Complex Tax Laws & Hostile Tax Dept are Responsible for Tax Avoidance

by
Justice Swatanter Kumar (Retd.)

"**Taxation is the price which civilized communities pay for the opportunity of remaining civilised.**" — *Albert Bushnell Hart, Actual Government, 1903*

Tax patently appears to be an individual liability. Examined objectively, it is an investment for development and for the good of the society. I am very happy that the All India Federation of Tax Practitioners has chosen me to engage in a deep and mutually enriching dialogue with Indian Tax Professionals. I assure you that your interest in Indian taxation jurisprudence will provide you with a unique and stimulating journey, through the realms of abstract philosophy and also right up to the challenging ground realities of developmental concerns.

India has a well-developed tax structure with clearly demarcated authority between the Central and State Government as well as the local bodies. Taxation policies have always been driven by the love of extremes: the taxation of private wealth is often termed as expropriation; the accumulation of wealth can – and does – drive insurmountable and unacceptable rifts between the haves and the have nots. Thus, the Father of this nation, Mahatma Gandhi, diplomatically proposed a third alternative, one he claimed that has the sanction of religion and philosophy behind it; independent India was to seek the protection of trusteeship, wherein individual wealth was protected to the extent that it confers a right to a livelihood – and the remainder was held "in trust" for the public good, preventing the accumulation of private legacies.

"There seems to be universal agreement that the present tax code is way too complex and needs to be completely overhauled. Complexity in itself creates opportunities for tax avoidance and also causes difficulties for honest tax-payers. It leads to confusion and mistakes that are often hard to distinguish from dishonesty. Consequently, penalties become a less appealing approach to enforcement, while simultaneously, detection becomes costlier"

This philosophy has, obviously, been a forerunner of its times. Modern international taxation practice, in a surprising parallel, also views taxation as a means for directing and regulating the flow of investment. That is, in Gandhiji's words.

"We can try to canalise economic trends, but we can't run against them in a head-on collision."

Another significant aspect that cannot go unnoticed is globalisation. Globalisation and taxation, today, are synonymous; they are but two

sides of the same coin. Finally, we have reached a time when Indian taxation jurisprudence recognises the worth of this philosophy and is coming to stand on its own feet. Driven in the wake of the recent, epoch-making, *Vodafone* decision of the Hon'ble Supreme Court of India, we now enter an age where the manner and scope of taxation is a factor which makes or breaks the foreign investment in any given country. In the words of the past Secretary-General of the united Nations, Mr. Kofi Annan:

"It has been said that arguing against globalisation is like arguing against the laws of gravity."

Global and comparative dialogue, through conferences such as this one and at turning points such as this, is critically important for all concerned. A country which is as yet developing, both in its global economic confidence and in its taxation regime, needs the encouragement and support of its contemporaries. Conversely, it has considerable potential to contribute uniquely to and better the system as a whole.

Personally I believe that India faces a range of internal challenges which require her to synthesise, for herself, a new blueprint of taxation; a format which would reach a compromise between the largesse of the State and any unhealthy concentration of wealth or resources in private hands.

India, in Mark Twain's words, is not only the cradle of the human civilisation, but also the land of the fabulously rich and the fabulously poor – the land of palaces and hovels.

> *"The biggest problem today is not only that the law is complex, but that it is administered in a complex and unfriendly manner. Focus must therefore change from simplification of tax laws to improving tax administration. Lessons can also be learnt from international best practices"*

Our economic challenges are statistically significant. The Organization for Economic Co-operation and Development (OECD) itself recognizes that a widening gap between the rich and the poor is a result of the limitations faced by taxationn systems around the world, in controlling and regulating the flow of redistribution monies (i.e., tax proceeds) among informal and unregulated economic labour. Naturally, this challenge is particularly exacerbated in India, where economic activity is dominated by the informal sector. How, therefore, may we best lejerage our potential in a globalised world, attractively package our best investment opportunities, while nevertheless serving as the vanguard of the poorest of the poor? These questions plague our tax authorities every day, in every case.

Simplification of Tax Laws

The often quoted statement is: '*equity and taxes are strangers*'; one could add that 'tax laws and simplicity are also strangers'. In the Wealth of Nations, Adam Smith famously noted that complexity makes taxes "more

burdensome to the people than they are beneficial to the sovereign". The cost of taxes is not just the taxes we pay, but also the cost of complexity, popularly now termed as 'compliance cost'.

There seems to be universal agreement that the present tax code is way too complex and needs to be completely overhauled. Complexity in itself creates opportunities for tax avoidance and also causes difficulties for honest tax-payers. It leads to confusion and mistakes that are often hard to distinguish from dishonesty. Consequently, penalties become a less appealing approach to enforcement, while simultaneously, detection becomes costlier.

In other words, complexity not only increases the cost of compliance for the tax-payer, but it also increases the cost of enforcement for the Government. Therefore, before giving in to demands of special interest groups, one must think hard about whether the alleged equity or advantage resulting from each new exception (exemption, deduction, etc.) is really worth the added complexity and confusion.

Law, despite its source, is essentially mutable and has to change with the changing needs of the society to ensure that the legislative intent is achieved. Simplification of the tax laws, thus, would be a welcome step. As far as possible, they should be simplified so that it is not subject to different interpretation by different parties. Simplification of indirect tax collection laws will help in resolving disputes. There has to be a dispute settlement mechanism within the department so that tax collection is made simpler and there is a less pressure on tax collection machinery and suggested the authorities to devise ways to facilitate smooth tax collection.

The biggest problem today is not only that the law is complex, but that it is administered in a complex and unfriendly manner. Focus must therefore change from simplification of tax laws to improving tax administration. Lessons can also be learnt from international best practices. For example, OECD and the United Nations have been incessantly working for reducing complexities in international taxation by drafting model treaties for avoiding double taxation.

I hope this National Conferences shall provide clarify and understanding to the complex laws relating to direct and indirect taxes. Such seminars, deliberations and interactions project solutions to complex problems. And as it is truly said that *strength lies in differences and not in similarities.*

Republicans Propose US Financial Products Tax Reform

The United States House of Representatives Ways and Means Committee Chairman Dave Camp (R - Michigan) has released a tax reform discussion draft for financial products, which outlines changes to tax rules designed to provide greater simplicity and uniformity, as part of the Committee's broader effort on comprehensive tax reform.

The Ways and Means Committee held 20 separate hearings on comprehensive tax reform in the last Congress, releasing an international tax reform discussion draft in October 2011. It was said that the new discussion draft is, in part, a response to the input and feedback the Committee received during a joint hearing of the Ways and Means Committee and Senate Finance Committee examining the complex relationship between the tax code and financial products.

Camp commented that: "The US is a leader in the financial world, but our broken and antiquated tax code has failed to keep up with the rapid pace of financial innovation on Wall Street. … Updating these tax rules to reflect modern developments in financial products will make the code simpler, fairer and more transparent for taxpayers; and it will also help to minimize the potential for abuse that has occurred in the past."

Following the views expressed in the joint hearing, the discussion draft consolidates several reforms that have been identified as necessary to provide more uniform tax treatment of financial products.

Firstly, it proposes to provide uniform tax treatment of financial derivatives. The draft would require taxpayers engaged in speculative financial activity to mark certain financial derivative products to fair market value at the end of each tax year, thus triggering the recognition of gain or loss for tax purposes.

The tax code already requires or permits mark-to-market accounting for specific financial products, such as certain contracts and options that are traded on exchanges, and for specific taxpayers, such as securities and commodities dealers and traders, but it is suggested that broadly extending mark-to-market accounting treatment to derivatives would provide a more accurate and consistent method of taxing these financial products and make them less susceptible to abuse.

Derivatives that are used by businesses in the ordinary course of their businesses to hedge against price, currency, interest rate and other risks would not be affected. In addition, for taxpayers that are engaged in hedging business risks, the draft would allow transactions that are properly treated as hedges for financial accounting purposes to be treated as hedges for tax purposes.

Secondly, the draft would also reform the tax rules that apply to debt restructurings that do not involve a forgiveness of principal. It is intended that this change would reduce the prevalence of "phantom" cancellation-of-indebtedness income when debt is restructured - a common practice during economic downturns - thereby creating a more taxpayer-favorable rule.

Thirdly, for bonds that are acquired on a secondary market at a discount, the draft would require the holder of the bond to recognize taxable income on the discount over the remaining life of the bond - conforming the tax treatment of such transactions to bonds acquired at a discount directly from the borrower.

At the same time, the amount of discount to be recognized for tax purposes would be limited to the discount that typically reflects an increase in interest rates that has occurred since the date the bond was originally issued - as opposed to steeper discounts that often reflect deterioration in the creditworthiness of the borrower. The draft would also allow taxpayers to claim "above-the-line" deductions for bonds acquired at a premium on a secondary market.

Fourthly, to simplify tax compliance and administration, and to determine more accurately the amount of gain or loss when a security is sold, the draft would require the cost basis of the security to be based on the average cost basis of all other shares or units of the identical security held by the taxpayer.

Fifthly, the draft reform would prevent the circumvention of the so-called "wash sale" anti-abuse rule, intended to prevent taxpayers from harvesting tax losses by selling securities at a loss and then immediately reacquiring the same securities, by using related parties such as spouses, children or entities controlled by the taxpayer. The draft would reform the rule so that it applies to transactions involving closely related parties.

Camp has also recognized that the discussion draft does not address several technical and policy issues that may need to be resolved in final legislation, and has invited comments on how to address such issues, in particular those related to valuing

derivatives that would become subject to mark-to-market tax treatment; and identifying financial products tax provisions under current law that may become obsolete or may require modification in light of the discussion draft.

USA

Treasury and IRS prepare for implementation of the FATCA

The U.S. Department of the Treasury and IRS on 17 January 2013 issued comprehensive final regulations implementing the information reporting and withholding tax provisions commonly known as the Foreign Account Tax Compliance Act (FATCA).

These regulations provide additional certainty for financial institutions and government counterparts by finalizing the step-by-step process for U.S. account identification, information reporting, and withholding requirements for foreign financial institutions (FFIs), other foreign entities, and U.S. withholding agents.

The final regulations issued:

– Build on intergovernmental agreements that foster international cooperation.
– Phase in the timelines for due diligence, reporting and withholding and align them with the intergovernmental agreements.
– Expand and clarify the scope of payments not subject to withholding.
– Refine and clarify the treatment of investment entities.
– Clarify the compliance and verification obligations of FFIs.

Treaty between United States and Japan – texts of protocol and exchange of notes released

The US Treasury Department has released the official English texts of the new protocol to the US-Japan income tax treaty and the accompanying exchange of notes. The protocol was signed on 24 January 2013 and amends the US-Japan income tax treaty that was signed on 6 November 2003.

The US Treasury Department also issued a Press Release announcing the signing of the protocol.

According to the Press Release, the protocol is intended to bring the existing income tax treaty into closer conformity with the current tax treaty policies of both the United States and Japan.

The Press Release further states that the protocol provides for:

- exclusive residence-country taxation of interest and of an expanded category of direct dividends (i.e. dividends paid by subsidiaries that are 50% or more owned for 6 months);
- full application of the US Foreign Investment in Real Property Tax Act (FIRPTA) to capital gains;
- resolution through mandatory binding arbitration of certain cases that the revenue authorities of the United States and Japan have been unable to resolve after a reasonable period of time;
- provisions that enable the competent authorities to assist each other in the collection of taxes; and
- full exchange of information between the competent authorities.

The protocol will enter into force when instruments of ratification are exchanged.

France

Exemption from VAT on sale of building land – transitional measure

In the updated Guideline of 23 January 2013 (BOI-TVA-IMM-10-10-20-20130123), the tax administration adopted a transitional measure in order to secure the new exemption from VAT for the sale of building land.

The Third Amending Financial Law for 2012 (Projet de loi de Finances rectificative pour 2012, PLFR, Law No. 2012-1510 of 29 December 2012) published in the Official Gazette of 30 December 2012, exempts from VAT sale of building land as from 1 January 2013. Consequently, article 257-I-3-2-a of the French Tax Code, which provided for the taxation on the sale of building land, has been abolished. This measure applied as from 31 December 2012, even though no transitional measures have been adopted so far.

Under the updated Guideline of 23 January 2013 (BOI-TVA-IMM-10-10-20-20130123), the sale of building land which occurs after 31 December 2012 but which had been agreed and signed before that date remain subject to VAT.

Tax credit: Reduction of the overall amount of tax credits in 2013

According to the Finance Law for 2013 (Loi de finances pour 2013, LF 2013), the cap for the overall amount of tax credits (under article 200-0 A of the French Tax Code) for 2013 is EUR 10.000.

In 2012, the cap for the overall amount of tax credits was EUR 18.000 + 4% of the taxable income. This amount has been reduced in the Finance Law for 2013 and the reference to the taxable income has been removed.

No VAT representative necessary for certain non-EU taxpayers

The Third Amending Financial Law for 2012 (Projet de loi de Finances rectificative pour 2012, PLFR, Law No. 2012-1510 of 29 December 2012) in the Official Gazette of 30 December 2012, modified the requirement to appoint a tax representative VAT for certain taxpayers. This obligation is no longer applicable to taxpayers established in a Non-EU country that signed an agreement on assistance in the recovery of tax claims, or a treaty which include assistance to the recovery of tax claims, with France. The list of Countries will be published in a Decree.

Before 1 January 2013, all non-EU companies without a permanent establishment in France had to appoint a tax representative in France, who is liable for the declaration and the payment of tax. If no tax representative is appointed, VAT is due by the customer (reverse charge).

As from 1 January 2013, taxpayers established in one of the countries listed on the Decree to be published, will no longer appoint a VAT representative in France to take in charge of their reporting obligations and/or payment of VAT. As consequence, they will have to:

- identify themselves to the French Tax authorities;
- declare their taxable transactions carried out in France; and
- pay the tax directly (if necessary).

Netherlands

Decree concerning restriction of interest deductibility for participations published

In the Official Gazette of 24 January 2013, a Decree of 16 January 2013 on the restriction of the interest deductibility for participations was published. The Decree, which applies retroactively from 1 January 2013, is in line with the Draft Decree published on 12 October 2012.

Important additions include the following:

- the term reorganizations include the situation of a capital contribution to the acquiring company, in which case the capital increase is equated with the issuing of shares; and
- the purchase price of shares exchanged within a group, which already owned on 31 December 2006, is set at 90% of the first acquisition price. With respect to those shares, the taxpayer does not have to show that those shares were previously acquired in the context of an expansion of the activities. However, with respect to the latest transfer in the context of the reorganization, the taxpayer still has to show that the shares exchanged are held in active company mainly involved in operational activities. A company his held to be active if at least 70% of its activities are operational activities.

Tax Plan 2013: New bill on taxation of rental income submitted to parliament

Recently, a new bill on taxation of rental income submitted to parliament because the previous bill, which was part of the Tax Plan 2013, was not adopted by the Upper House on 18 December 2012.

