case, the assessee is operating in low cost economy has generated location saving due to huge difference in cost of procurement between high cost economy and low cost economy like India. From a trading pricing prospective the common question in this case is: "who is entitled to additional profits in form of locational saving?" or "which country should tax the profits?" In this case, the assessee has established its sourcing subsidiary in India in order to earn or to have the advantage of the locational saving. However, the assessee has neither quantified locational saving nor has attributed any part*

of the additional profit on account of locational saving to the assessee, in India. It is pertinent to mention here that the assessee is the most critical part of global supply chain of the AE. It is responsible for identifying and qualifying the contracted manufacturer, for working with them and other designers to manufacture garments in the technical specifications, for selection of fabrics, for control over the manufacturer, for identifying appropriate sourcing of fabrics and accessories, for quality insurance, for transportation logistics and for coordinating logistics. The compensation model for the assessee which is based on reimbursement of the cost with the percentage mark up has not included locational saving attributable to the assessee. These facts prove that cost plus compensation @ 5% of cost of the assessee is not at arm's length because it does not include profit attributable to the assessee on account of locational saving.

5.3 Whether the assessed commission should be expressed as a percentage of the FOB price of goods sourced through the assessee?

In this case the AB has allowed commission of 5% of cost incurred by the assessee for its sourcing activities in India and has not computed commission on FOB price of goods sourced through the buying office. I have examined the compensation model along with the facts of the case and reached a conclusion that in this case commission should be expressed as a percentage of FOB price of goods sourced through the assessee for the following reasons:

(a) It is evident from the FAR analysis as discussed in Para 5.2.2 of this order that the assessee has played a major role in identifying suppliers, raw material, design, production control, manufacturing control, quality control, packing and export of merchandise and has been in constant touch with the buyer. It has assumed significant risks and has used both its tangibles and unique intangibles which resulted in enhancement and profitability of sourced goods as discussed in Para 5.2.4 and 5.2.5 of this order. These facts clearly prove that value addition activities of the assessee can only be expressed as a percentage of FOB of goods sourced through the assessee.

(b) The assessee is operating in a low cost country like India and its operating cost is so low that it is a very poor proxy of the value it adds to the sourced goods.

(c) The assessee has developed unique intangibles like supply chain management intangibles and Human Asset Intangible which has resulted in huge commercial and strategic advantage

to the AE and these intangibles have enhanced the profit potential of the AE. However, these intangibles did not form part of the operating cost. Accordingly, the value addition made by the assessee using intangible, to the FOB value the goods sourced through it remained unremunerated and operating cost plus mark up model does not capture the compensation for value addition made through these intangibles. Accordingly commission should be computed on FOB value of goods.

(d) The assessee has generated huge locational saving for the AE as discussion in Para 5.2.5 of this order. However, compensation model based on operating expense of the assessee does not include locational saving attributable to the assessee which could only be capture if commission is calculated on FOB value of goods sourced through the assessee.

In view of the above findings, it is held that the correct compensation model at arm's length price, in this case, would be commission of FOB cost of goods sourced from India.

6. The risk profile of the assessee has been discussed in detail in Para 5.2.1 of this order. It has been discussed in detail in this order that the assessee functions like an independent entrepreneur. Hence, it takes matching risks. For sake of convenience, risks relevant in the business of the assessee and risks disclosed in T.P. studies are analyzed in the following table:

SI. No.	*Risk matrix relevant to business of the assessee*	*The risk matrix as disclosed in transfer pricing report under Rule 10D*
1.	*Market Risk*	*Disclosed in transfer pricing report*
2.	*Service liability*	*Disclosed in transfer pricing report*
3	*Capacity utilization risk*	*Disclosed in transfer pricing report*
4.	*Foreign exchange risk*	*Disclosed in transfer pricing report*
5.	*Credit & collection risk*	*Disclosed in transfer pricing report*
6.	*Scheduling risk*	*Not disclosed in transfer pricing report but actually borne by assessee.*
7.	*Government & institutional risk*	*Not disclosed in transfer pricing report but actually borne by assessee.*

8.	*Operational risk*	*Not disclosed in transfer pricing report but actually borne by assessee.*
9.	*Asset redundancy risk*	*Not disclosed in transfer pricing report but actually borne by assessee.*
10.	*Infrastructure failure risk*	*Not disclosed in transfer pricing report but actually borne by assessee.*
11.	*Human capital intangible related risk (manpower risk)*	*Disclosed in transfer pricing report.*
12.	*Security risk*	*Not disclosed in transfer pricing report but actually borne by assessee.*
13.	*Environmental risk*	*Not disclosed in transfer pricing report but actually borne by assessee.*

It is evident from the risk analysis, as mentioned in the table above that the assessee is a risk bearing entity and it cannot be said that assessee- is a risk-free entity. It is an independent entrepreneur. Hence, there is no case for risk adjustment in the assessee's case. Without prejudice to the above finding that the assessee is a risk bearing entity and does not require any adjustment on account of risk, the claim of the assessee is not admissible on the following grounds:

(a) The assessee has not conducted risk analysis either in case of tested party and comparables and has not demonstrated its risk matrix of comparables as different from tested party.

(b) No computation of risk adjustment is filed.

(c) The onus to support risk adjustment is on the assessee, who has not discharged that onus.

********** ************

8.1 The assessee has adopted TNMM with a PLI of OP/OC. It may be pointed out that it is not the intention of this order to change the method adopted by the assessee. The method adopted by the assessee is accepted. The only change being made is on the cost base being applied while applying the PLI, chosen by the assessee. It has already been pointed that the costs do not include cost of sales made through the assessee. This being the case, the mark-up of 5% should obviously be calculated on the full FOB value of exports in on Rs.1202.96 Crores. Following the *discussion in the preceding paras, the operating income shall be calculated as a mark-up the FOB value of exports that have been facilitated by the assessee.*

9. Calculation of arm's length price

The assessee has credited total receipt of Rs.476,983,904 on the basis of operating cost of the assessee plus a markup of 5% and at the net level the net operating margin of Rs.24,914,814 comes to 5.22%. This is in consonance with the assessee's claim it is operating on cost plus 5% markup basis. Following the discussion in the preceding paras, the receipt as claimed by the assessee, shall be substituted by the FOB value of exports being Rs.1202.96 crores. The markup of 5% that shall be applied to this and the same shall be credited to the Profit & Loss Account. After taking into account this gross income, the net operating income is computed at Rs.601,480,000. Thus, the arm's length price is calculated as below:

Net Operating income (as calculated above)	*Rs.601,480,000*
Operating income shown by assessee	*Rs.24,918,814*
Difference	*Rs.576,561,186*

Accordingly, the value of the international transaction of the assessee shall be adjusted upward by Rs.576,561,186 to bring it to arm's length. Since the difference computed as a percentage of the Arm's Length Price is more than 5% no benefits under the proviso to Section 92C(2) is available to the assessee.

10. The transfer pricing approach may be summarized as below.

(i) The assessee has used TNMM as the method and OP/TC was claimed to be the PLI.

(ii) It was noticed that the cost of goods sold through the assessee has not been included in the cost base while computing the margin.

(iii) A show cause is this regard was issued to the assessee. The same is reproduced at Para 5.1.

(iv) The assessee markup has been calculated on the FOB value of exports made through the assessee. The rationale for this has been given at para 5.3.

(v) An adjustment of Rs.576,561,186 was made to the value of international transaction.

(vi) The assessee was afforded reasonable opportunity of being heard (including personal hearing) as mentioned on page 1 of this order."

8. The Dispute Resolution Panel (DRP) by order dated 30.09.2010 passed under Section 144C (5) of the Act reduced the said mark up of 5% of FOB value of exports to 3%. The Assessing Officer accordingly in the final assessment order dated 8.10.2010 passed under section 143(3)/144C(3) of the IT Act computed LFIL's income at Rs 36, 67, 95, 634/- as against the returned income of Rs 3,08,26,448 after making the addition on account of transfer pricing adjustment. The material part of DRP's reasoning is as follows:

> *"After going through the functions of the assessee, we find that it has assumed the role of a full risk bearing trader. Therefore, the plea of the assessee that the cost of goods should not be part of the cost base cannot be allowed. The assessee's plea that the Hon'ble ITAT and the Delhi High Court, have held that it is eligible for deduction u/s 80-O of the Income Tax Act has no application in the instant case as the decisions were not rendered in the context of setting the arms length price of the assessee's international transactions.*
>
> *International transactions have to be judged at a different level as opposed to transactions covered by the domestic law. The OECD also recognizes the fact that related parties may fashion their transactions in such a manner that may call for looking at the substance of transactions over the form they are given. The relevant portions of the OECD guidelines issued on 22.07.2010 are as below:–*
>
> *"1.67 Associated enterprises are able to make a such greater variety of contracts and arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between independent parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in the particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively. In such instances, tax administrations would have to determine what the underlying reality is behind a contractual arrangement in applying the arm's length principle.*
>
> *1.68 In addition, tax administrations may find it useful to refer to alternatively structured transactions between independent enterprises to determine whether the controlled transaction as structured satisfied the arm's length principle. Whether evidence from a particular alternative can be considered will depend on the facts and circumstances of the particular case, including the*

number and accuracy of the adjustments necessary to account for differences between the controlled transaction and the alternative and the quality of any other evidence that may be available."

Therefore, the assessee's claims that it does not bear the risks of a normal trader have to be tested in this light. Accordingly, we are inclined to accept the TPO's conclusion that the FOB value of goods should form part of the cost base for calculating the remuneration that should accrue to the assessee. That leads to the next question as to what should be the correct markup that should be applied. The TPO has applied the markup of 5% because the assessee is operating on a cost plus 5% model. However, when we are increasing the cost base manifold, the application of a markup of 5% will be excessive.

We accordingly hold that given the facts and circumstances of the case a markup of 3% will be reasonable. This will adequately cover the valuable intangibles that have been developed and used by the assessee as also the location saving that the assessee is passing on to its AE.

Directions under Section 144C(5) of the IT Act

In view of the discussion on each of the grounds of objections above, the Assessing Officer is directed to complete the assessment as per the draft order forwarded by him to the assessee subject to modification as discussed in Para 3 above. The Assessing Officer may incorporate the reasons given by the Panel at appropriate places in respect of the various objections while passing the final order. He is also directed to append a copy of these directions to the assessment order.

The objections of the assessee are disposed of as above."

9. LFIL preferred an appeal to the Tribunal against the assessment order, which by the impugned order dated 30.09.2011, even while accepting that the TNM Method was the appropriate method for calculation, rejected the LFIL's contention that under Rule 10B (1)(e) of the Income Tax Rules ("the Rules") made no provision for considering the cost incurred by third parties or an unrelated enterprise to compute net profit margin. The Tribunal by its impugned order held that the appellant was performing all critical functions with the help of tangible and unique intangibles as well as supply chain developed, which helped the AE to enhance its business and resulted in location saving to the consumer, compensation for the services rendered by LFIL to the AE, equivalent to the cost plus 5% markup, was not at arm's length. Since LFIL was providing crucial sourcing services and the AE was remunerated by third parties based on such services, the Tribunal relied upon the mark up on FOB value of goods sourced through LFIL as the appropriate method to work out arm's length compensation. The tribunal

accepted the TPO's reasoning for applying the 5% of the FOB value of exports to third parties by Indian manufacturers. The relevant part of the reasoning in the impugned order is reproduced below:

> *"The TPO did not consider the cost plus compensation @ 5% at arms length by holding that assessee is performing all critical functions, assuming significant risks and used both tangibles and unique intangibles developed by it over a period of time. The associated enterprise is not having technical capacity and manpower to assist the assessee in this regard. The assessee has developed several unique intangibles which has been given advantage in the form of low cost of product, quality of the product and enhanced the profitability of AE. These intangibles have developed profit potential of AE. The assessee has developed the supply chain management which gives customer a strategic and pricing advantage. The assessee has also developed its own human capital intangible at its own cost. The cost for the same is born by assessee. The AE has recognized that India offers both cost and operational advantage on account of lower salaries for the employees, low cost material and low cost manufacture.*
>
> *The associated enterprise is charging from the purchasers on the basis of FOB value of exports up to 5%. The total exports effected by the assessee during the year were Rs.1202.96 crores. Assessee has been paid in respect of the international transaction effected in the form of exports on the basis of cost plus 5%. The Learned AR's plea that no adjustment has been made in the earlier years. For this, he has submitted assessment order for AY 2002-03 to 2005-06 wherein the transaction net marginal method with operating profit over total cost (OP/TC) as a profit level indicator has been accepted. This TNMM method has been accepted in these years. Reliance is also placed on the decision of Hon'ble Supreme Court in the case of Radhasoami Satsang Vs. CIT, cited supra and CIT vs. New Poly Pack (P) Ltd., 245 ITR 492, other case laws. In this regard, we hold that the principle of res judicata is not applicable in the incometax proceedings. Each assessment year is a separate unit and what is decided in one year shall not ipso facto apply in the subsequent years. We have gone through the orders passed in the earlier years which has been placed in the paper book at pages 293 to 305 and for all these assessment years starting from 2002-03 to 2004-05, we find that while accepting profit level indicator nothing has been said about the basis on which the compensation has been received by the associated enterprise on the goods exported from India through assessee. As we have already stated earlier, the associated enterprise was receiving the compensation as a percentage of the FOB value of the goods exported through the*

assessee and as per the guidelines of the OECD which recognizes that the related party may fasten their transaction in such a manner that may call for looking at the substance of transactions over the form they are given. In this case, the associated enterprise was receiving the compensation on the basis of FOB value while the Indian associate (assessee) was compensated only by cost plus 5% mark up. When the associated enterprise are receiving the compensation at FOB value and the assessee which is providing critical functions with the help of tangible and unique intangibles developed over the years and with the help of supply chain management which are important to achieve the strategic and pricing advantage. All these help the associated enterprise to enhance and retain the business and also contributes towards the locational savings on account of low cost salary, low cost material and low cost manufacture in India. Therefore, in our considered view, the cost plus 5% mark up is definitely not on the arms length while working out the compensation for the services rendered by the assessee to the associated enterprise. In such a situation, mark up on the FOB value of the goods sourced through the assessee shall be the most appropriate method to work out the correct compensation at arms length price. Therefore, the rules of consistency cannot be applied forever when such facts have not been considered/discussed at all in the earlier years.

It is also pleaded that the assessee has received 80-O deduction in the earlier years in respect of providing these professional and technical services. In this regard, we hold that every assessment year is a separate assessment year for incometax purposes and the principle of res judicata is not applicable. Further during this year, the assessee has not claimed or entitled for 80-O deduction. Therefore, it cannot be a plea to justify the transaction at the arm's length.

Assessee claims that there is no provision in the Rule 10B(1)(e) to include the cost incurred by third parties or unrelated enterprise to compute the net profit margin of the assessee. For this proposition, we do not agree in view of the fact that assessee is providing all critical functions and the majority of work related to these exports is performed by assessee itself. Associate enterprise had no capacity to execute the work. The associated enterprise is charging from the third party on the basis of FOB value of the exports made possible by assessee. Assessee is providing sourcing services through its tangible and intangible capacity to these third party clients in the form of low cost product resulting into profitability and pricing advantage. The assessee's reliance on DCIT vs. Cheil Communication India

Pvt. Ltd., cited supra, is not of much help as in that case, the facts were different. In that case, the assessee was providing to their party/media agency for and on behalf of the principal. In that case, the advertising space has been let out to the third party vendor in the name of ultimate customer and the beneficiary of advertisement. The assessee in that case was simply acting as intermediary between ultimate customer and the third party vendor in order to placement of advertisement. In assessee's case, the associated enterprise has been receiving the mark up as 5% of the FOB value of exports effected by assessee by applying its tangible and intangible capacity. The critical and all crucial work is done by assessee. The AE is paying back to the assessee only on the basis of cost plus 5% mark up. Such an arrangement cannot be said at arms length. In our considered view, such method will go against the basic normal business sense, as inefficient and high cost services provided by assessee shall fetch more revenue to the assessee. Such an arrangement on the face of it cannot be said to be at arm's length. The AE is getting remuneration on FOB value of export for which critical and main functions are performed by assessee. We also uphold that the assessee has developed a technical capacity and owns manpower which had developed human intangibles to perform all the critical functions. These tangible and unique intangible have been developed over the years. In view of these facts, we hold that to arrive at arm's length of these transactions, the mark up must be on the basis of FOB (free on board) value of the exports. Since the AE is receiving 5% of FOB value then the total receipt by AE must be Rs.60.148 crores. Thus, the attribution between assessee and AE must be from this amount.

AO made addition of Rs.33.60 crores. If it is added to the actual receipts of assessee then it is much more than the total amount received by associated enterprise regard to these exports. Thus, the way in which this adjustment has been made gives abnormal / absurd results which cannot be sustained. The assessee was performing critical functions with the help of tangible and unique intangibles developed over the period of time and with the help of supply chain management which the assessee had developed, the majority of compensation based on the FOB value of the exports materialized through the assessee must come to the assessee. So the correct compensation at the arms length price based on the FOB cost of the goods sourced from India needs to be decided. The total export during the year was Rs.1202.96 crores. AE received in total of Rs.60.148 crores.

The assessee's claim that no agreement was entered by the assessee with the ventures to whom the goods are sourced shall *not justify the cost plus mark up. The associate enterprise entered into the agreements for sourcing the goods and the compensation is based on the FOB value of the goods sourced from the India and the assessee performing all crucial and critical function to fulfill the conditions to execute the agreements. Therefore, we find no merits in this plea. The other claim of the assessee that location savings attributable to the end purchaser is also not justified as the assessee has developed many unique intangibles and also human capital intangibles which gives the locational advantage to procure low cost goods which helps the associated enterprise to obtain/retain the business and also benefits the end purchaser. These tangibles and unique intangibles developed over the period of time and the developed supply chains of the management owned by assessee benefits the ultimate purchaser and also provide locational savings to the all including the associated enterprise. As we have already said that the amount of adjustment computed by the TPO cannot exceed the amount which could have been received by the associated enterprise. There is nothing on the record from where we could gather that the compensation @ 5% on FOB value received by AE is depressed or on lower side. In view of these facts, we are of the view that the amount of adjustment so computed should not exceed the amount received by the associated enterprise. In our considered view, the AO as well as the DRP has proceeded on a wrong footing which have given absurd results of adjustments. In view of the fact that majority and crucial services rendered by assessee, the distribution of compensation received by AE @ 5% of the FOB value of the exports between the assessee and the associated enterprise should be in the ratio of 80 : 20. The assessee must get 80% of the total receipt by AE from the ultimate purchasers. AO is directed to compute the arm's length price in the above manner."*

10. LFIL's counsel argued that the addition of Rs. 33, 59, 69, 186/- made on account of difference in the arm's length price of international transactions of buying/sourcing services is not sustainable for the reason that the TPO applied the TNMM method contrary to the Transfer Pricing Regulations. Section 92 of the Act stipulates that any income arising from an international transaction shall be computed having regard to the arm's length price. Further, Section 92F(ii) defines arm's length price as a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions. For the purpose of determining the arm's length price in relation to an international transaction, various methods are prescribed under section 92C(2) of the Act and Rule 10B of the Rules provide the manner in which such methods should be applied by the assessee, assessing officer, Transfer Pricing Officer, etc.

11. Mr. Porus Kaka, learned senior counsel, while stating that the TNMM was chosen by LFIL as the appropriate method to calculate the arm's length, provided the court with an interpretation of the provision. He argued that for applying TNMM, it would be noted that the net profit margin realized from the international transactions by the appellant is to be computed only with reference to the cost incurred by LFIL itself. The provision does not consider or impute cost incurred by the third parties or unrelated enterprises, to compute net profit margin of the appellant enterprise.

12. The learned counsel stated that the TPO, in the impugned order, enhanced the cost base of the appellant enterprise artificially by considering the cost of manufacture and export of finished goods by third party vendors which is clearly inconsistent with the manner of application of TNMM as provided in Rule 10B(1)(e). He argued that the TPO's enhancement of LFIL's cost base, by artificially considering the cost of manufacture and export of finished goods, clearly amounts to imputing notional adjustment/income in LFIL's hands on the basis of a fixed percentage of the FOB value of export made by unrelated party vendors. Thus, the value of exports by third party vendors or customers does not provide any benchmark for determining arm's length price.

13. The learned counsel for LFIL submitted that, while applying the TNMM method, payment made by an assessee to third party vendors for and on behalf of the principal (which was reimbursed by the AE), cannot to be included in the total cost for determining the profit margin and the mark up is to be applied to the cost incurred by the appellant company. The value of export by third party vendors to third party customers does not provide any substantial basis for determining the arm's length price

14. Counsel further submitted that the mark up upon the entire FOB value of the AE would artificially enhance the LFIL's cost base for applying the OP/TC margin. He urged that LFIL's compensation model should be based on functions performed by it and the operating costs thereby incurred and not on the cost of goods sourced from third party vendors in India. Thus, allocating a margin of the value of goods sourced by third party customers from exporters/vendors in India is inappropriate and unjustified.

15. Learned senior counsel further argued that in terms of the Transfer Pricing documentation, LFIL had established the international transactions of rendering buying services to be at arm's length price having regard to the operating profit margin earned by comparable companies having similar functional profile. The computation of LFIL's operating profit margin (OP/TC%) by enhancing the cost base i.e. by increasing the cost of sale facilitated by the assessee would lead to an arbitrary adjustment to the income of the appellant which was never intended by the legislation.

16. The learned counsel further contended that LFIL is performing such functions which undertake a limited risk, and do not involve the direct manufacture of goods. This is evident from the fact that LFIL has made no investment in the plant, inventory, working capital, *inter alia* nor does it bear any enterprise risk for manufacture and export of the goods. Thus, LFIL's functional and risk profile is entirely different and has nothing to do with manufacture and export of consumer goods by unrelated third parties. Counsel argued that LFIL was merely involved in rendering buying or sourcing support services with regard to such goods and received a handsome remuneration on a cost plus mark-up of 5% which adequately highlights the functions performed, assets utilized and risks borne by the appellant on application of TNMM.

17. It was next urged that the said method of assessment undertaken for determining the arm's length price of international transactions applying TNMM was accepted in the Transfer Pricing assessment consistently year after year. The TPO, in the previous years, did not dispute the functional analysis taken by LFIL and the factors determining LFIL's operations, the functions performed, assets utilized and risk assumed, often having similarities with every year's assessment. Counsel cited *Radhasaomi Satsang v. CIT*, 193 ITR 321, to argue that where a fundamental aspect permeating through the different assessment years is accepted one way or the other, a different view in the matter is not warranted, unless there was any material change in facts. Similarly, he also cited this Court's decision in the case of *CIT v. Neo Polypack (P) Ltd.* 245, ITR 492to rely on the rule of consistency despite the non applicability of the res judicata in tax proceedings. Thus, in conclusion it was argued that the application of TNMM by the TPO by enhancing the cost base by considering FOB value of export by unrelated party vendors was inconsistent with the Transfer Pricing regulations and thus liable to be deleted.

18. The learned counsel also pleaded that the concept of locational savings are attributed to the end purchaser only. The TPO by holding that the arm's length prices of international transactions of running, buying/sourcing services by LFIL ought to be 5% of the FOB value of exports, clearly misunderstood the business model and international transactions undertaken by the appellant. The TPO failed to consider the fact that the transaction of export of finished goods is being undertaken by third party vendors or exporters to the overseas customers, whereas neither LFIL nor its AE are parties to such contracts. By providing sourcing support services, none of them have gained any advantage on account of locational saving associated with the export of goods between exporters and overseas customers. Thus, it is submitted that the adjustment made by the TPO on ground of locational saving, is not sustainable and liable to be deleted.

19. The learned counsel also urged that the amount of adjustment computed by the TPO in the order passed cannot exceed the net margin i.e. gross revenue received from the end customers less amount paid to LFIL, i.e. the amount retained by the AE in respect of the transactions. LFIL rendering sourcing services has facilitated exports by the vendors/suppliers of nearly (USD 273.4 million @ Rs.44/$) Rs. 1,202.96 crores in the relevant previous year. The AE entered into the contract with the unrelated party customers for rendering buying services at 4% to 5% of FOB value of exports. The appellant has in turn received services fee (at cost +5%) of Rs. 47.69 crores which is nearly 4% of the FOB value of the export from the AE. However, the TPO/AO in the impugned order has computed the arm's length price of the appellant by considering a mark-up of 3% on the FOB value of exports that have been facilitated by the appellant computed an adjustment of Rs 33, 59, 69, 186/-.

20. The counsel argued that the adjustment made by the TPO/AO would result in LFILF, which is only a subsidiary, ended up receiving higher amount than what has been received by the AE from third party customers in lieu of facilitating the export of finished goods. This can be noted from the fact that such adjustment proposed by the TPO/AO has resulted in the AE retaining only 1% of the FOB value of export on the entire export of Rs 1202.96 crores, with nearly 80% of the remaining consideration on FOB value of export must be borne by LFIL. The counsel for the appellant argued that since substantial functions relating to the buying services, undertaking enterprise risks, utilization of substantial assets as well as bearing L/C charges were borne primarily by the AE. Thus, the TPO/AO has erroneously held that LFIL has developed several unique intangibles and developed a supply chain management, human capital at its own risk without appreciating that the appellant was only a captive offshore service provider not undertaking any independent enterprise risk. For this line of argument, counsel relied on the judgment of the Supreme Court, reported as *DIT v. M/s Morgan Stanley & Co.*, 2007 (7) SCC 1. Revenue's contentions

21. The learned counsel for the Revenue primarily relied upon the various orders of the AO, TPO and ITAT (Delhi Bench). His submission was that LFIL was involved in performing all of the crucial functions of the transaction. Moreover, all significant risks were borne by it, and unique intangibles developed by it over a period of time were crucial to the conduct of the transactions. These intangibles included supply chain management and human capital, which were owned and maintained by LFIL, at its cost, but were not reflected adequately in the assessment/price paid for these services by the AE on account of the relationship between the parties. These intangible provided several advantages exclusively to the AE in the form of low cost, quality of the product, strategic and pricing advantage as well as enhanced profitability. Learned counsel submits that LFIL offered cost and

operational advantages including lower salaries, low cost material and low manufacturing costs, while the AE, on the other hand, had neither quantified locational saving nor had it attributed any part of its additional profit on account of locational saving to the assessee in India. The assessee, according to counsel, did not show if the AE had any technical capacity or manpower and therefore, LFIL's claim of its involvement in execution of sourcing services could not be accepted.

22. The counsel for the Revenue urged that since the AE was receiving 5% of the FOB value from the purchasers and assessee in performing crucial and critical functions with the use of tangible and unique intangibles developed over a period of time, it is only proper that LFIL must receive the majority of the receipts with regard to the execution of work. Thus, he contends that the markup should be based on the FOB value and on that basis it was argued that the orders of lower authorities were to be sustained.

23. It was lastly argued that OECD also visualizes that AEs can structure their transactions in such manner as may require close scrutiny. The TPO's task is therefore to often look behind the facts as they seem and arrive at the substance of the transaction to compute the value of the transaction. The application of the cost plus (TNMM) method by basing the return on the FOB value therefore afforded a realistic picture. If this were not the case, learned counsel submitted that income generated by LFIL's services, but credited to the AE, would fall outside the tax net, contrary to the purpose of the transfer pricing provisions. Moreover, it was argued that if such services were directly provided by LFIL, without the AE acting as an intermediary, the payment for its services would far exceed the payment it is received from the AE, which is a crucial indicator that the transaction, as it currently stands, is not at arm's length and requires interference. Thus, it was argued by learned counsel that determination of ALP and real income was sound and did not call for interference.

Discussion regarding the relevant provisions of the IT Act and Rules

24. Companies with dispersed production facilities or those trading through different units (usually in different countries), employ transfer pricing, a mechanism that involves over or undercharging for goods or services sold between branches or constituent units at a price (usually) determined by the holding company. The main objective of transfer pricing is to take advantage of differential taxation between countries, by structuring transactions such that the legal incidence for tax occurs in a jurisdiction with lower tax rates. Accordingly, the endeavor of various states, or more precisely, their tax administrators, through various transfer pricing enactments and judicial rules, is to ensure that such devices or mechanisms are not used to locate profits and income in such a manner as to shift to low tax regimes, with the tax payer's ultimate objective of reduced tax burden, when in reality the incidence of tax in

the host jurisdiction should actually be higher. Transfer pricing laws thus seek to address the tension between these competing objectives. Crucially, in India, in balancing these objectives, the precise limits of the methods and mechanics of calculating the arm's length price are provided for by the IT Act and the IT Rules made thereunder, so as to ensure certainty in these calculations rather than roving enquiries.