The new bill specifies that the tax for the year 2013 will be levied at the rate of 0.014%. The tax applies for one year and it still has to be decided whether the tax will be continued in 2014.

Liechtenstein—Malta

Liechtenstein and Malta have recently finalized negotiations on a bilateral double taxation agreement

Talks lasted six month with delegations from Liechtenstein and Malta agreeing to conclude negotiations on the DTA. The agreement was signed in Vaduz in respect of taxes on income and on wealth.

The agreement follows the OECD's Model Convention and governs the tax treatment of wealth structures and funds.

The signing of the DTA is due to take place during the course of 2013. The text will be published following the signing. The agreement is expected to apply from January 1, 2014.

USA

IRS to seek records from UBS of US taxpayers suspected of hiding their income in accounts with Swiss bank Wegelin

On January 28, 2013, US District Judge William Pauley in Manhattan granted the IRS's request to issue a "John Doe" summons, which seeks information about possible tax fraud committed by individuals whose identities are not known, to UBS for the names of taxpayers who may have hidden income at Wegelin and other Swiss banks.

A UBS spokeswoman declined to comment on the ruling.

hen the government indicted Wegelin nearly a year ago, it alleged that the bank used a US correspondent account at UBS to handle funds for American clients, a standard industry practice for foreign banks. By covertly transferring money from undeclared Swiss accounts, Wegelin allowed clients to avoid paying income taxes in the United States, the government alleged.

Norway

Norway will pay near one million euros to strengthen Cyprus' anti-money laundering capabilities

A contract has been between the Planning Bureau and the Unit for Combating Money Laundering (MOKAS) for the financing of a project aiming to strengthen MOKAS' capacities and improve its efficiency to detect money laundering and the financing of terrorism.

The project will be implemented by MOKAS and cost a total €1,100,882. Norway will provide the majority of funds, 85 per cent, amounting to €935.750, while MOKAS will provide the remaining €165.132.

The main objective of the project is to automate the analysis and investigation procedure of MOKAS by implementing an IT system to support its core activities. This in turn will enhance the capabilities of the Unit making best use of available information and automatic recognition of relationships between data, information and suspects.

Seychelles

Journalist's investigation has caused the reaction of Seychelles International Business Authority (SIBA)

The SIBA expressed its concern in relation to the involvement of two international corporate service providers ("service providers") within the Al Jazeera article and documentary, entitled "People & power: How to rob Africa", published and aired on November 8, 2012 in view of the damage that matters of such nature may cause to the reputation of the Seychelles.

Following the SIBA initiating relevant actions under the law in conjunction with other relevant authorities, it was deemed to be necessary that the licenses of the two service providers involved be suspended pending further enquiries and examinations.

From these enquiries and examinations conducted, the conclusions were such that the SIBA deemed it necessary, pursuant to provisions of the relevant laws to revoke the licences of Premier Offshore Limited and Zen Offshore Services Limited.

The SIBA hereby reiterates that it will not hesitate to recourse to appropriate enforcement actions to deal with any parties under its regulatory and supervisory purview that are in non-compliance with the relevant legislations.

European Union—Denmark

European Commission asks Denmark to change exit tax provisions for individuals

On 24 January 2013, the European Commission announced that it had sent Denmark a reasoned opinion (second stage of the infringement procedure under article 258 of the Treaty on the Functioning of the EU (TFEU)) requesting the amendment of its exit tax rules. According to current Danish rules, when an individual leaves Denmark to take up residence in another Member State, the gain made on his portfolio of shares is calculated and taxed. This tax is collected from the individual either when the shares from the portfolio are sold, or when dividends or other types of income from these shares are received. The Commission considers that these rules infringe the free movement of people and capital provided by the Treaty on the Functioning of the EU (TFEU).

If Denmark does not comply with the reasoned opinion within 2 months, the matter may be referred to the Court of Justice of the European Union (ECJ).

European Union—Latvia

Council Implementing Decision on authorization for Latvian derogation from VAT Directive regarding timber transactions – official text published

The text of the Council Implementing Decision of 22 January 2013, authorizing Latvia to derogate from article 193 of the EU VAT Directive (2006/112) with regard to timber transactions, was published in the Official Journal of the European Union L 22 of 25 January 2013.

According to Latvian VAT legislation, as regards timber transactions, the person liable to pay tax is the taxable person for whom the taxable supply of goods or services is carried out, while under the EU VAT Directive, the taxable person supplying goods and services is usually liable for the payment of the tax. This special provision of Latvian legislation was adopted due to the high risk level for VAT fraud in this sector. The derogating measure has already been applicable under Council Implementing Decision 2009/1008/EU and is now extended until 31 December 2015.

EU—Poland

European Commission requests Poland to amend the scope of reduced VAT rates for medical equipment and pharmaceutical products

On 24 January 2013, the European Commission announced that it had sent Poland a reasoned opinion (second stage of the infringement procedure under article 258 of the Treaty on the Functioning of the EU (TFEU)) requesting the amendment of its reduced VAT rate applicable to medical equipment and pharmaceutical products to what is permitted under EU law. The EU VAT Directive (2006/112) allows a reduced VAT rate for medical equipment, aids and other appliances under the double condition that they are “normally intended to alleviate or treat disability” and “for the exclusive personal use of the disabled”. For pharmaceutical products, the VAT Directive allows a reduced VAT rate only for those related to health care, prevention of illnesses and medical and veterinary treatments. The Polish VAT legislation exceeds this scope as it grants a reduced VAT rate to medical equipment of general use, and to certain non-medicinal pharmaceutical products, such as disinfectants and spa products.

If Poland does not comply with the reasoned opinion within 2 months, the matter may be referred to

France

Non-deductibility of waivers of financial debt: clarification

On 29 January 2013, the French tax authorities clarified the regime of waiver of financial debt in the updated guidelines (BOI-BIC-BASE-50-20-10-20130129). This clarification confirms the measure adopted within the Second Amending Finance Law for 2012 (Loi de Finances Rectificative pour 2012, PLFR) that removed the possibility to deduct waivers of financial debt. Further details will be reported subsequently.

Greece

Ministry of Finance sets up Tax Reform Committee

On 23 January 2013, the Greek Ministry of Finance announced the setting up of a Tax Reform Committee under the presidency of the Deputy Minister of Finance. The Committee will consult with relevant stakeholders for the achievement of simplification, modernization and efficiency of the tax system. The mandate of the Committee is to study the following issues, in collaboration with the technical assistance provided to the country:

- simplification of the Income Tax Code;
- drafting of a Code of tax procedures; and
- elaboration of additional measures against tax evasion.

The Committee's proposals will be presented in April 2013.

OECD

OECD publishes two reports on energy policy, public finances and environmental goals

On 28 January 2013, the OECD published the reports Taxing Energy Use and Inventory of Estimated Budgetary Support and Tax Expenditures for Fossil Fuels 2013. The two new OECD reports provide wide-ranging evidence of how reforming subsidies and tax breaks for fossil fuels and rationalising fuel taxes can help countries boost finances and meet green objectives.

Taxing Energy Use provides the first systematic, comparative analysis of the structure and level of energy taxes in the 34 OECD

member countries. It sets out how tax rates vary between different types of fuel and different uses of fuel for each country. The information is also summarised in graphical form.

The report calculates what statutory tax rates on these diverse fuels imply in terms of taxation per unit of energy and per unit of carbon dioxide (CO_2) emissions. It shows the wide variations in these effective tax rates across countries, and details how rates also vary widely within countries between different types of fuel (diesel, natural gas, coal, etc.), even when they are used for similar purposes. For example:

- On average, the effective tax rate in terms of carbon emissions on diesel for road use is 37% lower than the comparable rate on gasoline; the rate in terms of energy content is 32% lower.
- In heating and industrial uses, the average effective tax rate in carbon terms on oil products is EUR 24 per tonne of CO_2, compared with EUR 13 per tonne for natural gas; the average rate on coal is only EUR 5 per tonne, despite its significant negative environmental impacts.
- Fuel used in agriculture, fishing and forestry is often exempt from tax.

This wide range of tax rates - when measured in terms of carbon emissions - results in wide differences in the tax disincentives to emit. Since CO_2 has broadly the same impact on atmospheric greenhouse gas concentrations (and thus climate change) however and wherever it is emitted, these differences underline the fragmentation in current international efforts to mitigate climate change.

The Inventory of Estimated Budgetary Support and Tax Expenditures for Fossil Fuels 2013 collects details on more than 550 fossil fuel support measures in the 34 OECD member countries, including many provided by state and provincial governments. The report also highlights progress made and the benefits identified by a number of OECD countries in reforming support to fossil fuels in recent years. For example:

- Germany reduced its total amount of estimated support for fossil-fuel production by more than half, to about EUR 2 billion (0.1% of GDP) in 2011, reflecting a decision to phase out support to the hard coal industry by 2018.

- Mexico has introduced a new and more efficient cash-transfer scheme to help poor households cover their energy needs, as well as a pilot programme to replace electricity subsidies for pumping irrigation water with direct cash transfers in some states, thereby removing the price distortion that has led to significant over-exploitation of groundwater.
- The United States has proposed a federal budget for FY2013 that would eliminate a number of tax preferences benefitting fossil fuels, which could increase government revenues by more than USD 23 billion over the 2013-17 period.

Governments support fossil-fuel production through market intervention, direct transfers of funds, undercharging of government-supplied goods or assets and tax concessions. Consumption of fossil fuels is supported by mechanisms including price controls, rebate schemes and tax relief. As tax treatment varies considerably across countries, the value of this support, which includes tax expenditures, is not internationally comparable.

Petroleum products benefitted from around two-thirds of the value of all support measures identified in the Inventory, with the remainder equally split between coal and natural gas.

OECD analysis identifies common strategies among governments that have successfully reduced fossil-fuel and electricity subsidies:

- Increase the availability and transparency of data on support.
- Provide better-targeted and transparent compensatory measures for economic restructuring or poverty alleviation to smooth the path for fossil-fuel subsidy reform.
- Integrate reforms to fossil-fuel subsidies in a package that includes broader structural reforms, where possible.
- Ensure public trust in the reform agenda through broad communication strategies, appropriate timing of subsidy removal, and implementation of compensatory social policies.

Japan Includes Tax Reforms In 2013 Budget

The first full-year budget for 2013/14 approved by the new Japanese Cabinet furthers Prime Minister Shinzo Abe's primary aim of stimulating the economy through public works spending, but also includes reforms to individual, corporate and investment taxation.

The overall size of the budget is put at JPY92.6 trillion (USD1 trillion), to be mainly financed by the issuance of new government bonds in the amount of JPY42.85 trillion and by tax revenue estimated at JPY43.1bn.

Much has been made of the fact that next year's tax revenue will be greater than bond issuance for the first time in four years, but it is also recognized that something will have to be done, sooner rather than later, about the continued rise in Japan's public debt and its servicing costs (that will amount to JPY22.2 trillion in 2013/14).

In addition, with Japan's rapidly ageing population, social security expenditure in 2013/14 is expected to rise by 10.4% to reach JPY29.1 trillion, and will account for nearly one-third of budget spending, while the projected spending on public works projects to stimulate economic growth, the Prime Minister's so-called "Abenomics" policy, will increase in 2013/14 for the first time in four years, up 15.6% from the previous year to some JPY5.3 trillion.

There is little reliance on tax cuts within the "Abenomics" economic stimulus plan, and the budget does not contain any measures to ease the effect of planned sales tax increases that are intended, in the next fiscal year, to begin fiscal deficit containment by raising around JPY13.5 trillion annually. Consumption tax should still increase from its present rate of 5% to 8% in April 2014, then to 10% in October 2015, while there is no movement towards the lower tax rates that have been suggested for necessities, such as food.

In fact, the tax reform package approved by the Cabinet at the same time as the overall budget also includes increased taxes for the wealthiest taxpayers by the introduction of a new 45% personal income tax rate band for those earning over JPY40m. The current highest marginal income tax rate is 40% on taxable incomes over JPY18m.

Inheritance taxes will also be increased by reducing the basic deduction by 40%, from the current amount calculated as “JPY50m plus JPY10m multiplied by the number of statutory heirs” to “JPY30m plus JPY6m multiplied by the number of statutory heirs,” and by raising the top tax rate to 55% from 50%.

However, the tax reforms also include some corporate tax breaks and investment incentives. For example, companies that make further investment in production facilities in Japan are to be given a tax incentive through a special depreciation allowance of 30% or a tax credit of 3% for the acquisition cost of the relevant production facilities, or of 7% for small and medium-sized enterprises (SMEs) making investments in the agricultural, forestry and fisheries, commerce, and service sectors.

There is also an increase to the maximum allowable tax deduction for research and development spending to 30% (from 20%) of a company’s corporate tax liability, as well as a new tax cut for business entertaining by SMEs (of up to JPY8m annually).

The government will also introduce a Japanese version of an individual savings account to allow investment of up to JPY5m without taxation for 10 years, and will extend the period of the current tax credit relating to housing loans for four years, from January 1, 2014 to the end of 2017, and raise the maximum amount of deductions to JPY5m for eligible houses (long-term quality and low-carbon houses) and to JPY4m for other houses acquired during that period.