25. Specifically, the object behind introduction of Chapter X of the IT Act was to prevent assessees from avoiding payment of tax by transferring income yielding assets to non-residents whilst at the same time retaining the power to benefit from such transactions i.e. the income so generated. Under the original 1961 IT Act, a similar provision was found under Section 92. By Finance Act, 2001 w.e.f. 1.4.2002, Section 92 was substituted by Sections 92 to 92F, provisions in Chapter X of the Act. The Central Board of Direct Taxes ("the CBDT") by its Circular No. 14/2001 dated 12.12.2001 [2001 252 ITR (ST.) 65] spelt out the scope and effect of these provisions The rationale for substituting the existing Section 92 of the IT Act was explained in the following extract of the said Circular:

> *"55.2Under the existing section 92 of the Income Tax Act, which was the only section dealing specifically with cross border transactions, an adjustment could be made to the profits of a resident arising from a business carried on between the resident and a non-resident, if it appeared to the Assessing Officer that owing to the close connection between them, the course of business was so arranged so s to produce less than expected profits to the resident. Rule 11 prescribed under the section provided a method of estimation of reasonable profits in such cases. However, this provision was of a general nature and limited in scope. It did not allow adjustment of income in the case of non- residents. It referred to a ?close connection? which was undefined and vague. It provided for adjustment of profits rather than adjustment of prices, and the rule prescribed for estimating profits was not scientific. It also did not apply to individual transactions such as payment of royalty, etc., which are not part of a regular business carried on between a resident and a non-resident. There were also no detailed rules prescribing the documentation required to be maintained.*
>
> *55.3 With a view to provide a detailed statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multi-national enterprises, the Act has substituted section 92 with a new section, and has introduced new Sections 92A to 92F in the Income Tax Act, relating to computation of income from an international transaction having regard to the arm's length price, meaning of associated enterprise, meaning of international transaction,*

> *computation of arm?s length price, maintenance of information and documents by persons entering into international transactions, furnishing of a report from an accountant by persons entering into international transactions and definitions of certain expressions occurring in the said sections."*

26. Chapter X opens with Section 92 which provides that the income arising from "international transactions" shall be calculated having regard to the ALP. The explanation to Section 92 clarifies that allowance for any expense or interest arising from an international transaction shall also be determined having regard to the ALP. Section 92A defines as to which the enterprises would, for the purposes of the provisions of Chapter X, come within the purview of an AE. Section 92A (1) generally defines an AE as one, which is, directly or indirectly, managed and controlled by another. The one appropriate mode, amongst the several, through which control can be exercised by one enterprise on the other is provided in sub-section (2) of Section 92A. In the eventuality of an enterprise fulfilling any of the attributes provided in sub-clause (a) to clause (m), the two enterprises under Section 92A(2) is deemed to be AE. Section 92B defines as to what would be construed as an "international transaction". In order to appreciate the full width, amplitude of an "international transaction" the meaning of which is provided in section 92B one would have to in addition read the definition of "transaction" given in Section 92F(v).

27. Section 92C is the provision enabling determination of ALP. Section 92C (1) states that ALP in relation to an "international transaction could be determined by any of the methods provided in the said sub-section which is "most appropriate" having regard to the nature of transactions or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors which may be prescribed by the Board. The methods provided being (a) comparable uncontrolled price method; (b) resale price method; (c) cost plus method; (d) profit split method; (e) transactional net margin method and; (f) such other method as may be prescribed by the Board. In determining the most appropriate method, regard is to be had to Rules 10A and 10B of the IT Rules, 1962. Section92C(3) casts the obligation of computing the ALP on the assessee, at the first instance. The AO then would proceed to determine the ALP in relation to an "international transaction" in accordance with Section 92C (1) and (2) only if he is of the opinion that any of the circumstances as indicated in Section 92Cs (3)(a) to sub-clause (d) of sub-Section (3) of Section 92C prevails. These circumstances are that the price charged or paid for international transaction has not been determined as prescribed under sub- section (1) and (2) of section 92C or, the assessee has not kept information and documents of its international transactions in the form prescribed under Section 92D (1) and the Rules made in that regard or, the information or

data used by the assessee in computing the ALP is not reliable or correct or, that the assessee, failed to furnish, within the specified time the information sought pursuant to a notice issued under Section 92D (3). The first proviso to Section 92 (3) mandates that before the AO proceeds to determine the ALP on the basis of the material or information or document available with him he shall give an opportunity by serving upon the assessee a show cause notice fixing thereby a date and time for the said purpose. Under Section 92C (4) the Assessing Officer is empowered to compute the total income of the assessee only after the ALP has been determined by the Assessing Officer in terms of the provision of sub-section (3) of Section 92C.

28. Under Section 92CA (inserted w.e.f. 1.6.2002), the AO is empowered to refer the computation of ALP, in relation to, an "international transaction" under Section 92C to the TPO, if he considers it "necessary" or "expedient" to do so with the prior approval of the Commissioner. It is only after a reference is made under Section 92CA (1) that the TPO gets a mandate to approach upon the assessee by issuing him a notice calling upon him to produce or cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the ALP. Section 92CA (3) provides that the TPO, by an order in writing, will determine the ALP in relation to an "international transaction" in accordance with Section 92C (3) after hearing such evidence as the assessee may produce including any information or documents referred to in Section 92D (3), after considering such evidence as the TPO may require on any specified points, and after taking into account all relevant material which the TPO has gathered. The TPO has to send a copy of the order, by which a determination of ALP is made both to the Assessing Officer and the assessee. Section 92CA (3A) provides the time frame within which the TPO has to pass an order under Section 92CA (3).

29. Prior to the Finance Act, 2007, Section 92CA (4) read as follows: "On receipt of the order under sub-section (3), the Assessing Officer shall proceed to compute the total income of the assessee under sub-section (4) of section 92C having regard to the arm's length price determined under sub-section (3) by the Transfer Pricing Officer."

30. It would be useful to recollect that the IT Act draws heavily from the Organization for Economic Co-operation and Development Model Tax Convention's interpretation under Article 9. In terms ofArticle 9, when conditions are made or imposed between two AEs in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have so accrued, may be included in the profits to bring them to a level that would prevail when independent enterprises would enter into comparable transactions under comparable conditions. Section 92F(ii) specifically defines Arm's Length Price as a price which is applied

or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions.

31. To compute arm's length price of an assessee, several methods are prescribed under Section 92C of IT Act. As per this provision, the arm's length price in relation to an international transaction shall be determined by the 'most appropriate method' out of the prescribed methods i.e.

> a) comparable uncontrolled price method; b) resale price method; c) cost plus method; d) transactional net margin method; e) profit split method and f) any method as prescribed by the Revenue. In case where more than one price can be determined by the most appropriate method, the arm's length price calculated is the arithmetic mean of such two or more prices. Thus, the provision does not entail any preference of methods and adopts the 'best method rule'.

32. Rules 10B and 10C of the IT Rules prescribe different measures on application of the methods prescribed for calculation of the arm's length price. In terms of Rule 10B (1)(e), while applying the TNMM, the normal margin of profit that is expected in the same line of trade forms the basis of turnover of either purchases or sales, whichever is considered more reliable. It examines the net profit margin relative to an appropriate base that a tax payer realizes from a controlled transaction and compares the profitability of either of the controlled parties with the profitability of the uncontrolled comparables. The net profit envisioned has to be computed with reference to the cost incurred or sales effected or assets employed or required to be employed by the enterprise or having regard to any other relevant base indicating that determination of the net profit is not a matter which can be carried out on an ad hoc basis.

33. Accordingly, Rule 10B(1)(e) prescribes, in detail, the steps to be undertaken while applying the TNNM method: first, one must compute the net profit margin of the assessee with the reference to the sales, costs, assets or any other relevant base. The net profit margin from an external (or internal) comparable (as discussed below) is then calculated, which is subsequently adjusted for factors materially affecting profit. This profit margin is then worked out after such adjustments is treated as the actual margin of profit, and added to the cost/other relevant base to arrive at the ALP.

34. The OECD Guidelines, which are instructive in such cases, clarify that any attempt to use TNMM should begin by comparing the net margin which the tested party makes from a controlled transaction with the net margin it makes from an uncontrolled one (an "internal comparable"). If this proves impossible, possibly if there are no transactions with uncontrolled parties, then the net margin which would have been made by an independent enterprise in a comparable

transaction (an "external comparable") serves as a guide to determine the ALP. Here, the strict criterion is of an independent enterprise, carrying out a comparable transaction, with the caveat that this will be only a guide. Indeed, the emphasis is very clearly on finding a comparable transaction. In addition, a functional analysis of both the associated enterprise and the independent enterprise is required to determine if the transactions are comparable. It might of course be possible to adjust results for minor functional differences, provided that there is sufficient comparability to begin with, The standard of comparability for application of TNMM is no less than that for the application of any other transfer pricing method.

35. The ITS 2009 Transfer Pricing Guidelines accepted by the OECD state, inter alia, that when an associated enterprise acts only as an agent or intermediary in the provision of the service, it is important in applying the cost plus method that, in the ultimate analysis, the return or mark-up is appropriate for the performance of the agency function rather than for the performance of services themselves. Rule 3.41 of the Transfer Pricing Guidelines 2009 state that in applying the TNMM, various considerations should influence the choice of margin used. These include the reliability of the value of assets employed in the calculations is measured and the factors affecting whether specific costs should be passed through, marked up or excluded entirely from the calculation. Under Rule 2.134, while applying a cost based transactional net margin method, fully loaded costs are often used, including all the direct and indirect costs attributable to the activity or transaction, together with an appropriate allocation in respect of the overheads of the business. It should not be based on the classification of costs as internal or external, but rather on comparability (including functional) analysis, and in particular on a determination of the value added by the tested party in relation to those costs. Rule 7.36 of the Guidelines, further state that when an associated enterprise is acting only as an agent or intermediary in the provision of services, it is important in applying the cost plus method that the return or mark-up is appropriate for the performance of an agency function rather than performance of the services themselves. In such a case it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services should be lower than would be appropriate for the performance of services themselves.

36. The appellant, during the relevant assessment year, entered into international transactions of buying services for sourcing of garments, handicrafts, leather products etc. in India for its affiliate, the AE, and was paid service charges of 5% of cost plus mark up incurred for providing these services. The assessee had worked out the arm's length of international transaction by applying TNMM by company operating profit margin of 26 companies and assessee's OP/OC taken at 5.17%.

37. The tax authorities – i.e. the TPO, and the AO (as well as the DRP) and the Tribunal accepted the application of TNMM by LFIL as "the most appropriate" one. Nevertheless, they did not consider the cost plus compensation at 5% at arm's length. The reasoning for not doing so was that LFIL was performing all critical functions, assuming significant risks and used both tangibles and intangibles developed by it over a period of time. Reliance was placed upon the technical capacity, manpower, low cost of product, quality of product in India available to the assessee and the enhanced profit potential the AE. The tribunal held that the cost plus 5% mark up is definitely not on the arms length while working out the compensation for the services rendered by LFIL to the associated enterprise and mark up on the FOB value of the goods sourced through the assessee shall be the most appropriate method for calculation of arm's length price.

38. In scrutinizing Transfer Pricing documents, the TPO undertakes an exercise known as "FAR" (functions performed, assets owned and risks assumed by the associated enterprises involved). This analysis plays a critical role in determining the arm's length price of an international transaction entered into between AEs. The FAR analysis defines roles, responsibilities and risks assumed by the parties involved providing steadfast pointers into the underlying economic substance of the transactions. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations too recognize the importance of FAR in the transfer pricing context, with the arm's length compensation between AEs reflecting the functions that each enterprise performs (taking into account the assets used and the risks assumed by either party).In this case, what prevailed with the TPO and all other authorities was the circumstance that LFI, i.e. the assessee, according to them, performed all the critical functions, assumed significant risks and used both tangibles and unique intangibles developed by it over a period of time. These intangibles included supply chain management which is important to achieve the strategic and pricing advantage, as well as human intangibles in the form of technical capacity and owned manpower to perform the critical functions. It was further held that the assessee had performed all critical functions, assumed significant risks and also developed significant supply chain intangibles in India and Li & Fung HK, the AE did not have either any technical expertise or manpower to carry out the sourcing activities in Hong Kong.

39. The TPO's determination enhanced LFIL's cost base for applying the operating profit over total cost margin. LFIL's compensation model is based on functions performed by it and the operating costs incurred by it and not on the cost of goods sourced from third party vendors in India. Allotting a margin of the value of goods sourced by third party customers from Indian exporters/vendors to compute the appellant's profit is unjustified. This Court is of opinion that to apply the TNMM, the

assessee's net profit margin realized from international transactions had to be calculated only with reference to cost incurred by it, and not by any other entity, either third party vendors or the AE. Textually, and within the bounds of the text must the AO/TPO operate, Rule 10B(1)(e) does not enable consideration or imputation of cost incurred by third parties or unrelated enterprises to compute the assessee's net profit margin for application of the TNMM. Rule 10B(1)(e) recognizes that "the net profit margin realized by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise ..." (emphasis supplied). It thus contemplates a determination of ALP with reference to the relevant factors (cost, assets, sales etc.) of the enterprise in question, i.e. the assessee, as opposed to the AE or any third party. The textual mandate, thus, is unambiguously clear.

40. The TPO's reasoning to enhance the assessee's cost base by considering the cost of manufacture and export of finished goods, i.e., ready-made garments by the third party venders (which cost is certainly not the cost incurred by the assessee), is nowhere supported by the TNMM under Rule 10B(1)(e) of the Rules. Having determined that (TNMM) to be the most appropriate method, the only rules and norms prescribed in that regard could have been applied to determine whether the exercise indicated by the assessee yielded an ALP. The approach of the TPO and the tax authorities in essence imputes notional adjustment/income in the assessee's hands on the basis of a fixed percentage of the free on board value of export made by unrelated party venders.

41. LFIL, in the Transfer Pricing documentation, established the international transactions of rendering buying services to be at the arm's length price having regard to the operating profit margin of comparable companies having similar functional profile. LFIL's computation of the operating profit margin (OP/TC per cent) by enhancing the cost base, i.e., by increasing the cost of the sales facilitated by LFIL leads to an arbitrary adjustment of its income, as such an alteration resides plainly outside the Rules and the provisions of the Act.

42. Moreover, there is considerable merit in the submission that the (finding of the) lower authorities, including the Tribunal, misdirected themselves in holding that LFIL assumed substantial risk. Whilst this Court would neither state that LFIL performed functions with a limited risk component, as it does not engage itself in manufacturing of garments (which is LFIL's stance), apart from broad assumptions made by the Revenue, no material on record testifies to that fact such that it can be the basis for an ALP adjustment. Indeed, LFIL has neither made investment in the plant, inventory, working capital, etc., nor does it claim to have any expertise in the manufacture of garments. More importantly, and given no material to the contrary, LFIL does not bear the enterprise

risk for manufacture and export of garments. LFIL's functional and risk profile thus is entirely different and has nothing to do with the manufacture and export of garments by unrelated third party vendors. Simply put, LFIL renders support services in relation to the exports, which are manufactured independently. Thus, attributing the costs of such third party manufacture, when LFIL does not engage in that activity, and more importantly, when those costs are clearly not LFIL's costs, but those of third parties, is clearly impermissible. A contrary conclusion would amount to treating it (the appellant) as the vendor/ exporters' partner in their manufacturing business – a completely unwarranted inference.