2013 TRI 225 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
BANGALORE "A" BENCH, BANGALORE

N. Barathvaja Sankar, Vice President and N.V. Vasudevan, Judicial Member

FACTS/HELD

1. **Transfer Pricing: Comparables cannot be ignored on ground of abnormal profits/losses if they are functionally comparable**
2. The assessee provided software research & development services to its' USA based AE and was remunerated on a 'cost plus' basis. The assessee claimed that applying the TNMM and using operating profits to cost as the Profit Level Indicator ("PLI"), its PLI of 9.98% was at arms length. The TPO & DRP rejected the assessee's claim and computed the ALP at 24.35% and made an adjustment of Rs. 6.20 crores. The Tribunal had to consider the following issues: (i) whether in selecting a comparable, a turnover filter has to be adopted, (ii) whether companies with abnormal margins can be regarded as comparable, (iii) whether a filter can be applied to distinguish between companies earning revenue from rendering "onsite services" as compared to those rendering "offshore services" even though there is no functional difference between the two activities & (iv) whether the TPO is confined to information in public domain or he can collect information u/s 133(6). HELD by the Tribunal:
   (i) S. 92C & Rule 10B(2) clearly lay down the principle that the turnover filter is an important criteria in choosing the comparables because significant differences in size of the companies would impact comparability even there is no functional difference in their activities. Size matters in business because a big company would be in a position to bargain the price and also attract more customers. It would also have a broad base of skilled employees who are able to give better output. A small company may not have these benefits and therefore, the turnover also

would come down reducing profit margin. As the assessee's turnover is Rs. 47 crores, only companies with a turnover between Rs. 1 to Rs. 200 crore should be considered for comparability (Quark Systems 38 SOT 207 (SB), Genesis Integrating Systems & OECD TP Guidelines, 2010, ICAI TP Guidelines followed);

(ii) (ii) U/s 92C & Rule 10B(2), there is no bar to considering companies with either abnormal profits or abnormal losses as comparable to the tested party, as long as they are functionally comparable. This issue does not arise in the OECD guidelines and the US TP regulations because they advocate the quartile method for determining ALP under which companies that fall in the extreme quartiles get excluded and only those that fall in the middle quartiles are reckoned for comparability. Cases of either abnormal profits or losses (referred to as outliners) get automatically excluded. However, Indian regulations specifically deviate from OECD guidelines and provide Arithmetic Mean method for determining ALP. In the arithmetic mean method, all companies that are in the sample are considered, without exception and the average of all the companies is considered as the ALP. Hence, while the general rule that companies with abnormal profits should be excluded may be in tune with the OECD guidelines, it is not in tune with Indian TP regulations. However, if there are specific reasons for abnormal profits or losses or other general reasons as to why they should not be regarded as comparables, then they can be excluded for comparability. It is for the Assessee to demonstrate existence of abnormal factors. On facts, as the assessee has not shown any factors for abnormal profits, no comparable can be excluded for that reason (contra view in Quark Systems & Sap Labs noted);

(iii) Though the functions performed by offshore service providers and onsite service providers is the same, i.e. development of computer software, under Rule 10B(2)(b) one has to have regard to the functions performed, taking into account assets employed or to be employed and the risks assumed by the respective parties to the transactions. The "market conditions" are different for on-site and

offshore work because in onsite development of computer software, the assessee does not employ assets or assume many risks. Even the per hour rate is different. The fact that in TNMM it is only the margins in an uncontrolled transaction that is tested does not mean that the fact that pricing will have an effect on the margins obtained in a transaction can be ignored. Companies which generate more than 75% of the export revenues from onsite operations outside India are effectively companies working outside India having their own geographical markets, cost of labour etc., and also return commensurate with the economic conditions in those countries. Thus assets and risk profile, pricing as well as prevailing market conditions are different in predominantly onsite companies from predominantly offshore companies like the assessee. Since, the entire operations of the assessee took place offshore i.e. in India; it should be compared with companies with major operations offshore, due to the reason that the economics and profitability of onsite operations are different from that of offshore business model;

(iv) The TPO is entitled to collect information u/s 133(6) though if it is sought to be used against the assessee, it must be furnished to the assessee and his objections taken into account. If the assessee seeks an opportunity to cross examine the party, that opportunity should be provided so that he can rebut the stand of that particular company. On facts, the assessee had not been able to show that the TPO had used information u/s.133(6).

Appeal partly allowed.

ITA No.1054/Bang/2011 (Assessment Year : 2007-08).

Heard on: 17th September, 2012.

Decided on: 23rd November, 2012.

Present at hearing: Padamchand Khincha, C.A., for Appellant. S.K. Ambastha, CIT-I(DR), for Respondent.

JUDGMENT

Per N.V. Vasudevan:– (Judicial Member)

This appeal by the assessee is against the order dated 30.09.2011 of the Dy.CIT, Circle 12(4), Bangalore passed u/s. 143(3) r.w.s. 144C of the Act.

2. Ground Nos. 1 to 16 raised by the assessee is with regard to the addition to the total income by way of adjustment to the Arms' Length Price (**"ALP"**) to an international transaction carried out by the assessee u/s. 92CA of the Act. These grounds read as follows:–

> "The learned Assessing Officer, learned Transfer Pricing Officer and Honorable Dispute Resolution Panel have erred in:–
>
> 1. passing the Order which is bad in law;
> 2. passing the order disregarding the principles of natural justice;
> 3. making a reference to Transfer Pricing Officer for determining arms' length price;
> 4. passing the order without demonstrating that appellant had motive of tax evasion;
> 5. ignoring the fact that the members of Dispute Resolution Panel also being jurisdictional Commissioner/Directors of Income Tax of the appellant, the constitution of the Dispute Resolution Panel is bad in law;
> 6. not appreciating that the charging or computation provision relating to income under the head "Profits & Gains of Business or Profession" do not refer to or include the amounts computed under Chapter X and therefore addition under Chapter X is bad in law;
> 7. adopting a flawed process of issuing notices u/s 133(6) and relying on the same without providing complete information and an opportunity to cross examine the companies concerned;
> 8. rejecting the comparables selected by the appellant and rejecting transfer pricing analysis of the appellant;
> 9. performing fresh transfer pricing analysis and adopting inappropriate filters in doing fresh transfer pricing analysis;
> 10. selecting inappropriate comparables;
> 11. rejecting additional comparables proposed by the appellant;
> 12. inappropriately computing the operating margins of comparables and the appellant;
> 13. treating foreign exchange gain or loss and provision for bad debts as non-operating in nature and fringe benefit tax as part of operating cost;
> 14. not making proper adjustment for enterprise level and transactional level differences between the appellant and the comparable companies;

15. not appreciating that the law does not compel adopting many (or any minimum) companies as comparables and that the appellant could justify the price paid/charged on the basis of any one comparable only;
16. not allowing the benefit of the +/-5% range mentioned in the proviso to section 92C(2)."

3. The assessee is a company. It was incorporated in June, 2000. M/s. Versata International Inc., USA holds the entire share capital of the assessee, except two shares. The assessee provides software research & development services for Versata International Inc. on a contract basis and as requested by Versata International Inc. It is not in dispute before us that the transaction of providing software research & development support services by the Assessee to Versata International Inc., was an international transaction with the Associated Enterprise "(**"AE"**) and therefore the price at which the assessee renders services to its AE has to pass the Arm's Length Price (ALP) test as laid down by section 92C of the Act. During the financial year 2006-07, the assessee provided software research & development support services to its AE and was remunerated on a 'cost plus' basis. The total value of international transaction with respect to the provision of software research & development support services by the assessee to its AE was Rs. 47,46,66,638.

4. In support of the assessee's claim that the price charged by it for services rendered to its AE was at arms' length, the assessee filed a report as required by the provisions of section 92E of the Act in Form 3EB together with detailed analysis. The assessee adopted the Transactional Net Margin Method (**"TNMM"**) as the most appropriate method for determining the ALP. The assessee adopted operating profits to cost as the Profit Level Indicator (**"PLI"**). The list of comparables ultimately chosen by the assessee for comparability is annexed as **Annexure-I** to this order and the process by which the same was arrived at is detailed in the Annexure to the report in Form 3EB. The PLI of the assessee as arrived at in the said report is annexed as **Annexure-II** to this order. It can be seen from Annexure-I that the arithmetic mean of comparables was computed at 14.53%. The PLI of the assessee (as per Annexure-II) was computed at 9.98%. It was the claim of the assessee that exercising the option of determining the ALP between +/- 5% of the arithmetic mean of the comparable prices, the range of operating margin would be between 8.80% & 20.25% on operating costs. Since the assessee's operating margin on operating cost was within the arms' length range, the assessee claimed that its international transaction was at arms' length.

5. The filters or criteria adopted by the tax payer in its TP study and the remarks of the Transfer Pricing Officer (**"TPO"**) to whom the AO referred determining of ALP on such approach were as follows:–

"Filters or criteria adopted by the taxpayer in its TP study:

Sl. No.	Particulars	Remark of the TPO
1	Companies for which sufficient financial data is not available to undertake analysis	This is an appropriate filter. Hence, it is accepted.
2	Companies that have ceased business operations or are currently inactive	This is an appropriate filter. Hence, it is accepted.
3	Companies undertaking significantly different functions compared to the tested party	This is an appropriate filter provided the decision is based on objective criteria and not by selecting / rejecting based on the margin of a company.
4	Companies that do not have significant (>25%) foreign exchange earnings	This is an appropriate filter. Hence, it is accepted.
5	Companies which have been making persistent operating losses	This is an appropriate filter. Hence, it is accepted.
6	Companies that had substantial (excess of 25%) transactions with related parties	It is an appropriate filter to eliminate the influence of controlled transactions.
7	Companies that had exceptional year(s) of operation	It will be an appropriate filter provided if one gives reason for such exceptional performance. Also the companies being service providers, one may not get exceptional sales without the service being rendered also exceptional i.e., one may not get any income without doing any work.
8	Companies that are duplicated in the database with different names or merged to form another company	It is an appropriate filter. Hence, it is accepted.

6. Thereafter the TPO was of the view that it would be appropriate to apply the following filters for selection of comparables:–

> "10.8 Final filters selected by the TPO for selection of comparables:

As per the above discussion, the following are the filters applied by the TPO for making the comparables functionally similar and also making economic circumstances similar as per the provisions of Rule 10B(2). These filters include the filters that are applied by the tax payer and accepted by the TPO.

- Companies whose data is not available for the FY 2006-07 were excluded.
- Companies whose software development service revenue <Rs.1 cr. were excluded
- Companies whose Software Development Service revenue is less than 75% of the total operating revenues were excluded unless segmental details are available and the segment qualifies this filter.
- Companies who have more than 25% related party transactions (income as well as expenditure combined) of the operating revenues were excluded
- Companies who have less than 25% of the operating revenues as export sales were excluded
- Companies who have diminishing revenues/persistent losses for the period under consideration were excluded
- Companies having different financial year ending (i.e. not March 31, 2006) or data of the company does not fall within 12 month period i.e. 01-04-2005 to 31-03-2006, were rejected
- Companies whose employee cost to operating revenues is less than 25% of the revenues were excluded
- Companies whose onsite revenue is more than 75% of the export revenues were excluded."

7. The TPO rejected 20 out of 28 comparables given by the assessee in its TP report (**Annexure I to this order**). The assessee before the TPO had also given some other additional comparables which was also rejected by the TPO. The TPO on his own, on a search carried on in Prowess Database arrived at a set of 18 comparables over and above the 8 comparables relied upon by the assessee in its TP study, which the TPO accepted were comparable. Thus, the TPO arrived at a set of 26 comparables. The set of 26 comparables is given as **Annexure-III**.

8. The assessee raised various objections to the methodology adopted and the reasons assigned by the TPO for rejecting the comparables chosen by the assessee in its TP study. In the course of proceedings before the TPO, notice u/s. 133(6) has been issued to the companies that were chosen as comparable by the assessee as well as the TPO and on the basis of the replies received in response to such notices, certain inferences were drawn by the TPO. The action of the TPO in relying on some of those

information was also challenged by the assessee. The TPO finally passed an order u/s. 92CA of the Act and on the basis of the comparables set out in **Annexure-III** to this order, arrived at arithmetic mean of 25.14%. After factoring the working capital adjustment of 0.79%, the adjusted arithmetic mean was determined at 24.35%. On the basis of that adjusted arithmetic mean and after factorizing of the operating profits to cost of the assessee which was 9.98%, the AO arrived at Rs. 6,20,48,644 as an addition by way of adjustment to ALP. The computation of the TPO in this regard was as follows:–

> "Computation of Arms Length Price:
>
> The arithmetic mean of the Profit Level indicators is taken as the arms length margin. (Please see Annexure B For details of computation of PLI of the comparables). Based on this, the arms length price of the software development services rendered by the taxpayer to its AE(s) is computed as under:

Arithmetic mean PLI	:	**25.14%**
Less: Working capital adjustment (Annexure-C)	:	**0.79%**
Adj. Arithmetic mean PLI	:	**24.35%**

Arm's Length Price:

Operating Cost	**Rs. 43,16,16,632/-**
Arms Length Margin	**24.35% of the Operating Cost**
Arms Length Price (ALP) @124.35% of operating cost	**Rs.53,67,15,282/-**

Price Received vis-à-vis the Arms Length Price:

The price charged by the tax payer to its Associated Enterprises is compared to the Arms Length price as under:

Arms Length Price @ 124.35% of operating cost	**Rs.53,67,15,282/-**
Price charged in the international transactions	**Rs. 47,46,66,638/-**
Shortfall being adjustment u/s 92CA	**Rs. 6,20,48,644/-**

> The above shortfall of Rs.6,20,48,644/- is treated as transfer pricing adjustment u/s 92CA."

9. Against the said adjustment proposed by the TPO which was incorporated in the draft assessment order by the AO, the assessee filed objections before the DRP. The DRP rejected those objections and confirmed the transfer pricing adjustment suggested by the TPO. The adjustment confirmed by the DRP was added to the total income of the assessee by the AO in the fair order of assessment. Against the said order of the Assessing Officer, the assessee has preferred the present appeal before the Tribunal.

10. The ld. counsel for the assessee as well as the ld. DR made rival submissions on various aspects of the adjustment made by the TPO. These objections will be dealt with under different heads.

(1) Turnover Filter

11. The ld. counsel for the assessee submitted that the TPO has applied a lower turnover filter of Rs. 1 crore, but has not chosen to apply any upper turnover limit. In this regard, it was submitted by him that under rule 10B(3) to the Income-tax Rules, it was necessary for comparing an uncontrolled transaction with an international transaction that there should not be any difference between the transactions compared or the enterprises entering into such transaction, which are likely to materially affect the price or cost charged or paid or profit arising from such transaction in the open market. Further it is also necessary to see that wherever there are some differences such differences should be capable of reasonable accurate adjustment in monetary terms to eliminate the effect of such differences. It was his submission that size was an important facet of the comparability exercise. It was submitted that significant differences in size of the companies would impact comparability. In this regard our attention was drawn to the decision of the Special Bench of the ITAT Chandigarh Bench in the case of *DCIT v. Quark Systems Pvt. Ltd.* 38 SOT 207, wherein the Special Bench had laid down that it is improper to proceed on the basis of lower limit of 1 crore turnover with no higher limit on turnover, as the same was not reasonable classification. Several other decisions were referred to in this regard laying down identical proposition. We are not referring to those decisions as the decision of the Special Bench on this aspect would hold the field. Reference was also made to the OECD TP Guidelines, 2010 wherein it has been observed as follows:–

> "Size criteria in terms of Sales, Assets or Number of Employees: The size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability."

12. The ICAI TP Guidelines note on this aspect lay down in para 15.4 that a transaction entered into by a Rs. 1,000 crore company cannot be compared with the transaction entered into by a Rs. 10 crore company. The two most obvious reasons are the size of the two companies and the relative economies of scale under which they operate. The fact that they operate in the same market may not make them comparable enterprises. The relevant extract is as follows [on Rule 10B(3)]:

> "Clause (i) lays down that if the differences are not material, the transactions would be comparable. These differences could either be with reference to the transaction or with reference to the enterprise. For instance, a transaction entered into by a Rs 1,000 crore company cannot be compared with the transaction

> entered into by a Rs 10 crore company. The two most obvious reasons are the size of the two companies and the relative economies of scale under which they operate."

13. It was further submitted that the TPO's range (Rs. 1 crore to infinity) has resulted in selection of companies like Infosys which is 277 times bigger than the Assessee (turnover of Rs. 13,149 crores as compared to Rs. 47.47 crores of Assessee). It was submitted that an appropriate turnover range should be applied in selecting comparable uncontrolled companies.