43. Indeed, having done the work, LFIL has developed experience and expertise which the Tribunal has held to be human capital and supply chain intangibles. But such description does not in any way reveal how the appellant bears any risk - either enterprise or economic. LFIL's remuneration on a cost plus mark-up of 5 per cent represents the functions performed, assets utilized and risks assumed by it.

Further, the TPO's determination that LFIL bore significant risks is not borne out from the records. In transactions in which LFIL was a party, it did not bear any financial risk. To the contrary, its costs towards establishment, transportation, salaries, etc. were fully reimbursed, and it was insulated from any economic or financial downside to any particular transaction. In other words, its remuneration was based entirely on the costs borne by it. In essence, it is a low risk contract service provider exclusively rendering sourcing support to the AE. It does not bear any significant operational risks for its functions, rendered to the third party vendor/customers. Rather, it is the AE that undertakes substantial functions and in fact assumes enterprise risks, such as market risk, credit risk etc. It also bears the letter of credit associated charges and other expenses.

44. Another important aspect which cannot be overlooked is that the the transfer pricing documentation maintained in terms of section 92D of the Act read with rule 10B of the Income-tax Rules, determined the arm's length price of the "international transaction" of the provision of buying services applying the TNMM, by comparing operating profit margin of LFIL with that of the comparable companies, as under:

Weighted average OP/OC per cent. of 26 comparable companies	4.07 per cent.
OP/OC per cent. of LFIL	5.17 er cent.

This exercise has not been discarded. In other words, the TPO and the appellate fora were aware that in accordance with the rules, a comparison of the profit margin of LFIL with that of other similarly functioning companies was shown, and is, at the first instance, relevant to determine the ALP. The profit margin, as well as the cost plus model adopted by LFIL, was not shown to be distorted or of such magnitude as to persuade the tax authorities into discarding the exercise altogether. Having not contradicted this comparison, the Revenue proceeded to its own determination and calculations. This, however, is improper, given that the assessment carried out by the assessee must first be rejected, for any further alterations to take place. Indeed, it cannot be that the Revenue admits to the correctness of LFIL's assessment but nonetheless proceeds to adopt a different method.

45. Indeed, once the TNMM was deemed most appropriate method, the distortions, if any, had to be addressed within its framework. Here, the unrelated transactions which were compared by LFIL have not been adversely commented upon, and neither has the choice of the TNMM. The TPO, therefore, ignored the relevant and crucial material, and straightaway proceeded to broaden the base for arriving at the profit margin, for attributed income of the assessee. Not only is this a clear infraction of the terms of the Act and Rules; the TPO went ahead to introduce what is clearly alien to the provisions of law and traveled outside the Rules.

46. The assessee had argued that no such adjustment was made in the earlier assessment years, for which assessment orders of previous four years were submitted, wherein the TNMM with operating profit over total cost (OP/TC) as a profit level indicator was accepted previously. Reliance was placed on decisions of the Supreme Court in Radhasoami Satsang (supra) and *CIT v. New Poly Pack* (supra) to support the aforementioned argument. Although previous tax assessments do not bar subsequent claims as res judicata, each assessment must be justified on its own terms, and as detailed above, the assessment by the TPO/AO, and the subsequent acceptance of these methods by the appellate authorities, is inconsistent with the IT Rules and the IT Act.

47. At this point, it is useful to note that the TPO is required to scrutinize the various methods that may be employed to evaluate their appropriateness, the correctness of the data, consideration of surrounding factors, etc. The selection of the most appropriate method will depend upon the facts of the case and factors mentioned in rules contained in Rule 10C. It would be useful here to refer to two circulars issued by the CBDT, which prescribe the ground rules defining the powers and jurisdiction of the tax authorities and administrators:

> Circular No. 12 dated 23rd August, 2001 reads as follows:
>
> *"The aforesaid provisions have been enacted with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profit and tax in India so that the profits chargeable to tax in India do not get diverted elsewhere by altering the prices charged and paid in intra-group transactions leading to erosion of our tax revenues.*

…………….. …………………..

(iii) it should be made clear to the concerned Assessing officer s that where an international transaction has been put to a scrutiny, the Assessing officer can have recourse to Sub-section (3) of section 92C only under the circumstances enumerated in Clauses (a) to (d) of that sub-section and in the event of material information or documents in his possession on the basis of which an opinion can be formed that any such circumstance exists. In all other cases, the value of the international transaction should be accepted without further scrutiny."

The following portions of Circular No. 14 are relevant:

"The relevant portions of Circular No. 12 may be usefully referred to as under the new provision is intended to ensure that profits taxable in India are not understated (or losses are not over stated) by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances.

The basic intention underlying the new transfer pricing regulations is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base. The new section 92 is, therefore, no intended to be applied in cases where the adoption of the Arm's length Price, determined under the regulations would result in a decrease in the overall tax incidence in India in respect of the parties involved in the international transaction.

Under the new provisions the primary onus is on the taxpayer to determine an Arms length Price in accordance with the rules, and to substantiate the same with the prescribed documentation. Where such onus is discharged by the assessee and the data used for determining the Arms length price is reliable and correct there can be no intervention by the Assessing officer. This made clear by sub section (3) of Section 92C of the Income-tax Act which provides that the Assessing officer may intervene only if he is, on the basis of material or information or document in his possession, of the opinion that the price charged in international transaction has not been determined in accordance with sub section (1) and (2) or information and documents relating to the international transaction have not been kept and are maintained by the assessee in accordance with the provisions contained in sub section (1) of section 92D of the Income-tax Act and the rules made there under; or the information or data used in computation of the Arms length price is not reliable correct; or the assessee has failed to furnish, within the specified time, any information or document which he *was required to furnish by a notice issued under sub section (3) of section 92D. If any one of such circumstances exists, the Assessing officer may reject the price adopted by the assessee and determine the Arms length Price in accordance with the same rules."*

48. The TPO after taking into account all relevant facts and data available to him has to determine arm's length price and pass a speaking order after obtaining the approval of the Department of Income Tax (Transfer Pricing). The order should contain details of data used, reasons for arriving at a certain price and applicability of methods, subject to judicial scrutiny. The order of the TPO, in the instant case, has not provided any substantive reasons for disregarding the TNM method as applied by LFIL. Further, the TPO's arbitrary exercise of adjusting the cost plus mark up of 5% on the FOB value of exports finds no mention in the IT Act nor the Rules. Such an exercise of discretion by the TPO, disregarding the LFIL's lawful tax planning measures with its group companies, is not in compliance with the IT Act and Rules of Income Tax.

49. This court summarizes its conclusions as follows:

(a) The broad basing of the profit determining denominator as the entire FOB value of the contracts entered into by the AE to determine the LFIL's ALP, as an "adjustment", is contrary to provisions of the Act and Rules;

(b) The impugned order has not shown how, and to what extent, LIFIL bears "significant" risks, or that the AE enjoys such locational advantages, as to warrant rejection of the Transfer pricing exercise undertaken by LFIL;

(c) Tax authorities should base their conclusions on specific facts, and not on vague generalities, such as "significant risk", "functional risk", "enterprise risk" etc. without any material on record to establish such findings. If such findings are warranted, they should be supported by demonstrable reason, based on objective facts and the relative evaluation of their weight and significance.

(d) Where all elements of a proper TNMM are detailed and disclosed in the assessee's reports, care should be taken by the tax administrators and authorities to analyze them in detail and then proceed to record reasons why some or all of them are unacceptable.

(e) The impugned order, upholding the determination of 3% margin over the FOB value of the AE's contract, is in error of law.

50. In light of the above circumstances, this Court is of the opinion that the TPO's addition of the cost plus 5% markup on the FOB value of exports among third parties to LFIL's calculation of arm's length price using the TNMM is without foundation and liable to be deleted. The

appeal is allowed and the order dated 25/11/11 of the ITAT Tribunal, Delhi Branch is liable to be and is accordingly set aside. The questions of law framed are answered in favour of the assessee, and against the revenue. The appeal is allowed in the above terms.

2013 TRI 2086 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
BANGALORE SPECIAL BENCH, BANGALORE

H.L. Karwa, President,
R.S. Syal, Accountant Member and
N.V. Vasudevan, Judicial Member

FACTS/HELD

SOP discount (difference between market price and issue price) is a deductible expenditure at the time of vesting of the option. An adjustment has to be made if the market price is different at the time of exercise of the option

1. The assessee framed an Employee Stock Option Plan (ESOP) pursuant to which it granted options to its employees to subscribe for shares at the face value of Rs. 10. As the market price of each share was Rs. 919, the assessee claimed that it had given a discount of Rs. 909 which was allowable as a deduction as 'employee compensation. Though the options vested equally over four years, the assessee claimed a larger amount in the first year than was available under the SEBI guidelines. The AO & CIT(A) rejected the claim on the ground that there was no "expenditure". On appeal to the Tribunal, the issue was referred to the Special Bench. HELD by the Special Bench:

(i) The difference (discount) between the market price of the shares and their issue price is "expenditure" in the hands of the assessee because it is a substitute to giving direct incentive in cash for availing the services of the employees. There is no difference between a case where the company issues shares to the public at market price and pays a part of the premium to the employees for their services and another where the shares are directly issued to employees at a reduced rate. In both situations, the employees stand compensated for their effort. By undertaking to issue shares at a discount, the company does not pay anything to its employees but incurs the obligation of issuing shares at a discounted price at a future date. This is nothing but "expenditure" u/s 37(1);

(ii) The liability cannot be regarded as being "contingent" in nature because the rendering of service for one year is sine qua non for becoming eligible to avail the benefit under the scheme. Once the service is rendered for one year, it becomes obligatory on the part of the company to honor its commitment of allowing the vesting of 25% of the option. The liability is incurred at the end of the first year though it is discharged at the end of the fourth year when the options are exercised by the employees. The fact that some options may lapse due to non-exercise/ resignation etc does not make the entire liability contingent;

(iii) However, the obligation to issue shares at a discounted premium does not arise at the stage the options are granted. It arises at the stage that the options are vested in the employees. The amount deductible has to be determined based on the period and percentage of vesting under the ESOP scheme;

(iv) There is likely to be a difference in the quantum of discount at the stage of vesting of the stock options (when the deduction is allowable) and at the stage of exercise of the options. The difference has to be adjusted by making suitable northwards or southwards adjustment at the time of exercise of the option depending on the market price of the shares then prevailing. The fact that the SEBI Guidelines do not provide for the adjustment of discount at the time of exercise of options is irrelevant because accounting principles cannot affect the position under the Income-tax Act.

(v) On facts, the assessee's method of claiming a larger deduction in the first year defies logic. As the options vest equally over a period of four years, the deduction ought to be claimed in four equal installments on a straight line basis (Ranbaxy Laboratories 124 TTJ 771 (Delhi) reversed, S.S.I. Ltd. v. DCIT 85 TTJ 1049 (Chennai) approved, PVP Ventures 211 Taxman 554 referred. See also Spray Engineering Devices Ltd 53 SOT 70 (Chd)

Order accordingly.

ITA Nos. 368, 369, 370, 371 & 1206/Bang/2010 (Assessment Years : 2003-2004, 2004-2005, 2005-2006, 2006-2007 & 2007-2008) and ITA No. 248/Bang/2010 (Assessment Year : 2004-2005).

Heard on: 27th & 28th June, 2013.

Decided on: 16th July, 2013.

Present at hearing: Padam Chand Khincha, for Appellant. S.K. Ambastha - CIT(DR), for Respondent in ITA Nos.368, 369, 370, 371 & 1206/Bang/2010. S.K. Ambastha - CIT(DR), for Appellant. Padam Chand Khincha, for Respondent in ITA No. 248/Bang/2010.

JUDGMENT

Per R.S. Syal:– (Accountant Member)

The Hon'ble President of the Income Tax Appellate Tribunal has, on a reference made by a Division Bench, constituted this Special Bench for adjudicating the following question of law:

> *"Whether discount on issue of Employee Stock Options is allowable as deduction in computing the income under the head profits and gains of business?"*

2. Since the subject matter of the above question is emanating in almost all the appeals under consideration, for the sake of convenience, we are taking up the factual matrix from the assessment year 2003-2004, which is the first year under reference and for which the leading orders have been passed by the authorities below. Both the sides have also broadly chosen to make submissions with reference to the facts, findings and conclusions drawn in the orders for the assessment year 2003-2004 in which the assessee claimed deduction on account of Employees Compensation under Employees Stock Option Plan (hereinafter called 'the ESOP') for the first time.

3. Briefly stated the facts of the case are that the assessee is engaged in the manufacture of Enzymes and Pharmaceutical ingredients. It formulated the ESOP 2000. A trust was set up under the name and style of "Biocon India Limited Employees Welfare Trust" for giving effect to the ESOP 2000 and another ESOP 2004 which was launched subsequently but during one of the years under consideration. The assessee claimed deduction of Rs. 3,38,63,779 as 'Employee compensation cost' u/s 37 of the Income-tax Act, 1961 (hereinafter called 'the Act') representing discount under the ESOP 2000. In the assessment completed u/s 143(3), the Assessing Officer (hereinafter also called 'the AO') disallowed the said claim on the ground that there was no specific provision entitling the assessee to deduction u/s 37(1) in this regard. He further held that the

Securities and Exchange Board of India (Employee Stock Option Scheme And Employee Stock Purchase Scheme) Guidelines, 1999 (hereinafter called 'the SEBI Guidelines' or 'the Guidelines'), on which the assessee had placed strong reliance in support of the deduction, would not apply as these cannot supersede the taxing principles. Thereafter, a notice u/s 148 was issued and an order dt. 19.12.2008 was passed u/s 143(3) read with section 147. In this order, the Assessing Officer held that the assessee was not entitled to weighted deduction u/s 35(2AB) on the expenditure incurred on software research. This view was canvassed on the premise that in the original order he had held that the expenditure in respect of ESOP was not deductible u/s 37(1), and in that view of the matter there was no point in allowing the weighted deduction on the claim of the assessee for ESOP expenses on account of employees engaged in research activities. He, therefore, made disallowance of Rs. 16.92 lakh in this regard. In the appeal against the said order passed u/s 143(3) read with section 147, the assessee, *inter alia*, assailed the said disallowance of Rs. 16.92 lakh. The learned CIT(A), vide the impugned order dated 13.11.2009, upheld the disallowance of ESOP expenditure of Rs. 3.38 crore, which forms the subject matter of the question before the special bench.