14. Reference was made to the decision of the ITAT Bangalore Bench in the case of *Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT*, ITA No.1231/Bang/2010, wherein relying on Dun and Bradstreet's analysis, the turnover of Rs. 1 crore to Rs. 200 crores was held to be proper. The following relevant observations were brought to our notice:–

> "9. Having heard both the parties and having considered the rival contentions and also the judicial precedents on the issue, we find that the TPO himself has rejected the companies which .ire (sic) making losses as comparables. This shows that there is a limit for the lower end for identifying the comparables. In such a situation, we are unable to understand as to why there should not be an upper limit also. What should be upper limit is another factor to be considered. We agree with the contention of the learned counsel for the assessee that the size matters in business. A big company would be in a position to bargain the price and also attract more customers. It would also have a broad base of skilled employees who are able to give better output. A small company may not have these benefits and therefore, the turnover also would come down reducing profit margin. Thus, as held by the various benches of the Tribunal, when companies which arc loss making are excluded from comparables, then the super profit making companies should also be excluded. For the purpose of classification of companies on the basis of net sales or turnover, we find that a reasonable classification has to be made. Dun & Bradstreet & Bradstreet and NASSCOM have given different ranges. Taking the Indian scenario into consideration, we feel that the classification made by Dun & Bradstreet is more suitable and reasonable. In view of the same, we hold that the turnover filter is very important and the companies having a turnover of Rs.1.00 crore to 200 crores have to be taken as a particular range and the assessee being in that range having turnover of 8.15 crores, the companies which also have turnover of 1.00 to 200.00 crores only should be taken into consideration for the purpose of making TP study."

15. It was brought to our notice that the above proposition has also been followed by the Honourable Bangalore ITAT in the following cases:

1. *M/s Kodiak Networks (India) Private Limited vs ACIT* (ITA No.1413/Bang/2010)
2. *M/s Genesis Microchip (I) Private Limited vs DCIT* (ITA No.1254/Bang/20l0).
3. *Electronic for Imaging India Private Limited* (ITA No. 1171/Bang/2010).

It was finally submitted that companies having turnover more than Rs. 200 crores ought to be rejected as not comparable with the Assessee.

16. The ld. DR, on the other hand pointed out that even the assessee in its own TP study has taken companies having turnover of more than Rs. 200 crores as comparables. In these circumstances, it was submitted by him that the assessee cannot have any grievance in this regard.

17. We have considered the rival submissions. The provisions of the Act and the Rules that are relevant for deciding the issue have to be first seen. Sec.92. of the Act provides that any income arising from an international transaction shall be computed having regard to the arm's length price. Sec.92-B provides that "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises. Sec.92-A defines what is an Associated Enterprise. In the present case there is no dispute that the transaction between the Assessee and its AE was an international transaction attracting the provisions of Sec.92 of the Act. Sec.92C provides the manner of computation of Arm's length price in an international transaction and it provides:–

> (1) that the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely:–
>
> (a) comparable uncontrolled price method;
>
> (b) resale price method;
>
> (c) cost plus method;
>
> (d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed:

Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices:

Provided further that if the variation between the arm's length price so determined and price at which the international transaction has actually been undertaken does not exceed five per cent of the latter, the price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price.

(3) Where during the course of any proceeding for the assessment of income, the Assessing Officer is, on the basis of material or information or document in his possession, of the opinion that–

(a) the price charged or paid in an international transaction has not been determined in accordance with sub-sections (1) and (2); or

(b) any information and document relating to an international transaction have not been kept and maintained by the assessee in accordance with the provisions contained in subsection (1) of section 92D and the rules made in this behalf; or

(c) the information or data used in computation of the arm's length price is not reliable or correct; or

(d) 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,

the Assessing Officer may proceed to determine the arm's length price in relation to the said international transaction in accordance with subsections (1) and (2), on the basis of such material or information or document available with him:

18. Rule 10B of the IT Rules, 1962 prescribes rules for Determination of arm's length price under section 92C:–

"10B. (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely:–

(a) …….

to

(d) ……..

(e) transactional net margin method, by which,–

(i) the net profit margin realised 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 or having regard to any other relevant base;

(ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

(iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);

(v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

(2) For the purposes of sub-rule (1), the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely:–

(a) the specific characteristics of the property transferred or services provided in either transaction;

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the

markets, overall economic development and level of competition and whether the markets are wholesale or retail.

(3) An uncontrolled transaction shall be comparable to an international transaction if–

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or

(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

(4) The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into:

Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared."

19. A reading of the provisions of Rule 10B(2) of the Rules shows that uncontrolled transaction has to be compared with international transaction having regard to the factors set out therein. Before us there is no dispute that the TNMM is the most appropriate method for determining the ALP of the international transaction. The disputes are with regard to the comparability of the comparable relied upon by the TPO.

20. In this regard we find that the provisions of law pointed out by the ld. counsel for the assessee as well as the decisions referred to by the ld. counsel for the assessee clearly lay down the principle that the turnover filter is an important criteria in choosing the comparables. The assessee's turnover is Rs. 47,46,66,638. It would therefore fall within the category of companies in the range of turnover between 1 crore and 200 crores (as laid down in the case of *Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT*, ITA No.1231/Bang/2010) . Thus, companies having turnover of more than 200 crores have to be eliminated from the list of comparables as laid down in several decisions referred to by the ld. counsel for the assessee. Applying those tests, the following companies will have to be excluded from the list of 26 comparables drawn by the TPO viz.,

		Turnover Rs.
(1)	Flextronics Software Systems Ltd.	848.66 crores
(2)	iGate Global Solutions Ltd.	747.27 crores

(3)	Mindtree Ltd.	590.39 crores
(4)	Persistent Systems Ltd.	293.74 crores
(5)	Sasken Communication Technologies Ltd.	343.57 crores
(6)	Tata Elxsi Ltd.	262.58 crores
(7)	Wipro Ltd.	961.09 crores.
(8)	Infosys Technologies Ltd.	13149 crores.

(2) <u>Use of information received in pursuance of notice u/s. 133(6) of the Act.</u>

21. The main submission of the ld. counsel for the assessee on the use of information received u/s. 133(6) of the Act by the TPO in determining ALP was that the TPO acted on the information received rather than on the information available in the public domain. It is his submission that there was an arbitrary selection of companies by the TPO for issuing notice u/s. 133(6) of the Act. It is also the complaint of the assessee that the TPO had relied on incomplete information. It is also the complaint of the assessee that whenever the information received u/s. 133(6) was favourable to the revenue, the same had been adopted even when that information was at variance with the information available in the annual report. The further contention of the ld. counsel for the assessee was that the TPO had not given opportunity of cross-examining the companies who had given information to the TPO, pursuant to the notice u/s. 133(6) of the Act. Attention was drawn to the decision of the ITAT Bangalore in the case of *Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT* (supra) wherein it was held as follows:–

> "13. We have already held that if any information is sought to be used against the assessee, the same has to be furnished to the assessee and thereafter, taking into consideration the assessee's objections, if any, only then can the TPO proceed to take a decision. If the assessee seeks an opportunity to cross examine the party, the assessee shall be provided such an opportunity. It is only during a cross examination that the assessee can rebut the stand of that particular company."

Besides the above, several other decisions were also referred to for identical proposition. In the final analysis, it was submitted that the information obtain u/s. 133(6) in so far as it is contrary to the information available in the public domain should be rejected.

22. The ld. DR however submitted that the power u/s. 133(6) of the Act is absolute and cannot be questioned by the assessee, unless the assessee is able to establish that the same is incorrect.

23. We will deal with this aspect after considering the other submissions made by the assessee on the transfer pricing adjustments, if necessary and required. If on other parameters on which the ALP has to

be determined, it is found that the price charged by the Assessee is at Arm's Length, we need not decide this aspect in this case.

(3) Improper selection of comparables

(a) Megasoft Ltd.:

24. This company was chosen as a comparable by the TPO. The objection of the assessee is that there are two segments in this company viz., (i) software development segment, and (ii) software product segment. The Assessee is a pure software services provider and not a software product developer. According to the Assessee there is no break up of revenue between software products and software services business on a standalone basis of this comparable. The TPO relied on information which was given by this company in which this company had explained that it has two divisions viz., BLUEALLY DIVISION and XIUS-BCGI DIVISION. Xius-BCGI Division does the business of product software. This company develops packaged products for the wireless and convergent telecom industry. These products are sold as packaged products to customers. While implementing these standardized products, customers may request the company to customize products or reconfigure products to fit into their business environment. Thereupon the company takes up the job of customizing the packaged software. The company also explained that 30 to 40% of the product software would constitute packaged product and around 50% to 60% would constitute customized capabilities and expenses related to travelling, boarding and lodging expense. Based on the above reply, the TPO proceeded to hold that the comparable company was mainly into customization of software products developed (which was akin to product software) internally and that the portion of the revenue from development of software sold and used for customization was less than 25% of the overall revenues. The TPO therefore held that less than 25% of the revenues of the comparable are from software products and therefore the comparable satisfied TPO's filter of more than 75% of revenues from software development services. The basis on which the TPO arrived at the PLI of 60.23% is given at page-115 and 116 of the order of the TPO. It is clear from the perusal of the same that the TPO has proceeded to determine the PLI at the entity level and not on the basis of segmental data.

25. In the order of the TPO, operating margin was computed for this company at 60.23%. It is the complaint of the assessee that the operating margins have been computed at entity level combining software services and software product segments. It was submitted that the product segment of Megasoft is substantially different from its software service segment. The product segment has employee cost of 27.65% whereas the software service segment has employee cost of 50%. Similarly, the profit margin on cost in product segment is 117.95% and in case of software service segment it is 23.11%. Both the segments are substantially different and therefore comparison at entity level is without basis and

would vitiate the comparability (submissions on page 381 to 383 of the PB-I). It was further submitted that Megasoft Limited has provided segmental break-up between the software services segment and software product segment (page 68 of PB-II), which was also adopted by the TPO in his show cause notice (Page 84 of PB-I). The segmental results i.e., results pertaining to software services segment of this company was:

Segmental Operating Revenues	Rs.63,71,32,544
Segmental Operating Expenses	Rs.51,75,13,211
Operating Profit	Rs.11,96,19,333
OP/TC (PLI)	23.11%

26. It was reiterated that in the given circumstances only PLI of software service segment viz., 23.11% ought to have been selected for comparison.

27. It was further submitted that the learned TPO in case of other comparable, similarly placed, had adopted the margins of only the software service segment for comparability purposes. Consistent with such stand, it was submitted that the margins of the software segment only should be adopted in the case of Megasoft also, in contrast to the entity level margins.

28. The margins at entity level and segment level of other comparables considered by the TPO in his first show cause notice were as follows (page 382 of PB-I):

Sl. No.	Company Name	Segment Margin	Company - wide Margin
1	Geometric	10.71%	8.51%
2	Kals Info Systems	30.55%	20.12%
3	R Systems	15.07%	9.64%
4	Sasken Communication	22.16%	10.57%
5	Tata Elxsi	26.51%	26.47%

29. In case of all the above comparables, the learned TPO has used segmental margins for comparability purpose. In all these cases, the revenues from software development exceeded 75% of the total revenues of the entity. Considering margins of Megasoft at the entity level would be inconsistent with the TPO's position in case of other comparables. It was submitted that a different approach was adopted in case of Megasoft possibly because in case of Megasoft, the margins at the entity level are higher than that at the segment level; whereas in case of other comparables (Eg: Kals, Sasken, Tata Elxsi, Geometric, R Systems) margins at the segment level were higher. It was submitted that learned TPO's approach is arbitrary and without basis. The Assessee therefore submitted that if at all Megasoft is considered as comparable then only the segmental margins, if at all, should be used for comparability

purpose. Both the segments being substantially different, considering the margins at entity level would vitiate the comparability.

30. Alternatively it was submitted that the profit margin of 60.23% was abnormally high and deserves to be rejected on this ground, as not within the parameters of comparability. In this regard, reference was made to the decision of Special Bench of ITAT Chandigarh in the case of *Quark Systems Pvt. Ltd.* (supra) besides several other tribunal decisions laying down identical proposition. Further it was submitted that Visual Soft Technologies Ltd. merged with Megasoft Ltd. w.e.f. 01.10.2006. Therefore the book results in the year in which the merger has taken place cannot be taken as a comparable. In this regard, reliance was placed on the decision of the Mumbai Bench of the ITAT in the case of *Emersons & Process Management India Pvt. Ltd. v. Addl. CIT* 13 Taxmann.com 149.

31. The learned DR relied on the order of the TPO and the DRP on this aspect.

32. We have considered the rival submissions. First we will consider the submission of the Assessee that companies with abnormal margins should not be regarded as comparable. In the case of *Quark Systems Pvt. Ltd.* (supra), the Special Bench had to deal with cases where the results were abnormal. The special Bench observed as follows:

> "Even if the taxpayer or its counsel had taken Datamatics as comparable in its T.P. audit, the taxpayer is entitled to point out to the Tribunal that above enterprise has wrongly been taken as comparable. In fact there are vast differences between tested party and the Datamatics. The case of Datamatics is like that of "Imercius Technologies" representing extreme positions. If Imercius Technologies has suffered heavy losses and, therefore, it is not treated as comparable by the tax authorities, they also have to consider that the Datamatics has earned extraordinary profit and has a huge turnover, besides differences in assets and other characteristics referred to by Shri Aggarwal."

The above observations of the special Bench is a pointer to the fact that where there are extraordinary profits and those companies are considered by the TPO for comparability but loss making companies are not considered as comparable, that would improper. The Tribunal found that such contradiction in approach should not be permitted. Similarly in the case of *M/S. Sap Labs India Pvt. Ltd.* 2010-TII-44-ITAT Bang-TP had observed as follows:

> "86. At the cost of repetition, we have to say that extreme cases should not be included in samples and extreme comparables mean not only the positive higher side but also the lower side. In the list of 22 comparables, many of them are having very low margin rate, not only less than 10 or 5, even below that. We

have already considered that the agreement entered into by the assessee with its German associate concern has contemplated a compensation of cost plus 6 per cent, or 1.5 times of the total wages bill, whichever is higher. This point we have to consider in the light of the fact that the assessee is working in a risk mitigated environment. That is why we have agreed with the argument of the assessee-company that there may not be extreme profits in the case of the assessee. When extremes are excluded from the samples, all sorts of extremes should be avoided. Otherwise, samples selected for comparative study may not be representative."

33. Even in the aforesaid decision the point that has been emphasized is that when the margins of comparable companies are either extremely low or high, the approach should be to eliminate both and not consider only the high or low margin comparables as it suits either the TPO or the Assessee.