4. Before proceeding further, we want to clarify that the disallowance of Rs. 3.38 crore was made in the original assessment order passed u/s 143(3). As this disallowance stood already made, there could have been no question of taking up this issue again in the reassessment order, which was, *inter alia*, confined to denial of weighted deduction u/s 35(2AB) towards ESOP expenses incurred in relation to employees engaged in software research. Since the learned CIT(A) has decided the question of disallowance of ESOP expenditure of Rs. 3.38 crore in the impugned order, we are refraining from expressing any opinion on the sustainability or otherwise of his action in taking up an issue for decision which did not arise from the order impugned before him. This issue is left to the wisdom of the Division Bench which will pass order on the instant appeals involving other issues as well, having regard to the decision of the special bench on the question reproduced above.

5. Reverting to the question of law posted before us, the facts for the assessment year 2003-2004 are that the assessee-company floated ESOP 2000 under which it granted option of shares with face value of Rs. 10 at the same rate by claiming that the market price of such shares was Rs. 919, thereby claiming the total discount per option at Rs. 909. During the previous year relevant to the assessment year 2003-04, the appellant company granted 71,510 options to its employees. The difference between the alleged market price and the exercise price, at Rs. 909 per option totaling Rs. 6.52 crore was claimed as compensation to the employees to be spread over the vesting period of four years. A deduction of Rs. 3.38 crore was claimed for the assessment year 2003-2004 on the strength of

the SEBI Guidelines. It was argued that the claim for deduction was in conformity with the accounting treatment prescribed as per the Schedule I of the Guidelines. The assessee claimed that the employee stock option compensation expense of Rs. 3.38 crore was deductible u/s 37(1) of the Act as all the requisite conditions were satisfied. To bolster its submission that the amount should be allowed as deduction in accordance with the SEBI Guidelines, the assessee relied on the judgment of the Hon'ble Supreme Court in the case of *Challapalli Sugar Ltd. v. CIT* (1975) 98 ITR 167 (SC) and *CIT v. U.P. State Industrial Development Corporation* (1997) 225 ITR 703 (SC) by contending that these judgments are authorities for the proposition that the accountancy rules also guide the deductibility or otherwise of expenses in the computation of total income. The assessee chiefly relied on the direct order on the issue passed by the Chennai Bench of the Tribunal in the case of *S.S.I. Ltd. v. DCIT* (2004) 85 TTJ (Chennai) 1049 upholding the claim for deduction of discount under ESOP on the basis of the SEBI Guidelines.

6. The authorities below did not accept the assessee's contention of the supremacy of the accounting principles for the purposes of computation of total income. Reliance in this regard was placed on the judgment of the Hon'ble Supreme Court in the case of *Tuticorin Alkali Chemicals & Fertilizers Ltd. v. CIT* (1997) 227 ITR 172 (SC) and *Godhra Electricity Co. Ltd. v. CIT* (1997) 225 ITR 746 (SC). It was noticed that all the options vested over a period of four years from the date of its grant. The physical custody of shares was not with the employees but rested with the trust. The trust was empowered to transfer back the same where the conditions precedent for ESOP were not fulfilled. The options received by the employees were subject to risk of its forfeiture as the eligible employees were required to fulfill number of conditions in an ongoing manner before becoming absolutely entitled to such shares. It was further noticed that the vesting period in this case was four years and an employee must continue to remain in employment so as to be eligible for deduction. In the backdrop of these facts, it was opined that the deduction could be allowed only in respect of real expenditure and not the hypothetical or notional or imaginary expenditure. As no actual expenditure was incurred, the claim for such deduction was denied. The decision in the case of SSI Ltd. (supra) was also distinguished as not applicable to the facts and circumstances of the assessee's case. The assessee is aggrieved against the denial of deduction for discount under ESOP.

7. We have heard Shri H. Padam Chand Khincha for the appellantassessee; Shri Rohit Jain for the Intervener, M/s. Bharti Airtel; Shri Sachin Kumar B.P. for the Intervener, M/s. Advinus Therapeatics Limited ; and Shri K.R.Pradeep for the Intervener, M/s. NDTV Media Limited, (all the four counsel are hereinafter collectively referred to as 'the ld. AR'). We have also heard Shri S.K.Ambastha, the ld. CIT

representing the Revenue. The moot question is as to whether the Discounted premium on ESOP also called as the Discount on issue of ESOP or the Employee stock option compensation expense or the Employees compensation expense or simply the Discount etc., is an allowable deduction in the computation the income under the head "Profits and gains of business or profession"? This larger question can be answered in the following three steps, viz.,

I. Whether any deduction of such discount is allowable ?

II. If yes, then when and how much?

III. Subsequent adjustment to discount

8. We will take up these three steps one by one for consideration and decision.

I. <u>WHETHER ANY DEDUCTION OF SUCH DISCOUNT IS ALLOWABLE ?</u>

9.1. The crux of the arguments put forth by the ld. AR is that discount under ESOP is nothing but employees cost incurred by the assessee for which deduction is warranted. On the other hand, the Revenue has set up a case that no deduction can be allowed as such discount is not only a short capital receipt but also a contingent liability.

<u>A. Is discount under ESOP a short capital receipt?</u>

9.2.1. The ld. DR stated that the question of deduction u/s 37 can arise only if the assessee incurs any expenditure, which thereafter satisfies the requisite conditions of the sub-section (1). He submitted that the word "expenditure" has been described by the Hon'ble Supreme Court in the case of *Indian Molasses Co. Ltd. v. CIT* [(1959) 37 ITR 66 (SC)] as denoting spending or paying out, i.e. something going out of the coffers of the assessee. It was put forth that by issuing shares at discounted premium, nothing is paid out by the company. Once there is no "paying out or away", the same cannot constitute an expenditure and resultantly section 37(1), which applies to only expenditure, cannot be activated. He further took pains in explaining that there is no revenue expenditure involved in the transaction of issuance of ESOP at discount. The so called 'discount' represents the difference between market price of the shares at the time of grant of options and the price at which such options are granted. Since the amount over and above the face value of the shares, being the share premium, is itself a capital receipt, any underrecovery of such share premium on account of obligation to issue shares to employees in future at a lower premium, would be a case of short capital receipt. If at all it is to be viewed in terms of expenditure, then, at best, it would be in the nature of a capital expenditure. He supported his view by relying on the order passed by the Delhi Bench of the Tribunal in *Ranbaxy Laboratories Limited v. Addl. CIT* [ITA Nos. 1855 & 3387/Del/2004] on 12.06.2009. It was stated that the Tribunal in that case has held that since the receipt of share premium is not taxable, any short receipt of such premium on issuing options to employees will be notional loss and not actual loss for which any liability is incurred. The learned Departmental Representative contended that the Mumbai bench of the Tribunal in the case of *VIP Industries v. DCIT* (ITA No.7242/Mum/2008) has also taken similar view vide its order dated 17.09.2010.

9.2.2. Per contra, the learned AR submitted that it is not a case of any short receipt of share premium but that of compensation given to employees. He supported the admissibility of deduction of the amount of discount on the strength of the order passed by the Chennai bench of the tribunal in the case of SSI Limited (supra) granting deduction of such discount by treating it as an employee cost. He submitted that the above view taken by the Chennai Bench has been approved by the Hon'ble Madras High Court in *CIT v. PVP Ventures Limited* vide its judgment dated 19.06.2012. The learned AR argued that PVP Ventures (supra) is a solitary judgment rendered by any High Court on the issue and hence the same needs to be followed in preference to any contrary Tribunal order. It was also pointed out that the Chennai bench's view has been subsequently followed by the Chandigarh Bench of the Tribunal in *ACIT v. Spray Engineering Devices Limited* ITA No.701/Chd/2009 vide its order dated 22.06.2012.

9.2.3. Let us examine the facts of the case of Ranbaxy Laboratories Limited (supra), which has been strongly relied by the learned Departmental Representative. It deals with a situation in which the assessee granted stock option to its employees. The shares were to be issued at Rs. 559 per share as against the face value of Rs. 10 and the market price on the date of grant at Rs. 738.95 per share. The assessee treated the difference between Rs. 738.95 and Rs. 595 as employees compensation in the books of account and charged the same to its Profit and loss account by spreading it over the vesting period. It was one of the years of the vesting period for which the assessee claimed deduction that came up for consideration before the Tribunal. It was held by the Tribunal that the market price of Rs. 738.55 per share would have resulted in realization of higher share premium. Since the assessee did not account for the difference between Rs. 738.55 and Rs. 10 as its income during the year, there was no loss of income. It was further noticed that by issuing shares at below the market price, there was no incurring of any expenditure. Rather it resulted into short receipt of share premium which the assessee was otherwise entitled to. As the receipt of share premium is not taxable, any short receipt of such premium will only be a notional loss and not actual loss requiring any deduction. The Tribunal further noticed that incurring of such notional loss cannot be considered as expenditure within the meaning of section 37(1) as there was no "spending" or "paying out or away". The contention of the assessee that SEBI Guidelines recommend claim for deduction of discount over the vesting period, did not find favour with the Tribunal on the ground that the SEBI Guidelines were not relevant in determining the total income chargeable to tax.

9.2.4. In order to appreciate the rival submissions, it is of the utmost importance to understand the concept of ESOP. Section 2(15A) of the Indian Companies Act, 1956 defines "employee stock option" to mean '*the option given to the whole-time Directors, Officers or employees of a company, which gives such Directors, Officers or employees, the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a predetermined price*". In an ESOP, the given company undertakes to issue shares to its employees at a future date at a price lower than the current market price. This is achieved by granting stock options to its employees at discount. The amount of discount represents the difference between market price of the shares at the time of the grant of option and the offer price. In order to be eligible for acquiring the shares under the ESOP, the concerned employees are obliged to render services to the company during the vesting period as given in the scheme. On the completion of the vesting period in the service of the company, such options vest with the employees. The options are then exercised by the employees by making application to the employer for the issue of shares against the options vested in them. The gap between the completion of vesting period and the time for exercising the options is usually negligible. The company, on the exercise of option by the employees, allots shares to them who can then freely sell such shares in the open market subject to the terms of the ESOP. Thus it can be seen that it is during the vesting period that the options granted to the employees vest with them. This period commences with the grant of option and terminates when the options so granted vest in the employees after serving the company for the agreed period. By granting the options, the company gets a sort of assurance from its employee for rendering uninterrupted services during the vesting period and as a *quid pro quo* it undertakes to compensate the employees with a certain amount given in the shape of discounted premium on the issue of shares.

9.2.5. The core of the arguments of the ld. DR in this regard is two-fold. First, that it is not an expenditure in itself and secondly, it is a short capital receipt or at the most a sort of capital expenditure. In our considered opinion both the legs of this contention are legally unsustainable.

9.2.6. There is no doubt that the amount of share premium is otherwise a capital receipt and hence not chargeable to tax in the hands of company. The Finance Act, 2012 has inserted clause (viib) of section 56(2) w.e.f. 1.4.2013 providing that: 'where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares', then such excess share premium shall be charged to tax under the head 'Income from other sources'. But for that, the amount of share premium has always been understood and accepted as a capital receipt. If a company issues shares to the public or the existing shareholders at less than the otherwise prevailing premium due to market sentiment or otherwise, such short receipt of premium would be a case of a receipt of a lower amount on capital account. It is so because the object of issuing such shares at a lower price is nowhere directly connected with the earning of income. It is in such like situation that the contention of the learned Departmental Representative would properly fit in, thereby debarring the company from claiming any deduction towards discounted premium. It is quite basic that the object of issuing shares can never be lost sight of. Having seen the rationale and modus operandi of the ESOP, it becomes out-and-out clear that when a company undertakes to issue shares to its employees at a discounted premium on a future date, the primary object of this exercise is not to raise share capital but to earn profit by securing the consistent and concentrated efforts of its dedicated employees during the vesting period. Such discount is construed, both by the employees and company, as nothing but a part of package of remuneration. In other words, such discounted premium on shares is a substitute to giving direct incentive in cash for availing the services of the employees. There is no difference in two situations viz., one, when the company issues shares to public at market price and a part of the premium is given to the employees in lieu of their services and two, when the shares are directly issued to employees at a reduced rate. In both the situations, the employees stand compensated for their effort. If under the first situation, the company, say, on receipt of premium amounting to Rs. 100 from issue of shares to public, gives Rs. 60 as incentive to its employees, such incentive of Rs. 60 would be remuneration to employees and hence deductible. In the same way, if the company, instead, issues shares to its employees at a premium of Rs. 40, the discounted premium of Rs. 60, being the difference between Rs. 100 and Rs. 40, is again nothing but a different mode of awarding remuneration to employees for their continued services. In both the cases, the object is to compensate employees to the tune of Rs. 60. It follows that the discount on premium under ESOP is simply one of the modes of compensating the employees for their services and is a part of their remuneration. Thus, the contention of the ld. DR that by issuing shares to employees at a discounted premium, the company got a lower capital receipt, is bereft of an force. The sole object of issuing shares to employees at a discounted premium is to compensate them for the continuity of their services to the company. By no stretch of imagination, we can describe such discount as either a short capital receipt or a capital expenditure. It is nothing but the employees cost incurred by the company. The substance of this transaction is disbursing compensation to the employees for their services, for which the form of issuing shares at a discounted premium is adopted.

9.2.7. Now we espouse the second part of the submission of the ld. DR in this regard. He canvassed a view that an expenditure denotes "paying out or away" and unless the money goes out from the assessee, there can be no expenditure so as to qualify for deduction u/s 37. Sub-section (1) of the section provides that any expenditure (not being expenditure in the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession". To put it differently, an expenditure must be laid out or expended wholly and exclusively for the purpose of business so as to be eligible for deduction u/s 37(1). There is absolutely no doubt that section 37(1) talks of granting deduction for an 'expenditure', and the Hon'ble Supreme Court in Indian Molasses Company (supra) has described 'expenditure' to mean what is 'paid out or away' and is something which has gone irretrievably. However, it is pertinent to note that this section does not restrict paying out of expenditure in cash alone. Section 43 contains the definition of certain terms relevant to income from profits of business or profession covering sections 28 to 41. Section 37 obviously falls under Chapter IV-D. Sub-section (2) of section 43 defines "paid" to mean: "actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under the head 'profits and gains of business or profession'." When we read the definition of the word "paid" u/s 43(2) in juxtaposition to section 37(1), the position which emerges is that it is not only paying of expenditure but also incurring of the expenditure which entails deduction u/s 37(1) subject to the fulfillment of other conditions. At this juncture, it is imperative to note that the word 'expenditure' has not been defined in the Act. However, sec. 2(h) of the Expenditure Act, 1957 defines 'expenditure' as : 'Any sum of money or money's worth spent or disbursed or for the spending or disbursing of which a liability has been incurred by an assessee……'. When section 43(2) of the Act is read in conjunction with section 37(1), the meaning of the term 'expenditure' turns out to be the same as is there in the aforequoted part of the definition under section 2(h) of the Expenditure Act, 1957, viz., not only 'paying out' but also 'incurring'. Coming back to our context, it is seen that by undertaking to issue shares at discounted premium, the company does not pay anything to its employees but incurs obligation of issuing shares at a discounted price on a future date in lieu of their services, which is nothing but an expenditure u/s 37(1) of the Act.

9.2.8. Though discount on premium is nothing but an expenditure u/s 37(1), it is worth noting that the Hon'ble Supreme Court in the case of

CIT v. Woodward Governor India (P) Limited [(2009) 312 ITR 254 (SC)] has gone to the extent of covering "loss" in certain circumstances within the purview of "expenditure" as used in section in 37(1). In that case, the assessee incurred additional liability due to exchange rate fluctuation on a revenue account. The Assessing Officer did not allow deduction u/s 37. When the matter finally reached the Hon'ble Supreme Court, their Lordships noticed that the word "expenditure" has not been defined in the Act. They held that : "the word "expenditure" is, therefore, required to be understood in the context in which it is used. Section 37 enjoins that any expenditure not being expenditure of the nature described in sections 30 to 36 laid out or expended wholly and exclusively for the purposes of the business should be allowed in computing the income chargeable under the head "profits and gains of business or profession". In sections 30 to 36 the expression "expenditure incurred", as well as allowance and depreciation, has also been used. For example depreciation and allowances are dealt with in section 32, therefore, the parliament has used expression "any expenditure" in section 37 to cover both. Therefore, the expression "expenditure" as used in section 37 made in the circumstances of a particular case, covers an amount which is really a "loss" even though the said amount has not gone out from the pocket of the assessee'. From the above enunciation of law by the Hon'ble Summit Court, there remains no doubt whatsoever that the term 'expenditure' in certain circumstances can also encompass 'loss' even though no amount is actually paid out. Ex consequenti, the alternative argument of the ld. DR that discount on shares is 'loss' and hence can't be covered u/s 37(1), also does not hold water in the light of the above judgment. In view of the above discussion, we, with utmost respect, are unable to concur with the view taken in Ranbaxy Laboratories Limited (supra).

B. Is discount a Contingent liability ?

9.3.1. The learned Departmental Representative supported the impugned order by contending that the entitlement to ESOP depends upon the fulfillment of several conditions laid down under the scheme. It is only when all such conditions are fulfilled and the employees render services during the vesting period that the question of any ascertained liability can arise. He submitted that during the entire vesting period, it is only a contingent liability and no deduction is admissible under the provisions of the Act for a contingent liability. The options so granted may lapse during the vesting period itself by reason of termination of employment or some of the employees may not choose to exercise the option even after rendering the services during the vesting period. It was, therefore, argued that the discount is nothing but a contingent liability during the vesting period not calling for any deduction. In the opposition, the learned AR submitted that the amount of discount claimed by the assessee as deduction is not a contingent liability but an ascertained liability. He stated that in the ESOP 2000, there is a vesting period of four years, which means that the options to the extent of 25% of the total grant would vest with the eligible employees at the end of first year after rendering unhindered service for one year and it would go on till the completion of four years.

9.3.2. It is a trite law and there can be no quarrel over the settled legal position that deduction is permissible in respect of an ascertained liability and not a contingent liability. Section 31 of the Indian Contract Act, 1872 defines "contingent contract" as "a contract to do or not do something, if some event, collateral to such contract does not happen". We need to determine as to whether the liability arising on the assessee-company for issuing shares at a discounted premium can be characterized as a contingent liability in the light of the definition of contingent contract. From the stand point of the company, the options under ESOP 2000 vest with the employees at the rate of 25% only on putting in service for one year by the employees. Unless such service is rendered, the employees do not qualify for such options. In other words, rendering of service for one year is sine qua non for becoming eligible to avail the benefit under the scheme. Once the service is rendered for one year, it becomes obligatory on the part of the company to honor its commitment of allowing the vesting of 25% of the option. It is at the end of the first year that the company incurs liability of fulfilling its promise of allowing proportionate discount, which liability would be actually discharged at the end of the fourth year when the options are exercised by the employees. Now the question arises as to whether the liability at the end of each year can be construed as a contingent one?

9.3.3. The Hon'ble Supreme Court in *Bharat Earth Movers v. CIT* [(2000) 245 ITR 428 (SC)] dealt with the deductibility or otherwise of provision for liability towards encashment of earned leave. In that case, the company floated beneficial scheme for its employees for encashment of leave. The earned leave could be accumulated up to certain days. The assessee created provision of Rs. 62.25 lakh for encashment of accrued leave and claimed deduction for the same. The Assessing Officer held it to be a contingent liability and hence not a permissible deduction. When the matter finally came up before the Hon'ble Supreme Court, it was held that the provision for meeting the liability for encashment of earned leave by the employee was an admissible deduction. In holding so, the Hon'ble Apex Court observed that : "*the law is settled : if a business liability has definitely arisen in the accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date. What should be certain is the incurring of the liability. It should also be capable of being estimated with reasonable certainty though the actual quantification may not be possible. If these requirements are satisfied the liability is not a contingent one. The liability is in praesenti though it will be discharged at a future date. It does not make any difference if the future date on which the liability shall have to be* *discharged is not certain.*" From the above enunciation of law by the Hon'ble Supreme Court, it is manifest that a definite business liability arising in an accounting year qualifies for deduction even though the liability may have to be quantified and discharged at a future date. We consider it our earnest duty to mention that the legislature has inserted clause (f) to section 43B by providing that "any sum payable by the assessee as an employer in lieu of any leave at the credit of his employee" shall be allowed as deduction in computing the income of the previous year in which such sum is actually paid. With this legislative amendment, the application of the ratio decidendi in the case of Bharat Earth Movers (supra) to the provision for leave encashment has been nullified. However, the principle laid down in the said judgment is absolutely intact that a liability definitely incurred by an assessee is deductible notwithstanding the fact that its quantification may take place in a later year. The mere fact that the quantification is not precisely possible at the time of incurring the liability would not make an ascertained liability a contingent.

9.3.4. Almost to the similar effect, there is another judgment of the Hon'ble Supreme Court in the case of *Rotork Controls India (P) . CIT* [(2009) 314 ITR 62 (SC)]. In that case, the assessee-company was engaged in selling certain products. At the time of sale, the company provided a standard warranty that in the event of certain part becoming defective within 12 months from the date of commissioning or 18 months from the date of dispatch, whichever is earlier, the company would rectify or replace the defective parts free of charge. This warranty was given under certain conditions stipulated in the warranty clause. The assessee made a provision for warranty at Rs. 5.18 lakh towards the warranty claim likely to arise on the sales effected by the assessee. The Assessing Officer disallowed the same on the ground that the liability was merely a contingent liability and hence not allowable as deduction u/s 37 of the Act. When the matter finally came up before the Hon'ble Supreme court, it entitled the assessee to deduction on the "accrual" concept by holding that a provision is recognized when : "*(a) an enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources will be required to settle the obligation : and (c) a reliable estimate can be made of the amount of the obligation*". Resultantly, the provision was held to be deductible.

9.3.5. When we consider the facts of the present case in the backdrop of the ratio laid down by the Hon'ble Supreme Court in Bharat Earth Movers (supra) and Rotork Controls India P. Ltd. (supra), it becomes vivid that the mandate of these cases is applicable with full force to the deductibility of the discount on incurring of liability on the rendition of service by the employees. The factum of the employees becoming entitled to exercise options at the end of the vesting period and it is only then that the actual amount of discount would be determined, is akin to the quantification of the precise liability taking place at a future date, thereby not disturbing the otherwise liability which stood incurred at the end of the each year on availing the services.

9.3.6. As regards the contention of the ld. DR about the contingent liability arising on account of the options lapsing during the vesting period or the employees not choosing to exercise the option, we find that normally it is provided in the schemes of ESOP that the vested options that lapse due to non-exercise and/or unvested options that get cancelled due to resignation of the employees or otherwise, would be available for grant at a future date or would be available for being re-granted at a future date. If we consider it at micro level qua each individual employee, it may sound contingent, but if view it at macro level qua the group of employees as a whole, it loses the tag of 'contingent' because such lapsing options are up for grabs to the other eligible employees. In any case, if some of the options remain unvested or are not exercised, the discount hitherto claimed as deduction is required to be reversed and offered for taxation in such later year. We, therefore, hold that the discount in relation to options vesting during the year cannot be held as a contingent liability.

C. Fringe benefit

9.4.1. There is another important dimension of this issue. Chapter XII-H of the Act consisting of sections 115W to 115WL with the caption : "Income-Tax on Fringe Benefits" has been inserted by the Finance Act, 2005 w.e.f. 1.4.2006. Memorandum explaining the provisions of the Finance Bill, 2005 highlights the details of the Fringe Benefits Tax. It provides that : 'Fringe benefits as outlined in section 115WB, mean any privilege, service, facility or amenity directly or indirectly provided by an employer to his employees (including former employees) by reason of their employment.' Charging section 115WA of this Chapter provides that : "In addition to the income-tax charged under this Act, there shall be charged for every assessment year……….fringe benefit tax in respect of fringe benefits provided or deemed to have been provided by an employee to his employees during the previous year…………". Section 115WB gives meaning to the expression 'Fringe Benefits'. Subsection (1) provides that for the purposes of this Chapter, 'fringe benefits' means any consideration for employment as provided under clauses (a) to (d). Clause (d), which is relevant for our purpose, states that : 'any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer free of cost or at concessional rate to his employees (including former employee or employees)' shall be taken as fringe benefit. Explanation to this clause clarifies that for the purposes of this clause,— (i) "specified security" means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and, where employees' stock option has been granted under any plan or scheme thereof, includes the securities offered under such plan or scheme. Thus it is discernible from the above provisions of the Act that the legislature itself contemplates the discount on premium under ESOP as a benefit provided by the employer to its employees during the course of service. If the legislature considers such discounted premium to the employees as a fringe benefit or 'any consideration for employment', it is not open to argue contrary. Once it is held as a consideration for employment, the natural corollary which follows is that such discount i) is an expenditure; ii) such expenditure is on account of an ascertained (not contingent) liability ; and iii) it cannot be treated as a short capital receipt. In view of the foregoing discussion, we are of the considered opinion that discount on shares under the ESOP is an allowable deduction.

II. IF YES, THEN WHEN AND HOW MUCH?

10.1. Having seen that the discount under ESOP is a deductible expenditure u/s 37(1), the next question is that 'when' and for 'how much' amount should the deduction be granted ?

10.2. The assessee is a limited company and hence h it is obliged to maintain its accounts on mercantile basis. Under such system of accounting, an item of income becomes taxable when a right to receive it is finally acquired notwithstanding the fact that when such income is actually received. Even if such income is actually received in a later year, its taxability would not be evaded for the year in which right to receive was finally acquired. In the same manner, an expense becomes deductible when liability to pay arises irrespective of its actual discharge. The incurring of liability and the resultant deduction cannot be marred by mere reason of some difficulty in proper quantification of such liability at that stage. The very point of incurring the liability enables the assessee to claim deduction under mercantile system of accounting. We have noticed the mandate of the Hon'ble Supreme Court in Bharat Earth Movers (supra) that if a business liability has definitely arisen in an accounting year, then the deduction should be allowed in that year itself notwithstanding the fact that such liability is incapable of proper quantification at that stage and is dischargeable at a future date. It follows that the deduction for an expense is allowable on incurring of liability and the same cannot be disturbed simply because of some difficulty in the proper quantification. A line of distinction needs to be drawn between a situation in which a liability is not incurred and a situation in which the liability is incurred but its quantification is not possible at the material time. Whereas in the first case, there cannot be any question of allowing deduction, in the second case, deduction has to be allowed for a sum determined on some rational basis representing the amount of liability incurred.

10.3. We have earlier underlined the concepts of grant of options, vesting of options and exercise of options. The period from grant of option to the vesting of option is the 'vesting period'. It is during such period that an employee is supposed to render service to the company so as to earn an entitlement to the shares at a discounted premium. The vesting period may vary from a case to case. If the vesting period is, say, four years with equal vesting at the end of each year, then it is at the end of the vesting period or during the exercise period, which in turn immediately succeeds the vesting period, that the employee becomes entitled to exercise 100 options or qualify for receipt of 100 shares at discount. Though the shares are allotted at the end of the vesting period, but it is during such vesting period that the entitlement is earned. It means that 25 options vest with the employee at the end of each year on his rendering service for the respective year. If during the interregnum, he leaves the service, say after one year, he will still remain entitled to exercise option for 25 shares at the discounted premium at the time of exercise of option. In that case, the benefit which would have accrued to him at the end of the second, third and fourth years would stand forfeited. Thus it becomes abundantly clear that an employee becomes entitled to the shares at a discounted premium over the vesting period depending upon the length of service provided by him to the company. In all such schemes, it is at the end of the vesting period that option is exercisable albeit the proportionate right to option is acquired by rendering service at the end of each year.

10.4. Similar is the position from the stand point of the company. An obligation falls upon the company to allot shares at the time of exercise of option depending upon the length of service rendered by the employee during the vesting period. The incurring of liability towards the discounted premium, being compensation to employee, is directly linked with the span of service put in by the employee. In the above illustration, when 25 out of 100 shares vest in the employee after rendering one year's service, the company also incurs equal obligation at the end of the first year for which it becomes entitled to rightfully claim deduction u/s 37(1) of the Act. Similarly at the end of the second year of service by the employees, the company can claim deduction for discounted premium in respect of further 25 shares so on and so forth till fourth year when the last tranche of discounted premium in respect of 25 shares becomes available for deduction. It, therefore, transpires that a company under the mercantile system can lawfully claim deduction for total discounted premium representing the employees cost over the vesting period at the rate at which there is vesting of options in the employees.