34. As far as the provisions of the Act are concerned, they lay down that the comparable companies should be functionally comparable to the tested party. There are no specific standards of comparability on the basis of abnormal profits or loss. Rule 10B(2) provides that the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely:–

(a) the specific characteristics of the property transferred or services provided in either transaction;

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

35. There is therefore no bar to considering companies with either abnormal profits or abnormal losses as comparable to the tested party, as long as they are functionally comparable. The OECD guidelines and in US TP regulations, this question may not arise at all because those regulations advocate the quartile method for determining ALP. Indian regulations specifically deviate from OECD guidelines and provide Arithmetic Mean method for determining ALP. In the quartile method,

companies that fall in the extreme quartiles get excluded and only those that fall in the middle quartiles are reckoned for comparability. Hence, cases of either abnormal profits or losses (which are referred to as outliners) get automatically excluded. In the arithmetic mean method, all companies that are in the sample are considered, without exception and the average of all the companies are considered as the ALP. Hence, a general rule that companies with abnormal profits should be excluded may be in tune with the principles enunciated in OECD guidelines but cannot be said to be in tune with Indian TP regulations. However, if there are specific reasons for abnormal profits or losses or other general reasons as to why they should not be regarded as comparables, then they can be excluded for comparability. It is for the Assessee to demonstrate existence of abnormal factors.

36. In the present case factors for abnormal profits have not been highlighted by the Assessee. In such circumstances it is not possible to accept the submission of the Assessee to exclude this company for the purpose of comparison.

37. The next plea of the Assessee is that if at all this company is considered as a comparable then the segmental margin of 23.11% (which is the margin for software service segment) alone should be considered for comparability. On the above submission, we find that the TPO considered the segmental margin (Software service segment) in the case of Geometric, Kals Info systems, R Systems, Sasken Communication and Tata Elxsi. Before DRP the Assessee pointed out that the segmental margin of 23.11% alone should be taken for comparability. The DRP has not given any specific finding on the above plea of the Assessee. Perusal of the order of the TPO shows that the TPO relied on information which was given by this company in which this company had explained that it has two divisions viz., BLUEALLY DIVISION and XIUS-BCGI DIVISION. Xius-BCGI Division does the business of product software (developing software). This company develops packaged products for the wireless and convergent telecom industry. These products are sold as packaged products to customers. While implementing these standardized products, customers may request the company to customize products or reconfigure products to fit into their business environment. Thereupon the company takes up the job of customizing the packaged software. The company also explained that 30 to 40% of the product software (software developed) would constitute packaged product and around 50% to 60% would constitute customized capabilities and expenses related to travelling, boarding and lodging expense. Based on the above reply, the TPO proceeded to hold that the comparable company was mainly into customization of software products developed (which was akin to software development) internally and that the portion of the revenue from development of software sold and used for customization was less than 25% of the overall revenues. The TPO therefore held that less than 25%

of the revenues of the comparable are from software products and therefore the comparable satisfied TPO's filter of more than 75% of revenues from software development services. Having drawn the above conclusion, the TPO did not bother to quantify the revenues which can be attributed to software product development and software development service but adopted the margin of this company at the entity level. In terms of Rule 10B(3)(b) of the Rules, an uncontrolled transaction shall be comparable to an international transaction if–

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or

(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

38. Neither the TPO nor the DRP have noticed that there is bound to be a difference between the Assessee and Megasoft and the profit arising to the Megasoft as a result of the existence of the software product segment and no finding has been given that reasonably accurate adjustments can be made to eliminate the material effects of such differences. For this reason, we are inclined to hold that the profit margin of 23.11% which is the margin of the software service segment be taken for comparability. In view of the above conclusion, we do not wish to go into the question as to whether less than 25% of the revenues of the comparable are from software products and therefore the comparable satisfied TPO's filter of more than 75% of revenues from software development services.

(b) Avani Cimcon Technologies Ltd.

39. As far as this company is concerned, the plea of the Assessee has been that this company is functionally different from the assessee. Based on the information available in the company's website, which reveals that this company has developed a software product by name "DXchange", it was submitted that this company would have revenue from software product sales apart from rendering of software services and therefore is functionally different from the assessee. It was further submitted that the Mumbai Bench of the Tribunal to the decision in the case of *Telcordia Technologies Pvt. Ltd. v. ACIT* – ITA No.7821/Mum/2011 wherein the Tribunal accepted the assessee's contention that this company has revenue from software product and observed that in the absence of segmental details, Avani Cincom cannot be considered as comparable to the assessee who was rendering software development services only and it was held as follows:–

"7.8 Avani Cincom Technologies Ltd. ('Avani Cincom'):

Here in this case also the segmental details of operating income of IT services and sale of software products have not been provided so as to see whether the profit ratio of this company can be taken into consideration for comparing the case that of assessee. In absence of any kind of details provided by the TPO, we are unable to persuade ourselves to include it as comparable party. Learned CIT DR has provided a copy of profit loss account which shows that mainly its earning is from software exports, however, the details of percentage of export of products or services have not been given. We, therefore, reject this company also from taking into consideration for comparability analysis."

It was also highlighted that the margin of this company at 52.59% which represents abnormal circumstances and profits. The following figures were placed before us:–

Particulars	FYs 05-06	06-07	07-08	08-09
Operating Revenue	21761611	35477523	29342809	28039851
Operating Expns.	16417661	23249646	23359186	31108949
Operating Profit	5343950	12227877	5983623	(3069098)
Operating Margin	32.55%	52.59%	25.62%	- 9.87%

40. It was submitted that this company has made unusually high profit during the financial year 06-07. The operating revenues increased 63.03% which indicates that it was an extraordinary year for this company. Even the growth of software industry for the previous year as per NASSCOM was 32%. The growth rate of this company was double the industry average. In view of the above, it was argued that this company ought to have been rejected as a comparable.

41. We have given a careful consideration to the submissions made on behalf of the Assessee and are of the view that the same deserves to be accepted. The reasons given by the Assessee for excluding this company as comparable are found to be acceptable. The decision of ITAT (Mumbai) in the case of *Telcordia Technologies Pvt. Ltd. v. ACIT* (supra) also supports the plea of the assessee. We therefore accept the plea of the Assessee to reject this company as a comparable.

(c) Celestial Labs Ltd.

42. As far as this company is concerned, the stand of the assessee is that it is absolutely a research & development company. In this regard, the following submissions were made:–

- In the Director's Report (page 20 of PB-Il), it is stated that "the company has applied for Income Tax concession for in-house R&D centre expenditure at Hyderabad under section 35(2AB) of the Income Tax Act."

- As per the Notes to Accounts - Schedule 15, under "Deferred Revenue Expenditure" (page 31 of PB-II), it is mentioned that, "Expenditure incurred on research and development of new products has been treated as deferred revenue expenditure and the same has been written off in 10 years equally yearly installments from the year in which it is incurred."
- An amount of Rs. 11,692,020/- has been debited to the Profit and Loss Account as "Deferred Revenue Expenditure" (page 30 of PB-II). This amounts to nearly 8.28 percent of the sales of this company.

It was therefore submitted that the acceptance of this company as a comparable for the reason that it is into pure software development activities and is not engaged in R&D activities is bad in law.

43. Further reference was also made to the decision of the Mumbai Bench of the Tribunal in the case of *Teva Pharma Private Ltd. v. Addl. CIT* – ITA No.6623/Mum/2011 (for AY 2007-08) in which the comparability of this company for clinical trial research segment. The relevant extract of discussion regarding this company is as follows:

> **"The learned D.R. however drew our attention to page-389 of the paper book which is an extract from the Directors report which reads as follows:**
>
> > 'The Company has developed a de novo drug design tool "CELSUITE" to drug discovery in, finding the lead molecules for drug discovery and protected the IPR by filing under the copy if sic (of) right/patent act. (Apprised and funded by Department of Science and Technology New Delhi) based on our insilico expertise (applying bioinformatics tools). The Company has developed a molecule to treat Leucoderma and multiple cancer and protected the IPR by filing the patent. The patent details have been discussed with Patent officials and the response is very favorable. The cloning and purification under wet lab procedures are under progress with our collaborative Institute, Department of Microbiology, Osmania University, Hyderabad. In the industrial biotechnology area, the company has signed the Technology transfer agreement with IMTECH CHANDIGARH (a very reputed CSIR organization) to manufacture and market initially two Enzymes, Alpha Amylase and Alkaline Protease in India and overseas. The company is planning to set up a biotechnology facility to manufacture industrial enzymes. This facility would also include the research laboratories for carrying out further R & D activities to develop new candidates' drug molecules and license them to Interested Pharma and Bio Companies across the GLOBE. The

proposed Facility will be set up in Genome Valley at Hyderabad in Andhra Pradesh.'

According to the learned D.R. celestial labs is also in the field of research in pharmaceutical products and should be considered as comparable. As rightly submitted by the learned counsel for the Assessee, the discovery is in relation to a software discovery of new drugs. Moreover the company also is owner of the IPR. There is however a reference to development of a molecule to treat cancer using bio-informatics tools for which patenting process was also being pursued. As explained earlier it is a diversified company and therefore cannot be considered as comparable functionally with that of the Assessee. There has been no attempt made to identify and eliminate and make adjustment of the profit margins so that the difference in functional comparability can be eliminated. By not resorting to such a process of making adjustment, the TPO has rendered this company as not qualifying for comparability. We therefore accept the plea of the Assessee in this regard.' "

44. It was submitted that the learned DR in the above case vehemently argued that this company is into research in pharmaceutical products. The ITAT concluded that this company is owner of IPR, it has software for discovery of new drugs and has developed molecule to treat cancer. In the ultimate analysis, the ITAT did not consider this company as a comparable in clinical trial segment, for the reason that this company has diverse business. It was submitted that, however, from the above extracts it is clear that this company is not into software development activities, accordingly, this company should be rejected as a comparable being functionally different.

45. From the material available on record, it transpires that the TPO has accepted that up to AY 06-07 this company was classified as a Research and Development company. According to the TPO in AY 07-08 this company has been classified as software development service provider in the Capitaline/Prowess database as well as in the annual report of this company. The TPO has relied on the response from this company to a notice u/s.133(6) of the Act in which it has said that it is in the business of providing software development services. The Assessee in reply to the proposal of the AO to treat this as a comparable has pointed out that this company provides software products/services as well as bioinformatics services and that the segmental data for each activity is not available and therefore this company should not be treated as comparable. Besides the above, the Assessee has point out to several references in the annual report for 31.3.2007 highlighting the fact that this company was develops biotechnology products and provides related software development services. The TPO called for segmental data at the

entity level from this company. The TPO also called for description of software development process. In response to the request of the TPO this company in its reply dated 29.3.2010 has given details of employees working in software development but it is not clear as to whether any segmental data was given or not. Besides the above there is no other detail in the TPO's order as to the nature of software development services performed by the Assessee. Celestial labs had come out with a public issue of shares and in that connection issued Draft Red Herring Prospectus (DRHP) in which the business of this company was explained as to clinical research. The TPO wanted to know as to whether the primary business of this company is software development services as indicated in the annual report for FY 06-07 or clinical research and manufacture of bio products and other products as stated in the DRHP. There is no reference to any reply by Celestial labs to the above clarification of the TPO. The TPO without any basis has however concluded that the business mentioned in the DRHP are the services or businesses that would be started by utilizing the funds garnered though the Initial Public Offer (IPO) and thus in no way connected with business operations of the company during FY 06-07. We are of the view that in the light of the submissions made by the Assessee and the fact that this company was basically/admittedly in clinical research and manufacture of bio products and other products, there is no clear basis on which the TPO concluded that this company was mainly in the business of providing software development services. We therefore accept the plea of the Assessee that this company ought not to have been considered as comparable.

(d) KALS Information Systems Ltd.

46. As far as this company is concerned, the contention of the assessee is that the aforesaid company has revenues from both software development and software products. Besides the above, it was also pointed out that this company is engaged in providing training. It was also submitted that as per the annual repot, the salary cost debited under the software development expenditure was Rs. 45,93,351. The same was less than 25% of the software services revenue and therefore the salary cost filter test fails in this case. Reference was made to the Pune Bench Tribunal's decision of the ITAT in the case of *Bindview India Private Limited vs. DCI*, ITA No. ITA No 1386/PN/1O wherein KALS as comparable was rejected for AY 2006-07 on account of it being functionally different from software companies. The relevant extract are as follows:

> "16. Another issue relating to selection of comparables by the TPO is regarding inclusion of Kals Information System Ltd. The assessee has objected to its inclusion on the basis that functionally the company is not comparable. With reference to pages 185-186 of the Paper Book, it is explained that the said

> company is engaged in development of software products and services and is not comparable to software development services provided by the assessee. The appellant has submitted an extract on pages 185-186 of the Paper Book from the website of the company to establish that it is engaged in providing of I T enabled services and that the said company is into development of software products, etc. All these aspects have not been factually rebutted and, in our view, the said concern is liable to be excluded from the final set of comparables, and thus on this aspect, assessee succeeds."

Based on all the above, it was submitted on behalf of the assessee that KALS Information Systems Limited should be rejected as a comparable.

47. We have given a careful consideration to the submission made on behalf of the Assessee. We find that the TPO has drawn conclusions on the basis of information obtained by issue of notice u/s.133(6) of the Act. This information which was not available in public domain could not have been used by the TPO, when the same is contrary to the annual report of this company as highlighted by the Assessee in its letter dated 21.6.2010 to the TPO. We also find that in the decision referred to by the learned counsel for the Assessee, the Mumbai Bench of ITAT has held that this company was developing software products and not purely or mainly software development service provider. We therefore accept the plea of the Assessee that this company is not comparable.

(e) Accel Transmatic Ltd.

48. With regard to this company, the complaint of the assessee is that this company is not a pure software development service company. It is further submitted that in a Mumbai Tribunal Decision of *Capgemini India (F) Ltd v Ad. CIT* 12 Taxman.com 51, the DRP accepted the contention of the assessee that Accel Transmatic should be rejected as comparable. The relevant observations of DRP as extracted by the ITAT in its order are as follows:

> "In regard to Accel Transmatics Ltd. the assessee submitted the company profile and its annual report for financial year 2005-06 from which the DRP noted that the business activities of the company were as under.
>
> (i) Transmatic system - design, development and manufacture of multi function kiosks Queue management system, ticket vending system
>
> (ii) Ushus Technologies - offshore development centre for embedded software, net work system, imaging technologies, outsourced product development
>
> (iii) Accel IT Academy (the net stop for engineers)- training services in hardware and networking, enterprise system management, embedded system, VLSI designs, CAD/CAM/BPO

(iv) Accel Animation Studies software services for 2D/3D animation, special effect, erection, game asset development.

4.3 On careful perusal of the business activities of Accel Transmatic Ltd. DRP agreed with the assessee that the company was functionally different from the assessee company as it was engaged in the services in the form of ACCEL IT and ACCEL animation services for 2D and 3D animation and therefore assessee's claim that this company was functionally different was accepted. DRP therefore directed the Assessing Officer to exclude ACCEL Transmatic Ltd. from the final list of comparables for the purpose of determining TNMM margin."

49. Besides the above, it was pointed out that this company has related party transactions which is more than the permitted level and therefore should not be taken for comparability purposes. The submission of the ld. counsel for the assessee was that if the above company should not be considered as comparable. The ld. DR, on the other hand, relied on the order of the TPO.

50. We have considered the submissions and are of the view that the plea of the assessee that the aforesaid company should not be treated as comparables was considered by the Tribunal in *Capgemini India Ltd* (supra) where the assessee was software developer. The Tribunal, in the said decision referred to by the ld. counsel for the assessee, has accepted that this company was not comparable in the case of the assesses engaged in software development services business. Accepting the argument of the ld. counsel for the assessee, we hold that the aforesaid company should be excluded as comparables.

Assessee's comparables

51. It is the grievance of the Assessee that the lower authorities have rejected certain comparables selected and proposed by the assessee on the ground that they have predominant onsite revenues and are functionally different. The justification for retaining the comparables selected by the assessee are available on pages 318 to 331 and pages 394 to 402 of PB-I. The comparables that have been rejected by the TPO, but do not deserve to be so rejected, according to the Assessee are:

Sl. No.	Name of the Company	Operating Revenues	Operating Margin on Cost
1	Indium Software (India) Limited	6,49,14,480	2.03%
2	E2E Infotech Limited	21,548,500	10.81%
3	Goldstone Technologies Limited	410,348,370	22.94%
4	Thinksoft Global Services Limited	526,597,803	19.12%
5	Visu International Limited	900,319,768	19.90%
6	Maars Software International Limited	355,488,750	-1.68%
7	Akshay Software Technologies Limited	71,283,298	3.98%
8	VJIL Consulting Limited	130,249,104	-14.92%
9	Synfosys Business Solutions Limited	62,238,020	12.17%

52. As far as the rejection of the comparables cited by the assessee in its TP study is concerned, we find the following. In some cases, the comparables selected by the assessee were rejected for the reason that they do not satisfy the onsite revenue filter i.e., if revenues of comparable companies from rendering onsite software exceed 75% of the total revenue, then they should not be regarded as comparable to the assessee where revenue is from rendering offshore software development services. At page 24 of the Order, the TPO has stated the following reasons for applying the onsite revenue filter:

1. The market conditions are different for onsite than offshore work.
2. The pricing structure is different in onsite work.
3. The assets are negligible in the onsite companies.
4. The margins for onsite are lower when compared to offshore work.
5. The labour markets are different for offshore and onsite work, as the people who are working on onsite get competitive salaries of the resident countries.
6. Cost arbitrage is not available for the onsite work.
7. The companies whose revenues are generated mainly from onsite work almost mimic a company which is resident in that country.

53. The stand of the Assessee on the above aspects is that the learned TPO had contended that "market conditions" are different for on-site and offshore work, but he has not substantiated how market conditions differ. The learned TPO has failed to appreciate that whether a company operates onsite or offshore, the functions performed are the same. What is important from an arms' length perspective are the functions performed and not the place of its performance. It is not that a company performs altogether different functions under onsite assignments. The margins in offshore or onsite operations are not greatly dissimilar although the rate per hour may substantially differ. Similarity of functions performed and absence of dissimilarities in margins should lead to the acceptance of onsite work and its data for comparison purposes. Accordingly, the assessee submits that this reason of the TPO is without basis.

54. On the reasoning of the TPO that the pricing structure is different in onsite work, it is the submission of the assessee this aspect was irrelevant. The method selected is TNNM. What is tested is margin and not price. If pricing structure were to be considered as criteria, then it will have to be seen as to what is the pricing structure of all the comparable for various projects. The pricing would differ from project to project, domain to domain and on various other parameters. Such

exercise has not been done. Further as admitted by the TPO, once functional similarity is accepted, companies can be compared. The attempt to separate onsite activity for comparison purposes is thus without basis.

55. On the reasoning of the TPO that the assets are negligible in the onsite companies, it is the stand of the Assessee that while discussing turnover filter, the learned TPO has stated that software companies do not require much infrastructure. The TPO in case of other assessees has held that software companies whether onsite or offshore do not require much infrastructure. Therefore question of assets being negligible only for onsite operation should not matter because as per the TPO not much assets are required for software companies.

56. On the reasoning of the TPO that Margins are lower in case of onsite operations, it is the stand of the Assessee that margin is not a criteria to select or reject a comparable under Rule I0B(2) of the I.T. Rules. The assessee submits that comparability of an uncontrolled transaction has to be tested on touchstone of the principles enunciated in Rule I0B(2). The margin of an uncontrolled transaction is not a criterion to select or reject a comparable. Taking margin as a criterion to select or reject a comparable would be incongruous because what is tested under TNMM is the margin itself. It was further pointed out that in case of service companies the return is primarily linked to functions performed rather than location of performance. This is all the more so for the IT industry and in a world that is flat. Based on the above, the assessee urged that the learned TPO's conclusion that margins are different in case of onsite revenues is without basis and ought to be rejected.

57. The learned TPO has stated that the labour markets are different for offshore and onsite work, as the people who are working on onsite get competitive salaries of the resident countries. Further, cost arbitrage is not available for onsite work. The learned TPO has stated that pricing structure is different in onsite work. In this regard, the assessee submitted that the learned TPO has not substantiated the above statements. In the absence of adequate substantiation, the statements appear fanciful and born out of imagination.

58. It was argued that under TNMM, the assessee is selected as the tested party. What is to be tested under TNMM is the net margins of the assessee. The cost for recipient of service has no bearing on the margins of the assessee. Whether the recipient of service gets cost arbitrage or not is not a consideration for testing the margins of the assessee. Two companies may have similar margins although their gross margins may differ. When net margins are being compared, difference in gross margins cannot be a factor for rejection of companies as a comparable. Similarly for software companies when net margins are being compared, price/rate differential should not be criteria for acceptance or rejection of a company as a comparable. It was pointed out that though it is true that a

professional sent on onsite projects are paid higher salaries, however the billing rates are also higher. It is on the basis of the cost structure that revenues are agreed upon. In case of onsite operations both income and cost would go up. There cannot be a presumption that margins have been sacrificed to secure revenues. Such an indication of the learned TPO is without any basis.

59. The learned TPO has further stated that companies whose revenues are generated mainly from onsite work mimic a company which is a resident in that country. This again is a conclusion without basis. It is again a conclusion whose relevance to the case on hand has not been established. The same is therefore to be ignored. Further, the TP Regulations or OECD Guidelines do not prescribe application of onsite filter. Therefore, onsite revenue filter should not be used. Accordingly the assessee submits that onsite revenue filter should not be adopted in judging whether a company is to be retained as a comparable or not.

60. We have given a careful consideration to the above submissions made on behalf of the Assessee. We find that the DRP has not dealt with any of the above submissions but have in page 23 and 24 of their order have held that the application of onsite revenue filter was justified. Rule 10B(2) & (3) of the IT Rules, 1962 would be relevant to render a decision on the above contentions of the parties before us. Those rules have already been set out in the earlier part of this order. The crux of the rules, in so far as it relates to the contentions regarding application of the Onsite revenue filter, is that comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely:–

(a) the specific characteristics of the property transferred or services provided in either transaction;

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

61. It is only when there are no difference between the uncontrolled transaction and the international transaction as set out above or if there are differences but such difference will not affect the price or cost charged

or paid or profit arising from such transactions or if there will be differences in price or cost charged or pair or profit arising from such transactions, such differences should be reasonably capable of being quantified and adjustment made to eliminate the effect of such differences.

62. The Indian software sector provides both on-site and offshore services. The Assessee in the present case is mainly offshore service provider and it generates income only from offshore software development service. Most of the uncontrolled enterprises follow hybrid model with revenue mix both from onsite and offshore. It is true that in terms of the functions performed both in the case of offshore service provider and onsite service provider, it is development of computer software. But having regard to Rule 10B(2)(b) it is necessary to have regard to the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions.

63. The first objection of the Assessee is that the TPO has observed that "market conditions" are different for on-site and offshore work, but he has not substantiated how market conditions differ. We fail to see any substance in such objection. The fact is that in onsite development of computer software, the Assessee does not employ assets nor does the Assessee assume many risks which the offshore software developer assumes. Even the Assessee accepts that the per hour rate will be different in the case of offshore software development and onsite software development.

64. The next objection of the Assessee is that when the most appropriate method selected for determining ALP is the TNMM there is no reason as to why one should look at price difference in offshore software development and onsite software development. It is no doubt true that in TNMM it is only the margins in an uncontrolled transaction that is tested with reference to the controlled transaction but it is not possible to ignore the fact that pricing will have an effect on the margins obtained in a transaction. The argument that if pricing structure were to be considered as criteria, then it will have to be seen as to what is the pricing structure of all the comparable for various projects cannot be accepted because the TPO has not chosen any other onsite software service provider with a revenue composition of more than 75% from onsite software services as comparable. As rightly observed by the TPO, the pricing is different in onsite when compared to offshore operations. The further observations of the TPO that the reasons for the same lie in the fact that while in the case of OFFSHORE projects most of the costs are incurred in India; an ONSITE project has to be carried out abroad significantly increasing the employee cost and other costs.

65. The next objection of the Assessee is with regard to Assets employed. The companies, which predominantly generate revenues from

onsite activity, do not have significant assets as most of the work is carried on the site of customer outside India. The argument that the TPO has himself observed that software service providers do not require much assets cannot be basis to accept the Assessee's plea. Those observations are made by the TPO in the context of application of turnover filter and have been quoted out of context by the Assessee.

66. The next argument of the Assessee is that TPO has held that margins are lower in onsite software services and that margin is not a criteria to select or reject a comparable under Rule I0B(2) of the I.T. Rules. We are of the view that this argument again ignores the fact that the approach of the TPO has been to highlight the fact that there can be no functional comparability, if the assets employed and risks assumed are taken into consideration. It is in that context the TPO has referred to the margins.

67. The companies who generate more than 75% of the export revenues from onsite operations outside India are effectively companies working outside India having their own geographical markets, cost of labour etc., and also return commensurate with the economic conditions in those countries. Thus assets and risk profile, pricing as well as prevailing market conditions are different in predominantly onsite companies from predominantly offshore companies like the taxpayer. Since, the entire operations of the tax payer are taking place offshore i.e. in India; it is but natural that it should be compared with companies with major operations offshore, due to the reason that the economics and profitability of onsite operations are different from that of offshore business model. As already stated the Assessee has limited its analysis only to functions but not to the assets, risks as well as prevailing market conditions in which both the buyer and seller of services located. Hence, the companies in which more than 75% of their export revenues come from onsite operations are to be excluded from the comparability study as they are not functioning in similar economic circumstances to that of the tax payer. Hence, it is held that this filter is appropriately applied by the TPO.

68. Admittedly the onsite revenue in the case of the following comparable companies identified by the Assessee was more than 75% of its export revenues viz.,

a) Visu International Ltd.
b) Maars Software International Ltd.
c) Akshay Software Technologies Ltd.
d) VJIL Consulting Ltd.
e) Synfosys Business Solutions Ltd.

The above companies were therefore rightly not considered as comparable by the TPO. We hold accordingly.

69. Another reason given by the TPO for rejecting E2E Infotech Ltd., a comparable identified by the Assessee but rejected by the TPO, was for

the reason that the details of this company was insufficient. On the above, the assessee has pointed out that the Annual Report of this company for FY 07-08 is available and details for FY 06-07 are available in this report. It is the stand of the Assessee that this company is comparable in all respects. The Assessee admits that there is no information on related party transactions and in the absence of such information it has to be presumed that there are no RPT.

70. We have perused the TPO's order and find that this company does not figure in the list of comparable selected by the Assessee in its TP study. In submissions before DRP the Assessee has taken a stand that this company has no related party transaction. In the circumstances when the comparability has neither been considered by the TPO or the DRP, we do not think that at this stage we can take a view on comparability or otherwise of this company. In any event the details furnished are sketchy and it is not possible to take one view or the other on the claim of the Assessee. We therefore hold that this company has been rightly not considered for comparability.

71. M/s. Indium India Ltd., a comparable considered by the Assessee in its TP study was rejected by the TPO as not comparable on the ground that the said company was rendering software testing services. It is the plea of the assessee that software testing is an integral part of software development cycle. It is further pointed out that the TPO in his analysis has selected Ishir Infotech Ltd., which renders software testing activities as comparable. This contention of the Assessee is not correct. At page 98 of the TPO's order, the objection of the Assessee for selecting Ishir InfoTech Ltd. as comparable is for the reason that this company was outsourcing software development and that the company does not satisfy 25% employee cost filter. Both these objections have been found to be not sustainable by the TPO. The question therefore would be as to whether software testing services would be equivalent to software development services. Software testing is only part of software development life cycle. It cannot be equated with software development services. The TPO in our view rightly excluded this company for comparability purposes.

72. With regard to Goldstone Technology Ltd., the same was rejected as a comparable by the TPO for the reason that it was engaged in I.T. enabled services. It is the claim of the Assessee that in the company's annual report, flow of revenue in this company is from software development both, onsite and offshore operations. On the above, we find that this company has clarified in response to notice of the AO u/s.133(6) of the Act that it is not in the business of software development but in ITES. The alternative plea of the Assessee is that it should be allowed opportunity to cross examine this company on its reply to the notice of TPO u/s.133(6) of the Act. We have seen the objections of the Assessee which is based only on a reading of the Annual report and the claim of the Assessee is not on sound basis and is purely on surmises. We are of

the view that the rejection by the TPO of this company as a comparable is on sound basis and the same is upheld.

73. Regarding Thinksoft Global Solutions Ltd., it was submitted that this company was rejected as comparable by the TPO for the reason that it was engaged in the software testing services. As already stated, this ground of rejection of comparable by the TPO has already been held by us to be proper.

74. Thus the claim of the Assessee to include 9 companies as comparable is found to be not acceptable.

75. The use of information received by the TPO by issue of notice u/s.133(6) of the Act without affording opportunity of cross examining the companies concerned, now needs to be dealt with. On this issue the only grievance of the Assessee which survives is the use of information received by the Assessee from Goldstone Technologies. We have already seen that the basis on which the Assessee challenges the information received u/s.133(6) of the Act is not sound. We therefore do not think that the right to cross examine this company will serve any purpose. The other objection of the Assessee was that TVS Infotech was considered as a comparable initially by the TPO because as per information furnished by this company in response to notice of TPO u/s.133(6) this company did not have any related party transaction. The Annual report of this company however showed that this company fails RPT filter. The TPO therefore rejected this company as comparable. We are of the view that the TPO in the case of this company has not used information u/s.133(6) of the Act and therefore the Assessee can have no grievance. If on the other hand the Assessee wants to show that information available in public domain is not correct then the onus would be on the Assessee to establish the same. The Assessee cannot ask for a right to cross examine on a surmise that the information given in response to notice u/s.133(6) of the Act would be correct and that given in the annual report is incorrect. The Assessee if he is able to show prima facie that the information available in public domain is incorrect then we will be persuaded to afford opportunity to the Assessee but not on a claim which lacks substance and is based on surmises.