10.5. From the above discussion it is lucid that at the event of granting options, the company does not incur any obligation to issue the shares at discounted premium. Mere granting of option does neither entitle the employee to exercise such option nor allow the company to claim deduction for the discounted premium. It is during the vesting period that the company incurs obligation to issue discounted shares at the time of exercise of option. Thus the event of granting options does not cast any liability on the company. On the other end is the date of exercising the options. Though the employees become entitled to exercise the option at such stage but the fact is that it is simply a result of vesting of options with them over the vesting period on the rendition of services to the company. In other words, it is a stage of realization of income earned during the vesting period. In the same manner, though the company becomes liable to issue shares at the time of the exercise of option, but it is in lieu of the employees compensation liability which it incurred over the vesting period by obtaining their services. From the above it is apparent that the company incurs liability to issue shares at the discounted premium only during the vesting period. The liability is neither incurred at the stage of the grant of options nor when such options are exercised.

10.6. Let us consider the facts of the case of SSI Industries Ltd. (supra), which has been strongly relied by the ld. AR in support of his claim for deduction of discount during the years of vesting of options. In that case the vesting period was three years and the assessment order was passed u/s 143(3), inter alia, allowing deduction of Rs. 66.82 lakh under the head "Staff welfare expenses" on account of amortization of discounted value of option over a period of three years. The CIT revised such order by directing the A.O. to disallow ESOP expenditure of Rs. 66.82 lakh. When the matter came up before the Tribunal, it was held that the expenditure in that behalf was an ascertained liability and not contingent upon happening of certain events. It was further noticed that the assessee claimed deduction of such discount on ESOP by following the SEBI Guidelines. As the expenditure itself was an ascertained liability, the Tribunal held that the same to be deductible.

10.7. Before proceeding further it would be befitting to take stock of the nutshell of the SEBI Guidelines in this regard. These Guidelines provide for granting of deduction on account of discount on issue of options during the vesting period. It has been so explained with the help of an example in Schedule I to the Guidelines. For the sake of simplicity, we are taking an instance under which an option of share with face value of Rs. 10 is given under ESOP to employees at the option price of Rs. 10 as against the market price of such shares at Rs. 110 on that date. Further suppose that the vesting period is four years with equal vesting @ 25% at the end of each year. Total discount comes to Rs. 100 (Rs. 110 – Rs. 10). These Guidelines provide for claiming deduction in the accounts for a total discount of Rs. 100 divided over the vesting period of four years on straight line basis at the rate of Rs. 25 each. The case of SSI Limited (supra) deals with a controversy relating to one of the vesting years. The tribunal entitled the assessee to proportionate deduction. Thus it is evident that the view taken by the tribunal in that case not only matches with the SEBI Guidelines but also the 'accrual concept' in the mercantile system of accounting, thereby allowing deduction at the stage of incurring of liability.

10.8. Reverting to the questions of 'when' and 'how much' of deduction for discount on options is to be granted, we hold that the liability to pay the discounted premium is incurred during the vesting period and the amount of such deduction is to be found out as per the terms of the ESOP scheme by considering the period and percentage of vesting during such period. We, therefore, agree with the conclusion drawn by the tribunal in SSI Ltd.'s case allowing deduction of the discounted premium during the years of vesting on a straight line basis, which coincides with our above reasoning.

III. SUBSEQUENT ADJUSTMENT TO DISCOUNT

11.1.1. Having answered the first major issue in affirmative that the discount on options under ESOP is an ascertained liability and the second major issue that the discount is deductible over the vesting period on straight line basis unless the vesting is not uniform, then arises the present issue as to whether any subsequent adjustment is warranted at the time of exercise of options, to the deductions earlier allowed for the amount of discount. It is noticed that the assessment years 2003-2004 to 2007-2008 are under consideration and during these years ESOP 2000 has come to an end and the ESOP 2004 has started. Further, the extant issue is a vital part of the overall question of the deductibility or otherwise of the amount of discount under ESOP.

11.1.2. We have noticed above that the company incurs a definite liability during the vesting period, but its proper quantification is not possible at that stage as the actual amount of employees cost to the company, can be finally determined at the time of the exercise of option or when the options remain unvested or lapse at the end of the exercise period. It is at this later stage that the provisional amount of discount on ESOP, initially quantified on the basis of market price at the time of grant of options, needs to be suitably adjusted with the actual amount of discount.

11.1.3. As regards the adjustment of discount when the options remain unvested or lapse at the end of the exercise period, it is but natural that there is no employee cost to that extent and hence there can be no deduction of discount *qua* such part of unvested or lapsing options. But, as the amount was claimed as deduction by the company during the period starting with the date of grant till the happening of this event, such discount needs to be reversed and taken as income. It is so because logically when the options have not eventually vested in the employees, to that extent, the company has incurred no employee cost. And if there is no cost to the company, the tentative amount of deduction earlier claimed on the basis of the market price at the time of grant of option ceases to be admissible and hence needs to be reversed. The ld. AR stated that the discount in respect of the unvested/lapsing options has been reversed on the happening of such events and the overall employee cost has been correspondingly reduced. We find that the SEBI Guidelines also provide that the discount written off in respect of unvested options and the options lapsing at the end of the exercise period shall be reversed at the appropriate time. As the accounting treatment directed through the Guidelines accords with the taxation principle of not allowing deduction for the amount of discount on unvested/lapsing options and further the assessee has admitted to have offered such amount as income in the relevant years, we stop here by holding that the amount of discount claimed as deduction earlier in respect of unvested/lapsing options, has to be taxed as income on the happening of such events.

11.1.4. Now we take up the second situation in which the options are exercised by the employees after putting in service during the vesting period. In such a scenario, the actual amount of remuneration to the employees would be only the amount of actual discounted premium at the time of exercise of option. The Hon'ble Supreme Court in the case of *CIT v. Infosys Technologies Limited* [(2008) 297 ITR 167 (SC)] relevant to the assessment years 1997-98 to 1999-2000 has held that the allotment of shares to employees under ESOP subject to a lock in period of five years and other conditions could not be treated as a perquisite as there was no benefit and the value of benefit, if any, was unascertainable at the time when options were exercised. The Finance Act, 1999 inserted section 17(2)(iiia) with effect from 1st April, 2000 providing that : "the value of any specified security allotted or transferred, directly or indirectly, by any person free of cost or at a concessional rate to an individual who is or has been in employment of that person" shall be treated as a perquisite. It further provides that in a case the allotment or transfer of specified securities is made in pursuance of an option exercised by an individual, the value of the specified securities shall be taxable in the previous year in which such option is exercised by such individual. Such clause (iiia) was subsequently deleted with effect from 1st April, 2001. After certain changes to the relevant provisions in this regard, the position which now stands is that the discount on ESOP is taxable as perquisite u/s 17(2)(vi) for : 'the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee'. Clause (c) of Explanation to section 17(2)(vi) provides that : ' the value of any specified security or sweat equity shares shall be the fair market value of the specified security or sweat equity shares, as the case may be, on the date on which the option is exercised by the assessee as reduced by the amount actually paid by, or recovered from, the assessee in respect of such security or shares'. Two things surface from the above provisions. First, that the perquisite arises on the 'allotment' of shares and second, the value of such perquisite is to be computed by considering the fair market value of the shares on 'the date on which the option is exercised' by the assessee as reduced by the amount actually paid. The position that such amount was or was not taxable during some of the years in the hands of the employees is not relevant in considering the occasion and the amount of benefit accruing to the employee under ESOP. Any exemption or the deductibility of an allowance or benefit to employee from taxation does not obliterate the benefit itself. It simply means that the benefit accrued to the assessee but the same did not attract tax. The position has now been clarified beyond doubt by the legislature that the ESOP discount, which is nothing but the reward for services, is a taxable perquisite to the employee at the time of exercise of option, and its valuation is to be done by considering the fair market value of the shares on the date on which the option is exercised.

11.1.5. The other side of the coin is the amount of remuneration to the employees in the hands of the company. We have noticed earlier that an expense becomes deductible on the incurring of liability under the mercantile system of accounting. Although the stage of taxability of perquisite in the hands of the employee may differ from the stage of the deductibility of expense in the hands of the company depending upon the method of account followed by the company, but the amount of such discount or employees remuneration can never be different. If the value of perquisite in the hands of the employee, whether or not taxable, is 'x', then its cost in the hands of the company has also to be 'x'. It can neither be 'x+1' nor 'x-1'. It is simple and plain that the amount of remuneration which percolates to the employees will always be equal to the amount flowing from the company and such remuneration to the employee in the present context is the amount which he actually becomes entitled to on the exercise of options. Thus, it is palpable that since the remuneration to the employees under the ESOP is the amount of discount w.r.t. the market price of shares at the time of exercise of option, the employees cost in the hands of the company should also be w.r.t. the same base.

11.1.6. The amount of discount at the stage of granting of options w.r.t. the market price of shares at the time of grant of options is always a tentative employees cost because of the impossibility in correctly visualizing the likely market price of shares at the time of exercise of option by the employees, which, in turn, would reflect the correct employees cost. Since the definite liability is incurred during the vesting period, it has to be quantified on some logical basis. It is this market price at the time of the grant of options which is considered for working out the amount of discount during the vesting period. But, since actual amount of employees cost can be precisely determined only at the time of the exercise of option by the employees, the provisional amount of discount availed as deduction during the vesting period needs to be adjusted in the light of the actual discount on the basis of the market price of the shares at the time of exercise of options. It can be done by making suitable northwards or southwards adjustment at the time of exercise of option. This can be explained with the following example with the assumption of vesting period of four years and the benefit vesting at 25% each at the end of 1st to 4th years:–

	At the time of granting option	At the time of exercise of option		
		Situation I	Situation II	Situation III
Market value per share	110	110	130	90
Option price	10	10	10	10
Employees compensation or Discount	100	100	120	80

11.1.7. From the above table it can be noticed that the market price of the shares at the time of grant of option was Rs. 110 against the option price of Rs. 10, which resulted in discount at Rs. 100. With the vesting period of four years with the equal vesting, the company can rightly claim deduction at the rate of Rs. 25 each at the end of first, second, third and fourth year of vesting. But this total deduction for discount of Rs. 100 over the vesting period needs to be adjusted at the time of exercise of option by the employee when the shares are issued. In Situation I, the market price of shares at the time of exercise of option is at Rs. 110, which is similar to the market price at the time of grant of option. As the total amount of discount of Rs. 100 over the vesting period is actually quantified at Rs. 100, no further adjustment to the discount is required at the time of exercise of option. In Situation II, the market price of the share at the time of exercise of option has gone up to Rs. 130. The amount of real compensation to employee is Rs. 120 as against the tentative compensation of Rs. 100 per share which was accounted for and allowed as deduction during the vesting period. As the actual quantification of the compensation has turned out to be Rs. 120, the company is entitled to a further deduction of Rs. 20 at the time of exercise of option. In Situation III, the market price of the share at the time of exercise of option has come down to Rs. 90. The amount of real compensation to employees is Rs. 80 as against the tentative compensation of Rs. 100, which was allowed as deduction during the vesting period. As the actual quantification of the compensation has turned out to be Rs. 80, the company is liable to reverse the deduction of Rs. 20 at the time of exercise of option.

Taxation vis-à-vis Accountancy principles

11.2.1. It has been noticed that broadly there are three stages having effect on the total income of the company in the life cycle of ESOP, viz., i) during the vesting period, ii) at the time of unvesting/lapse of options and iii) finally at the time of exercise of options. It has been argued that the assessee company claimed deduction for the amount of discount during the vesting period on the basis of the market price of shares at the time of grant of options and also reversed the proportionate discount on unvesting/lapsing of options at the appropriate time on the basis of the SEBI Guidelines. If this contention is correct, it would mean that the first two stages have been rightly given effect to. But the appellant assessee does not appear to have made any downward adjustment to the amount of discount at the time of exercise of option by the employees with the difference in the market price of the shares at the time of grant of option and price at the time of exercise of option. The argument seems to be that the SEBI Guidelines do not provide for such downward adjustment. It has been argued by the ld. AR that where the provisions of the Act specifically provide for treatment of a particular source of income in a particular manner, then the germane provision should be followed. If, however, there is no specific provision dealing with an issue in the Act, then the accounting principles should be adhered to while determining the total income of the assessee. In this regard, he relied on the judgment in the case of Challapalli Sugars Ltd.'s [supra] , wherein the Hon'ble Supreme Court has held that the interest payable on capital borrowed by the assessee for purchase of plant and machinery before the commencement of business should be capitalized on the basis of accepted accountancy rule. Similarly in the case of U.P. State Industrial Development Corporation (supra), the Hon'ble Apex Court held in the case of an underwriter that it would be right to consider the net investment, that is the purchase price less the underwriting commission received by the underwriter as investment as against treating the gross amount by taking into consideration the principles of commercial accounting. He stated that since there is no specific provision in the Act providing for the treatment of discount on ESOP in the computation of total income, the accounting principles formulated by way of the SEBI Guidelines are required to be followed.

11.2.2. In the oppugnation, the learned Departmental Representative submitted that the SEBI Guidelines cannot mandate the deductibility or otherwise of an amount under the provisions of the Act. He relied on the judgments of the Hon'ble Supreme Court in Tuticorin Alkali Chemicals & Fertilizers Ltd. (supra) and Godhra Electricity Company Ltd. (supra) in support of this proposition.

11.2.3. We are not persuaded by the submissions put forth by the ld. AR that, in the absence of any specific provision in the Act, the accounting principles should be followed for determining the total income of the assessee. What is true for accounting purpose need not necessarily be true for taxation. Taxation principles are enshrined in the legislature. Power to legislate lies with the Parliament. Accounting standards or Guidance Note or Guidelines etc., by whatever name called, issued by any autonomous or even statutory bodies including the Institute of Chartered Accountants of India, or for that matter, the SEBI are meant only to prescribe the way in which the transactions should be recorded in books or reflected in the annual accounts. These guidelines do not have the force of an Act of Parliament. Since the subject matter of tax on income falls in the Union List as per Part XI of the Indian Constitution, it is only the Parliament which can legislate on its scope.