76. The comparable now accepted as comparable and their operating margins before and after working capital adjustment are detailed in the table given below:–

TABLE 1 – TURNOVER RANGE 1 TO 200 CRORES AND AFTER CONSIDERING COMPARABLES SELECTED BY THE ASSESSEE

Sl. No.	Name of the Company	Operating Revenues	Operating Margin on Cost	Adjusted Margin on Cost
1.	Datamatics Ltd.	545,088,027	1.38%	0.58%
2.	E-Zest Solutions Ltd.	62,594,544	36.12%	37.23%

3.	Geometic Ltd. (seg)	1,583,797,773	10.71%	10.81%
4.	Helios & Matheson Information Technology Ltd.	1,786,380,304	36.63%	35.62%
5.	Ishir Infotech Ltd.	74,209,887	30.12%	31.60%
6.	LGS Global Ltd. (Lanco Global Solutions Ltd.)	453,893,898	15.75%	16.36%
7.	Lucid Software Ltd.	16,992,078	19.37%	18.24%
8.	Mediasoft Solutions Pvt. Ltd.	18,508,785	3.66%	2.77%
9.	Megasoft Ltd (Seg.)	637,132,545	23.11%	17.85%
10.	Quintegra Solutions Ltd.	627,216,924	12.56%	10.42%
11.	R S Software (India) Ltd.	1,010,449,441	13.47%	14.33%
12.	R Systems International Ltd. (Seg)	1,120,172,651	15.07%	14.44%
13.	SIP Technologies & Exports Ltd.	37,980,955	13.90%	11.90%
14.	Thirdware Solutions Ltd. (Seg)	360,850,000	25.12%	22.71%
	Arithmetic Mean			**17.508%**

77. The differential between the margins of the assessee as above and of the comparable in the Table given above, is beyond the 5% range. Applying, the proviso to section 92C(2), adjustment is required to be made to the reported values of the assessee's transactions with its associated enterprises. The AO is directed to make adjustment to the ALP adopting the arithmetic mean of 17.508% and consequent addition to the total income.

78. The other issues raised by the Assessee viz., (i) the reference to TPO being bad in law; (ii) the CIT's approval for reference to TPO also being bad in law; (iii) the additions being unsustainable as the definition of income or the computation process under section 28 to 44 not envisaging a reference to or incorporation of an adjustment proposed under Chapter X are without any merit and are contrary to the ruling of the Special Bench of the Tribunal in the case of Aztec Software 107 ITD 141 (SB)(Bang).

79. The following other objections were also raised by the Assessee regarding determination of ALP:

(A) Inappropriate computation of operating margins of comparables and that of the Assessee:

This objection in our view does not require any specific consideration and will be covered by the decision that will be rendered on point (B) below.

(B) Treating foreign exchange gain or loss and provision for bad debts as non-operating in nature and fringe benefit tax as part of operating cost:

As far as foreign exchange gain/loss being considered as not forming part of the operating cost, the reasoning of the revenue is that such loss or gain cannot be said to be one realized from international transaction though they may form part of the gain/loss of the enterprise and therefore they should be excluded while determining operating cost. On the above issue we find that the Bangalore Bench of ITAT in the case of *Sap Labs India (P) Ltd. vs. ACIT* (2011) 44 SOT 156 (Bang.) has taken the view that Foreign Exchange Fluctuation gains are required to be added to operating revenue. Following the same, the AO is directed to accept the claim of the Assessee in this regard. As far as provision for bad debts are concerned, the TPO has accepted that the same would be part of operating expenses provided the same is incurred every year for at least three years and the manner in which provision is made is consistent. The Assessee in reply to the query of the TPO on the above aspect has not furnished any details. We are of the view that the Assessee should be afforded opportunity to explain its position on the above and the AO is directed to consider the same in accordance with law. As far as Fringe Benefit Tax (FBT) is concerned, the same was not considered by the TPO as part of operating cost in the case of comparables and therefore the same should also not be considered as part of operating cost of the Assessee. We hold accordingly and direct the AO to compute the operating cost of the Assessee.

(C) Not making proper adjustment for enterprise level and transactional level differences between the Assessee and comparable companies.

(D) Adjustment for differential in risk to be given.

As far as point (C) and (D) are concerned, the arguments advanced are general with no supporting facts, hence rejected. The submissions of the Assessee in this regard are at pages 413 to 422 of the paper book.

80. Thus Gr.No.1 to 16 is decided as indicated above and the AO is directed to work out the adjustment to ALP keeping in mind the directions as given above.

81. Grounds 17.1 to 17.4 raised by the assessee reads as follows:–

"The learned Assessing Officer and Honorable Dispute Resolution Panel have erred in:–

17. Excluding a sum of Rs. 1,78,58,079/- being expenses incurred in foreign currency from export turnover on the ground that these expenses are incurred in rendering technical services rendered to clients outside India while computing deduction under section 10A;

17.2 Not appreciating that the appellant, at all times during the relevant previous year, was engaged in development of computer software and not in rendering of technical services;

17.3 Excluding a sum of Rs.24,29,913/- being telecommunication and insurance expenses from export turnover; and

17.4 not appreciating that expenses that are reduced from the export turnover should also be reduced from the total turnover."

82. Ground 18 raised by the Assessee reads as under:–

"The learned Assessing Officer and Honorable Dispute Resolution Panel have erred in:-

18. disallowing a sum of Rs. 1,76,98,160/- being research and development expenses under section 37 of the Act stating that the said expenditure is not revenue in nature;

83. The Assessee had debited in the profit and loss account a sum of Rs.1,76,98,160 under the head Research and Development. The Assessee explained that these expenses were incurred for developing/improvising new products in domestic markets. Admittedly these expenses were not incurred for M/S. Versata International Inc., the Assessee's holding company and this is evident from the fact that the TPO while computing the ALP of the international transaction between the Assessee and the AE (Holding company) took operating profit to cost as PLI and has not considered this expenditure as part of the cost for providing services by the Assessee to the holding company. The break-up of these expenditure is given in Schedule-10 to the Profit and Loss account and are in the nature of salary, rent, staff welfare, electricity communication expenses, legal charges, bank charges, insurance etc., which are basically revenue expenses in nature. The plea of the Assessee was that it was in the business of rendering software development services and as a continuous process to develop and improvise new products in domestic market, it has to indulge in research and development. The expenses were for exploring the possibility of domestic market through pilot projects. The expenses were wholly and exclusively for the purpose of existing business carried on by the Assessee. The expenses were revenue in nature and did not result in any advantage/benefit of enduring nature to the Assessee. It was the plea of the Assessee that the information technology industry is fast changing and there is a great degree of obsolescence and therefore expenses of this nature cannot be said to result in any enduring benefit to the Assessee. Among other decisions the Assessee relied on the decision of the Hon'ble Supreme Court in the case of *Alembic Chemicals Works Co. Ltd. vs. CIT* 177 ITR 377 (SC).

84. In the assessment order, the learned AO has disallowed a sum of Rs. 1,76,98,160/- being research and development expenses under section 37 of the Act stating that the said expenditure is not revenue in nature. The Assessee pleaded before DRP that the expenditure should be allowed

as deduction u/s37 of the Act or alternatively, if considered as capital expenditure, deduction should be allowed u/s.35 of the Act as expenditure incurred on Scientific Research. The DRP however proceeded under an erroneous assumption that these expenses were incurred on behalf of the AE. The DRP thereafter held that the Assessee has not explained as to how these expenses were deductible.

85. Before us, the assessee submitted that these expenses were incurred by it in developing two websites by name www.billbuddy.com and www.carbuy.com. In case of www.billbuddy.com, a customer could upload his telephone bill and the website would analyze the call charges and give output. In case of www.carbuy.com, the website would give comparison of various cars etc, to make informed decision to buyers. The assessee during the year incurred expenses like salaries and related benefits paid to employees, outsourcing charges, rent, electricity, insurance, travelling & conveyance, trainings etc for development of the above website. The Assessee submitted that these expenses should be considered as revenue expenditure. It was submitted that in the following decisions it has been held that website development expenses are revenue in nature.

1. *CIT v Indian Visit.com (P) Ltd* 176 Taxman 164
2. *Lyons Technologies Ltd. v ACIT* - I.T.A. No.3060/AHD/2004
3. *M/S. Kisan Ratilal Choksey Shares & Securities Pvt. Ltd. v Addl. CIT* — ITA No.4821 /Mum/2009

The learned DR relied on the order of the AO.

86. We have considered the rival contentions. The submissions made before us that the above expenses were incurred for website development is contrary to the stand of the Assessee before DRP/AO that these expenses were for exploring the possibility of domestic market through pilot projects. Unless the nature of the expenses is examined it is not possible to decide as to whether the same were revenue in nature and that it relates to existing business of an Assessee. The alternative contention of the Assessee that the claim should be examined u/s.35 of the Act also cannot be decided unless the correct description of the expense is considered. We therefore set aside the order of the AO on this issue and remand the issue for consideration afresh by the AO after affording opportunity of being heard to the Assessee.

87. Grounds No.19 & 20 raised by the Assessee reads as follows:

> "19. disallowing a sum of Rs. 12,50,000 being provision for building registration charges without appreciating that same has been written back in the later assessment year and therefore is deductible expenditure; and

> 20. disallowing a sum of Rs. 28,25,890 being provision towards foreign travel expenses on the ground that these are liabilities on provisional basis."

88. During the previous year, the assessee had made provision of Rs.12,50,000/- towards building registration charges. The AO has disallowed the same on the ground that it is a provision. The assessee submitted that the provision has been reversed and offered to tax during the AY 2009-10 and therefore same should not be taxed in the year under consideration. The limited plea of the Assessee before us is that if the sum is disallowed in this year the same should not be taxed in AY 09-10. We are of the view that it would be appropriate to direct the AO not to tax the same sum in AY 09-10 as the sum has already suffered tax by disallowance in the present AY. With the above directions, Gr.No.19 is dismissed.

89. As far as Gr.No.20 is concerned, the facts are that the AO disallowed a sum of Rs. 28,25,890/- being travel expenses on the ground that the appellant did not furnish the name of employees who have travelled with details of the places including the invoices, bills and the amount thereof. In this regard, it was submitted that its employees go for foreign travel for onsite jobs. The assessee gives travel advance to the employees before their foreign travel. If the employees return before 31st March, their accounts are settled. However some time, the employees return after 31st March. In such cases, the appellant makes a provision in the books of account from the date of travel to 31st March based on its per diem policy. The same is settled in the succeeding year after return of the employees. The provision being towards actual expenditure incurred is allowable as deduction. The portion of provision is towards hotel and boarding charges. A provision is made towards hotel and boarding charges from the date of booking to 31st March. A provision is made based on the details of expenditure provided by AE who make the payment. The appellant reimburses these expenses at cost to the AE subsequently. The assessee submits that expenditure for the purposes of section 37 includes amounts which the assessee has actually expended or which the assessee has provided for or laid out in respect of an accrued liability. The assessee submits that the additions made by the AO are to be deleted.

90. With respect to AO's and DRP's contention that the assessee did not submit details, the assessee brought to our notice that the details were never called for by the AO. The assessee also submitted these details before the DRP (employee wise provision details alongwith month of settlement as Annexure 4 to DRP submissions — pages 502 to 505 of PB). The learned DR relied on the order of the AO.

91. We have considered the rival submissions. The disallowance in question has been made for the reason that expenditure cannot be

claimed on the basis of provision and that the liability in respect of the expenditure has not accrued to the Assessee during the previous year. In our view this cannot be the basis to disallow the claim of the Assessee for deduction. The law in this regard is now well settled. The Hon'ble Supreme Court in the case of *Bharat Earth Movers vs CIT* 245 ITR 482(SC) had an occasion to consider the claim for deduction on account of a contingent liability. The following principles were laid down by the Hon'ble Supreme Court:–

> 'If a business liability has definitely arisen in 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 as contingent one. The liability is in present 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'.

92. In the present case, we find from the details of expenses which were claimed as a provision, the Assessee has the system of reversing expenses wherever the same was not incurred by the Assessee, in the succeeding Assessment years. We are of the view that the AO should be directed to examine the issue afresh in the light of the decision of the Hon'ble Supreme Court referred to above and ascertain as to the reasonableness of the basis on which the provision is made, examine as to whether the Assessee reverses excess provision when the actual expenses details are available and also see if the Assessee follows the method of accounting consistently. The AO will afford opportunity of being heard to the Assessee and decide the issue afresh.

93. Ground No.21 is with regard to levy of Rs. 86,13,925 as interest u/s. 234B of the Act, which is purely consequential. The AO is directed to give consequential relief.

94. In the result, the appeal by the Assessee is partly allowed.

Pronounced in the open court on this 23rd day of November, 2012.

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2013 TRI 265 (S.C. Ind.)

SUPREME COURT OF INDIA

D.K. Jain and Madan B. Lokur, JJ.

Satya Nand Munjal
v.
Commissioner of Gift Tax

FACTS/HELD

1. **Taxability of a revocable transfer as deemed gift u/s 4(1)(c) of the Gift-tax Act**
2. The assessee owned 6000 shares of Hero Cycles. On 20.02.1982, he executed a deed of revocable transfer in favour of M/s Yogesh Chandra. The deed permitted the assessee to, after completion of 74 months from the date of transfer but before the expiry of 82 months from the said date, exercise the power of revoking the gift. In other words, there was a window of 8 months within which the gift could be revoked. The deed of revocable transfer specifically stated that the gift shall not include any bonus shares or right shares received and/or accruing or coming to the transferee from Hero Cycles by virtue of ownership of the said shares. Effectively, therefore, only a gift of 6000 equity shares was made by the assessee to the transferee. On 29.09.1982 & 31.5.1986, the company issued 4000 and 10,000 bonus shares to the transferee. On 15.6.1988, the assessee revoked the gift with the result that the 6000 shares gifted to the transferee came back to the assessee. However, the 14,000 bonus shares allotted to the transferee while it was the holder of the equity shares of the company continued with the transferee. In AY 1982-83, the GTO relied on McDowell 154 ITR 148 (SC) and held that the revocable transfer was only for the purpose of reducing the wealth tax liability and was void. He, however, made a protective gift-tax assessment. The Tribunal and the High Court (CGT vs. Satya Nand Munjal 256 ITR 516 (P&H)) reversed the AO and held that a revocable transfer was valid even if its object was to avoid wealth-tax. The assessee was held liable to pay gift-tax u/r 11 of the Gift-tax

Act. In AY 1989-90 the AO & CIT(A) held that the 14,000 shares belonged to the assessee and as the revocation was only with respect to the 6,000 shares and the 14,000 bonus shares continued with the transferee, there was a chargeable gift to that extent. The Tribunal reversed the AO & CIT(A). On appeal by the department, the High Court reversed the Tribunal and held that the assessee was liable to gift tax on the value of the bonus shares gifted by him to the transferee applying the principles of Escorts Farms (Ramgarh) 222 ITR 509 (SC). On appeal by the assessee to the Supreme Court, HELD:

> The fundamental question is whether there was in fact a gift of 14,000 bonus shares made by the assessee to the transferee. The answer to this question lies in s. 4(1)(c) of the Gift-tax Act which provides that "*where there is a release, discharge, surrender, forfeiture or abandonment of any debt, contract or other actionable claim or of any interest in property by any person, the value of the release, discharge, surrender, forfeiture or abandonment to the extent to which it has not been found to the satisfaction of the AO to have been bona fide, shall be deemed to be a gift made by the person responsible for the release, discharge, surrender, forfeiture or abandonment*". On facts, the assessee had made a valid revocable gift of 6000 equity shares in the company on 20.2.1982 to the transferee. The only event that took place in AY 1989-90 was the revocation of the gift by the assessee on 15.6.1988. The question whether the revocation of the gift of the original shares in AY 1989-90 constitutes a gift of the bonus shares that were allotted to the transferee on 29.09.1982 and 31.05.1986 requires to be answered in the light of s.4(1)(c). The question of applicability of Escorts Farms has to be decided after a finding is reached on the applicability of the first part of s. 4(1)(c) (*matter remanded*).