11.2.4. Be that as it may, there is no weight in the contention of the ld. AR that there is no specific provision in the Act on the ESOP discount. It is axiomatic that the taxation rules are always embodied in the relevant Act, either in a specific or a general manner. These can be specific by making a clear cut provision in respect of deductibility of a particular item of expense or taxation of a particular item of income. General provisions are those which set out the overall principles to govern the deductibility or taxability of unspecified items. For example, the definition of 'income' u/s 2(24) has been given by the Act in an inclusive manner. There have been enshrined clauses (i) to (xvi) dealing with the items specifically listed. However, the provision has been couched in such a way so as to include general items of receipts having character of income, even though not specifically mentioned. Similar is the position regarding deductions. Under the head 'Profits and gains of business or profession', there are sections granting deductions in respect of specific expenses or allowances. Similarly, there is section 37(1), which grants deduction for expenses not specifically set out in other sections, if the conditions stipulated in the section, are fulfilled. All other items of expenses, which fulfill the requisite conditions, gain deductibility under section 37(1). To put it in simple words, this section is a specific provision for granting deduction in respect of the unspecified or the general categories of expenses. Discount on ESOP is a general expense and hence covered by the specific provision of section 37. The contention of the ld. AR that there is no provision in the Act dealing with the deductibility of ESOP discount, is therefore, devoid of any merit. This concludes the question of granting of deduction of discount during the vesting period.

11.2.5. The SEBI Guidelines have been taken shelter of to contend that there is no requirement for the adjustment of discount at the time of exercise of options. Primarily, we are unable to trace the proposition anywhere from the Act that the accounting principles are also determinative of the tax liability. The jurisprudence is rather the other way around. In Tuticorin Alkali Chemicals & Fertilizers Ltd. (supra), the Hon'ble Supreme Court has laid down in so many words that the taxing principles cannot walk on the footsteps of the accounting principles. At this juncture, it would be useful to have a glimpse at the following observations of the Hon'ble Supreme Court in the afore noted case: 'It is true that this court has very often referred to accounting practice for ascertainment of profit made by a company or value of the assets of a company. But when the question is whether a receipt of money is taxable or not or whether certain deductions from that receipt are permissible in law or not, the question has to be decided according to the principles of law and not in accordance with accountancy practice. Accounting practice cannot override section 56 or any other provision of the Act. As was pointed out by Lord Russell in the case of B. S. C. Footwear Ltd. [1970] 77 ITR 857, 860 (CA), the income-tax law does not march step by step in the footprints of the accountancy profession.'

11.2.6. The same view has been adopted by the Hon'ble Supreme Court in Godhra Electricity Company Ltd. (supra), by holding that : 'Income-tax is a levy on income. No doubt, the Income-tax Act takes into account two points of time at which the liability to tax is attracted, viz., the accrual of the income or 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 does not materialise.'

11.2.7. It follows that accounting principles have absolutely no role to play in the matter of determination of total income under the Act. If an accounting principle is referred to by the higher judiciary, then there is an underlying presumption that such accounting principle is in conformity with and not in conflict with the taxation principle. The essence of the matter is that taxation principles are to be followed. If an accounting principle is in conformity with the mandate of taxing principle and reference is made to such accounting principle while deciding the issue, it does not mean that the accounting principle has been followed. It simply means that the taxation principle has been followed and the accounting principle, which is in line with such taxation principle, has been simply taken note of. If however, an accounting principle runs counter to the taxation principle, then there is no prize for guessing that it is only the taxation principle which shall prevail.

11.2.8. The plea now raised before us by the ld. AR, relying on the case of Challapalli Sugars Ltd.'s case, was also taken up before the Hon'ble Supreme Court in the case of Tuticorin Alkalis (supra). Dealing with the same, the Hon'ble Supreme Court held that : "The question in *Challapalli Sugars Ltd.*'s case [1975] 98 ITR 167 (SC) was about computation of depreciation and development rebate under the Indian Income-tax Act, 1922. In order to calculate depreciation and development rebate it was necessary to find out "the actual cost" of the plant and machinery purchased by the company. This court held that "cost" is a word of wider connotation than "price". There was a difference between the price of a machinery and its cost. This court thereafter pointed out that the expression "actual cost" had not been defined in the Act. It was, therefore, necessary to find out the commercial sense of the phrase. …………The judgment in Challapalli's case [1975] 98 ITR 167 (SC), goes to show that the court was not in any way departing from legal principles because of any opinion expressed by the Institute of Chartered Accountants." From the above observations there is not even an iota of doubt in our minds that there can be no question of following the accounting principle or Guidance notes etc. in the matter of determination of total income.

11.2.9. The trump card of the ld. AR to bolster his submission for assigning the status of binding force to the SEBI Guidelines is the order in the case of SSI Limited (supra) which came to be affirmed by the Hon'ble Madras High Court in PVP Ventures (supra). We have noticed above that the said case dealt a situation falling within one of the three years of the vesting period, in which it was held that one third of the total amount of discount computed on the basis of the market price of the shares at the time of grant of option, is deductible. It is evident from the SEBI Guidelines that these deal with the deductibility of discount in the hands of company during the years of vesting period. These Guidelines are silent on the position emanating from variation in the market price of the shares at the time of exercise of option by the employees vis-à-vis the market price at the time of grant of option. In other words, the SEBI Guidelines prescribe accounting treatment only in respect of the period of vesting of the options and the situation arising out of unvested options or vested options lapsing. The very reference by the Chennai Bench of the Tribunal in SSI Limited (supra) to the SEBI Guidelines is indicative of the fact that it dealt with a year during which the options were vesting with the employees and the company claimed discount during the vesting period. The Hon'ble Madras High Court in the case of PVP Ventures (supra) has upheld the view taken by the Chennai Bench in the case of SSI Limited (supra). The granting of the binding force to the SEBI Guidelines by the Hon'ble Madras High Court should be viewed in the context of the issue before it, which was about the deductibility of discount during one of the vesting years. In the earlier part of this order, we have held that the deductibility of discount during the vesting period, as prescribed under the SEBI Guidelines, matches with the treatment under the mercantile system of accounting. To that extent, we also hold that the SEBI guidelines are applicable in the matter of deduction of discount. Neither there was any issue before the Hon'ble Madras High Court nor it dealt with a situation in which the market price of the shares at the time of exercise of option is more or less than the market price at the time of grant of option. It is a situation which has also not been dealt with by the Guidelines. Accordingly, the aforenoted taxation principle of granting deduction for the additional discount and reversing deduction for the short amount of discount at the time of exercise of option, needs to be scrupulously followed.

11.3. We, therefore, sum up the position that the discount under ESOP is in the nature of employees cost and is hence deductible during the vesting period w.r.t. the market price of shares at the time of grant of options to the employees. The amount of discount claimed as deduction during the vesting period is required to be reversed in relation to the unvesting/lapsing options at the appropriate time. However, an adjustment to the income is called for at the time of exercise of option by the amount of difference in the amount of discount calculated with reference the market price at the time of grant of option and the market price at the time of exercise of option. No accounting principle can be determinative in the matter of computation of total income under the Act. The question before the special bench is thus answered in affirmative by holding that discount on issue of Employee Stock Options is allowable as deduction in computing the income under the head 'Profits and gains of business or profession'.

SOME RELEVANT FACTORS IN ASSESSEE'S CASE

12.1. Having answered the question in affirmative, let us examine its applicability to the facts of the appellant's case. It has been seen above that the authorities below refused to grant deduction of the discount at the very threshold. Resultantly, the verification of the correctness of calculation of discount stood ousted. Since we have overturned such view in above terms, the verification of calculation in accordance with our directions becomes imperative. We, therefore, set aside the impugned orders on this issue and remit the matter to the file of the AO for finding out the correct amount of deduction accordingly.

12.2. It would be imperative to highlight certain points having bearing on the issue which have come to our notice during the course of hearing. The AO is directed to look, *inter alia*, into these aspects in quantifying the amount of eligible deduction.

a. The assessee-company was a closely held company in the previous year relevant to the assessment year 2003-2004 and as such there was no question of the listing of its shares and having some market price at the time of grant of options. Ordinarily, the amount of discount on premium which is written off over the vesting period represents the market price of the shares listed on the stock exchange on the date of grant of option as reduced by the price at which option is given to the employees. However, presently there is no availability of any market price of such shares on the date of grant of option as the company came to be listed on a stock exchange in a subsequent year. On a pointed query, the ld. AR furnished the details of such claim by showing that it granted 71,510 options with discount of Rs. 909 per option making total discount at Rs. 6.50 crore. He stated that the face value of shares is at Rs. 10 against which the deduction for discounted premium over the vesting period has been claimed at Rs. 909, meaning thereby that the market price of the share on the date of grant of option was taken at Rs. 919. No material worth the name has been placed on record to indicate as to how a share with face value of Rs. 10 has been valued at Rs. 919 for claiming deduction towards discount at Rs. 909 per share. This aspect of valuation of shares at Rs. 919 per share needs to be examined by the Assessing Officer.

b. We have held above that the deduction of the discounted premium is to be claimed over the vesting period. The assessee claimed deduction for discount amounting to Rs. 3.38 crore for the A.Y. 2003-04. On being called upon to furnish bifurcation of such claim, the assessee filed a chart showing its detail comprising of four amounts. First amount of Rs. 1.62 crore has been shown as the first tranche of 25% option. Second amount of Rs. 81.25 lakh as the second tranche of 25% option; third amount of Rs. 54.16 lakh as the third tranche of 25% option and the last amount of Rs. 40.62 lakh as the fourth tranche of 25% option. We are unable to understand as to how the last three amounts can qualify for deduction at the end of the first year itself. On a specific query, it was stated by the ld. AR that the assessee claimed deduction for the proportionate part of discount for the second, third and fourth year at the end of the first year itself because 25% of options vested in the employees at the end of the first to fourth year each. This defies all logics and rationalities. When the options vest equally over a period of four years, it is but natural that the company would incur equal liability for the discounted premium @ 25% of total discount on receipt of services of the employees at the end of each year. The way in which the assessee has claimed deduction runs contrary even to the SEBI Guidelines, which also provide for deduction on straight line basis. The manner of the assessee's claiming deduction has resulted in needlessly increasing the amount of deduction for the first year at the cost of deduction for the subsequent three years. It needs to be set right by apportioning the total amount of the discounted premium evenly over the vesting period of four years.

c. It has been noticed above that the stage for the grant of deduction of discount is on the respective vesting of the options. In ESOP 2000, the vesting takes place @ 25% after each year of service. It means that the first part of 25% deduction would be available on the completion of one year from the date of grant of option. The assessee was required to indicate the date of grant of options in respect of which deduction has been claimed in the instant year. Two letters granting options to Shri Murali Krishnan K.N. and Neville Bain have been randomly filed which are dated 2nd April, 2002. If the options are granted on 2nd April, 2002, then 25% of the total option shall vest in the employees at the end of the first year from this date, which date would be 1st April, 2003. As such, the amount would become deductible in the previous year relevant to assessment year 2004-2005 and not 2003-2004. The ld. AR contended that though these letters are dated 2nd April, 2002, but in fact the options were granted on 1st April, 2002. The correct date of grant and vesting needs to be verified at the AO's end.

d. The ld. AR has stated that the amount of discount claimed as deduction in the earlier years in respect of unvesting/lapsing options has been reversed at the relevant time. There is no finding either in the assessment or the impugned order in this regard. This fact should also be verified by the AO to ensure that the overall expenditure booked by the company is restricted only to the extent of the exercised options.

12.3. The AO will decide the instant issue in the fresh proceedings as per our above directions on the legal question before this special bench and by considering, *inter alia*, the aforenoted case-specific factual scenario dealt with in para 12.2. above. Needless to say, the assessee, who will have liberty to lead any fresh evidence in its defence, will be allowed a reasonable opportunity of hearing.

13. Before parting with this matter we wish to place on record our deep appreciation for the illuminating arguments advanced by both the sides, which greatly assisted us in the disposal of the issue raised before the special bench. We also want to make it clear that all the cases relied on by both the sides have been duly taken into consideration while deciding the matter. The omission of reference to some of such cases in the order is either due to their irrelevance or to ease the order from the burden of the repetitive *ratio decidendi* laid down in such decisions.

14. Now the instant appeals are directed to be placed before the Division Bench for disposal having regard to the decision of the special bench on the questions raised before it.

Order pronounced on this 16th day of July 2013.

2013 TRI 2113 (S.C. Ind.)

SUPREME COURT OF INDIA

R.M. Lodha, J. Chelameswar and Madan B. Lokur, JJ.

The C.I.T-II Ahmedabad, Gujarat
v.
M/s Mastek Ltd.

FACTS/HELD

Section 260A(4): High Court has power to hear the appeal on questions not formulated at the stage of admission of the appeal

1. The department filed an appeal u/s 260A in the High Court in which it raised several questions. The High Court admitted the appeal and framed two substantial questions of law. The Department filed a SLP claiming that by necessary implication, the other questions raised in the memo of appeal before the

High Court had been rejected. HELD by the Supreme Court dismissing the SLP:

> The Revenue is under some misconception. The proviso following the main provision of Section 260A(4) of the Act states that nothing stated in sub-section (4), i.e., "The appeal shall be heard only on the question so formulated' shall be deemed to take away or abridge the power of the Court to hear, for reasons to be recorded, the appeal on any other substantial question of law not formulated by it, if it is satisfied that the case involves such question". The High Court's power to frame substantial question(s) of law at the time of hearing of the appeal other than the questions on appeal has been admitted remains under Section 260A(4). This power is subject, however, to two conditions, (one) the Court must be satisfied that appeal involves such questions, and (two) the Court has to record reasons therefor.

Special Leave Petition is dismissed.

Petition(s) for Special Leave to Appeal (Civil)....../2013 CC 3075/2013.

Heard on: 4th March, 2013.

Decided on: 4th March, 2013.

Present at hearing: R.P. Bhatt, Sr. Advocate, Sahil Tagotra, Om Prakash & Anil Katiyar, Advocates, for Petitioner. None, for Respondent.

JUDGMENT

Heard Mr. R.P. Bhatt, learned senior counsel for the petitioner.

We find that appeal filed by the Revenue under Section 260A of the Income Tax Act, 1961 (for short, 'Act') has been admitted by the High Court and two substantial questions of law have been framed for consideration of the appeal.

The grievance of the Revenue is that by necessary implication, the other questions raised in the memo of appeal before the High Court have been rejected.

We are afraid that the Revenue is under some mis-conception. The proviso following the main provision of Section 260A(4) of the Act states that nothing stated in sub-section (4), i.e., 'The appeal shall be heard only on the question so formulated' shall be deemed to take away or abridge the power of the Court to hear, for reasons to be recorded, the appeal on any other substantial question of law not formulated by it, if it is satisfied that the case involves such question.

The High Court's power to frame substantial question(s) of law at the time of hearing of the appeal other than the questions on appeal has been admitted remains under Section 260A(4). This power is subject, however, to two conditions, (one) the Court must be satisfied that appeal involves such questions, and (two) the Court has to record reasons therefor.

In view of the above legal position, we do not find any justifiable reason to entertain this special leave petition, although we are inclined to condone delay of 72 days.

Delay condoned.

Special leave petition is dismissed.