Appeals allowed.

Civil Appeal No. 3914 of 2010 with Civil Appeal No. 3915 of 2010.

Decided on: 22nd January, 2013.

JUDGMENT

Madan B. Lokur, J.–

1. Civil Appeal No. 3914/2010 (Assessee: Satya Nand Munjal) and Civil Appeal No. 3915/2010 (Assessee: Om Prakash Munjal) arise out of

G.T.A. No. 3/2001 and G.T.A. No. 2/2001 respectively both decided by the High Court of Punjab & Haryana on 17th December, 2008. The relevant Assessment Year is 1989-90.

2. At the instance of the Revenue, the High Court was called upon to decide the following common substantial question of law:–

> "Whether, on the facts and in the circumstances of the case, the ITAT was right in law in quashing the gift-tax assessment in the assessee's case."

3. The High Court set aside the order of the Income Tax Appellate Tribunal (the Tribunal) and held in favour of the Commissioner of Gift Tax by upholding the assessment order. It is in these circumstances that the assessee is now before us.

4. For convenience, we refer to the facts in the case of Satya Nand Munjal.

The facts:

5. On 20th February 1982 the assessee, being the absolute owner of 6000 fully paid up equity shares of the face value of Rs. 25 each of M/s Hero Cycles (P) Ltd. executed a deed of revocable transfer in favour of M/s Yogesh Chandra and Brothers Associates (the transferee). Under the deed, the assessee could, on completion of 74 months from the date of transfer but before the expiry of 82 months from the said date, exercise the power of revoking the gift. In other words, the assessee left a window of 8 months within which the gift could be revoked.

6. The deed of revocable transfer specifically stated that the gift shall not include any bonus shares or right shares received and/or accruing or coming to the transferee from M/s Hero Cycles (P) Ltd. (the company) by virtue of ownership or by virtue of the shares gifted by the assessee and standing in the name of the transferee. Effectively, therefore, only a gift of 6000 equity shares was made by the assessee to the transferee.

7. On 29th September 1982 the company issued bonus shares and since the transferee was a holder of the gifted equity shares, 4000 bonus shares of the said company were allotted to the transferee. Similarly, on 31st May 1986 another 10,000 bonus shares were allotted to the transferee by the company.

8. Thereafter, during the window of eight months, the assessee revoked the gift on 15th June 1988 with the result that the 6000 shares gifted to the transferee came back to the assessee. However, the 14,000 bonus shares allotted to the transferee while it was the holder of the equity shares of the company continued with the transferee.

Assessment proceedings for AY 1982-83:

9. For the Assessment Year 1982-83, the Gift Tax Officer passed an assessment order on 17th February 1987 in respect of the assessee. He

held that the revocable transaction entered into by the assessee was only for the purpose of reducing the tax liability. As such, it could not be accepted as a valid gift. For arriving at this conclusion, the assessing officer relied upon *McDowell & Co. v. Commercial Tax Officer*, [1985] 154 ITR 148. Accordingly, the assessing officer, while holding the gift to be void, made the assessment on a protective basis.

10. Feeling aggrieved by the assessment order, the assessee preferred an appeal before the Commissioner of Gift Tax (Appeals) but found no success. The Commissioner of Gift Tax (Appeals), however, held that since the gift was void, a protective assessment could not be made.

11. The assessee then preferred a further appeal to the Tribunal and by its order dated 23rd August 1991 allowing the appeal; the Tribunal held the revocable gift to be valid. It was noted that the concept of a revocable transfer by way of gift is recognized by Section 6(2) of the Gift Tax Act, 1958 (the Act). The value of the gift in such a case was to be calculated in terms of Rule 11 of the Gift Tax Rules, 1958.

12. Although the decision was rendered by the Tribunal after the gift had been revoked by the assessee, it was held that if the assessee "does not exercise an option to revoke the gift within the provided for period of 82 months, then at that point of time also, there will be a further valuation of the residuary interest….".

13. Feeling aggrieved by the decision of Tribunal, the Revenue took up the matter in appeal before the Punjab & Haryana High Court. By its judgment and order in *Commissioner of Gift-tax v. Satya Nand Munjal*, [2002] 256 ITR 516 the High Court dismissed the appeal and held:

> "It is a legitimate attempt on the part of the assessee to save money by following a legal method. If on account of a lacuna in the law or otherwise the assessee is able to avoid payment of tax within the letter of law, it cannot be said that the action is void because it is intended to save payment of tax. So long as the law exists in its present form, the taxpayer is entitled to take its advantage. We find no ground to accept the contention that merely because the gift was made with the purpose of saving on payment of wealth-tax, it needs to be ignored."

14. The position as it stood, therefore, was that the crevocable gift made by the assessee was held to be a valid gift and the assessee was liable to pay gift tax on the value of the gift as determined under Rule 11 of the Gift Tax Rules, 1958.

Assessment proceedings for AY 1989-90:

15. All of a sudden, on 30th January 1996 the Gift Tax Officer issued a notice to the assessee under Section 16(1) of the Act to the effect that for the Assessment Year 1989-90 the gift made by the assessee was chargeable to gift tax and that it had escaped assessment for that

Assessment Year. The assessee responded to the notice by simply stating that there is no gift that had escaped assessment.

16. On 24th March 1998 the assessing officer passed a reassessment order for the Assessment Year 1989-90. While doing so, he framed two issues for consideration: firstly, whether the transferee becomes the owner of the bonus shares particularly because the shares have been received by it as a result of a revocable transfer; secondly, whether the bonus shares received by the transferee could be described as a benefit derived by the transferee from the transferred shares.

17. The assessing officer held that the transferee does not become the owner of the gifted shares until the transfer is an irrevocable transfer. Proceeding on this basis, it was held that the 14,000 bonus shares allotted to the transferee were a part and parcel of the gifted shares and the assessee only took back 6000 shares from the transferee pursuant to the revocable gift. Consequently, it was held that the assessee had surrendered his right to get back 14,000 bonus shares which were treated as a gift by the assessee to the transferee in view of the provisions of Section 4(1)(c) of the Act. The assessee was taxed accordingly.

18. Feeling aggrieved by the reassessment order, the assessee preferred an appeal to the Commissioner of Gift Tax (Appeals). By his order dated 8th September 1998 the Commissioner held that since there was no regular transfer of the bonus shares, the transferee could not claim any ownership of the shares. In fact he was only a trustee of the assessee in respect of the bonus shares. The Commissioner also referred to *McDowell & Co*. and held that the assessee had carefully planned his affairs in such a manner as to deprive the Revenue of a substantial amount of gift tax. The reassessment order was accordingly upheld.

19. The assessee then took up the matter with the Tribunal which held in its order dated 23rd May 2000 that in view of the assessment to gift tax made in respect of the assessee for the Assessment Year 1982-83, the notice issued under Section 16(1) of the Act was merely a change of opinion and, as such the reassessment proceedings could not have been taken up. On the merits of the case, it was noted that neither the dividend income on the bonus shares nor their value had been taxed in the hands of the assessee. Consequently, the assessee was liable to succeed on the merits of the case also. The gift tax reassessment was accordingly quashed by the Tribunal.

20. The Revenue then came up in appeal before the High Court with the substantial question of law mentioned above.

21. In the impugned order, the High Court held that the assessee was liable to gift tax on the value of the bonus shares which were a gift made by the assessee to the transferee. It was held that the bonus shares were income from the original shares by relying upon *Escorts Farms (Ramgarh)*

Ltd. v. Commissioner of Income Tax, [1996] 222 ITR 509. Accordingly, the order of the Tribunal was set aside and the reassessment order upheld.

Discussion and conclusions:

22. Although learned counsel for the assessee seriously doubted the correctness of the impugned judgment and order on several grounds, we find that it is not necessary for us to go into all the issues raised by him.

23. The fundamental question before the High Court was whether there was in fact a gift of 14,000 bonus shares made by the assess to the transferee. The answer to this question lies in the interpretation of Section 4(1)(c) of the Act which reads as follows:–

> **"Gifts to include certain transfers.**
>
> 4. (1) For the purposes of this Act,–
>
> (a) xxx
>
> (b) xxx
>
> (c) where there is a release, discharge, surrender, forfeiture or abandonment of any debt, contract or other actionable claim or of any interest in property by any person, the value of the release, discharge, surrender, forfeiture or abandonment to the extent to which it has not been found to the satisfaction of the Assessing Officer to have been bona fide, shall be deemed to be a gift made by the person responsible for the release, discharge, surrender, forfeiture or abandonment;
>
> (d) to (e) xxx"

24. A perusal of the impugned judgment and order facially indicates that there has been no consideration of the provisions of Section 4(1)(c) of the Act. From the rather elaborate narration of facts, it is quite clear that the assessee had made a valid revocable gift of 6000 equity shares in the company on 20th February 1982 to the transferee. This is a finding of fact conclusively determined by the High Court in the assessee's own case.

25. The only event that took place in the previous year relevant to the Assessment Year 1989-90 was the revocation of the gift by the assessee on 15th June 1988. Was this event enough for the Gift Tax Officer, in 1996, to re-open the assessment for the year 1989-90, while keeping in mind the fact that bonus shares were allotted to the transferee on 29th September 1982 and 31st May 1986? It is possible, on an interpretation of Section 4(1)(c) of the Act to answer this question either way, but unfortunately the High Court did not even notice this provision of the Act. Of course, the submission of learned counsel for the assessee is that on an interpretation of Section 4(1)(c) of the Act, it cannot be said by any stretch of imagination, that the assessee had made a gift of 14,000 bonus shares to the transferee in the previous year relevant to the Assessment Year 1989-90.

26. However, we are not inclined to decide this issue finally since we do not have the view of the High Court on the interpretation of Section 4(1)(c) of the Act. Nor do we have the view of the High Court on the applicability or otherwise of the principle laid down in *McDowell & Co*.

27. As far as the applicability of *Escorts Farms* is concerned, the question that arose for consideration in that case was the determination of the cost of acquisition of the original shares when bonus shares are subsequently issued. That is the second part of Section 4(1)(c) of the Act and that question would arise (if at all) only after a finding is given by the High Court on the first part of Section 4(1)(c) of the Act. But, as we have noted above, the High Court has not considered the interpretation of Section 4(1)(c) of the Act.

28. Under the circumstances we have no option but remand the matter for de novo consideration by the High Court keeping in mind the provisions of Section 4(1)(c) of the Act as well as the orders passed in the case of the assessee for the Assessment Year 1982-83. We do so accordingly.

29. In view of the above, both the Civil Appeals are allowed and the impugned judgment and order of the High Court is set aside but without any order as to costs.

30. We make it clear that the parties are entitled to raise all contentions before the High Court and are at liberty to file additional documents, if necessary.

2013 TRI 271 (H.C. Del.)

HIGH COURT OF NEW DELHI

Badar Durrez Ahmed and R.V. Easwar, JJ.

CIT
v.
Mak Data Ltd.

FACTS/HELD

1. **Section 271(1)(c): Surrender of income without explanation attracts penalty**
2. A survey u/s 133A was conducted on the assessee's premises in the course of which certain documents belonged to certain

entities who had applied for shares in the assessee company were found. The AO called upon the assessee to prove the nature and source of the monies received as share capital, the creditworthiness of the applicants and the genuineness of the transactions. The assessee offered Rs. 40.74 lakhs as income from other sources "*to avoid litigation and to buy peace*". It was made clear that in making the surrender, there was no admission of concealment. The AO completed the assessment by adding the said sum and levied penalty u/s 271(1)(c) for furnishing inaccurate particulars of income u/s 271(1)(c). This was upheld by the CIT(A) though reversed by the Tribunal (*included in file*) on the ground that there was no material to show any concealment and even in the penalty order it was not specified as to the particular credit in respect of which the penalty was being imposed. It was also emphasized by the Tribunal that the assessee had made it clear while surrendering that there was no admission of concealment and that the offer was made in a spirit of settlement. On appeal by the Department to the High Court, HELD reversing the Tribunal:

> When the AO called upon the assessee to produce evidence as to the nature and source of the amount received as share capital, the creditworthiness of the applicants and the genuineness of the transactions the assessee simply folded up and surrendered the sum of Rs. 40.74 lakhs by merely stating that it wanted to "*buy peace*". In the absence of any explanation in respect of the surrendered income, the first part of clause (A) of Explanation 1 to s. 271(1)(c) is attracted because the nature and source of the amount surrendered are facts material to the computation of total income. The absence of any explanation regarding the receipt of the money, which is in the exclusive knowledge of the assessee leads to an adverse inference against the assessee and is statutorily considered as amounting to concealment of income under the first part of clause (A) of the Explanation to s. 271(1)(c) and penalty has to be levied.

Appeal allowed.

ITA No.415/2012.

Decided on: 22nd January, 2013.

Present at hearing: Sanjeev Sabharwal, Advocate, for Appellant. None, for Respondent.

JUDGMENT

R.V. Easwar, J.–

The following substantial question of law was framed by this Court on 11th October, 2012:–

> *"Whether the Tribunal fell into error in setting aside the order of penalty imposed by the AO and upheld by the CIT (A)?"*

2. This is an appeal by the Revenue under Section 260A of the Income Tax Act, 1961 ('Act' for short) and it pertains to the assessment year 2004-05. An assessment was completed upon the assessee under Section 143(3) of the Act in which an addition of Rs. 40,74,700/- was made in the following circumstances. There was a survey under Section 133A on 16th December, 2003 in the course of which some documents pertaining to the assessee were found and were impounded. These documents consisted of blank transfer deeds for shares duly signed, affidavits, share application forms, copies of bank accounts, income tax returns and assessment orders of certain other companies. Those documents were forwarded to the AO assessing the present assessee who called upon the assessee to explain the contents of the documents and the genuineness of the transactions represented by them. It appears that the documents belonged to certain entities who had applied for shares in the assessee company. What the AO wanted the assessee to do was to prove the nature and source of the monies received as share capital, the creditworthiness of the applicants and the genuineness of the transactions.

3. In response to the above notice which was issued on 26th October, 2006, the assessee stated as under:–

> *"It has been stated that the company had received share application money from different entities aggregating to a sum of Rs. 239 lacs during the past 3 years as:*

Assessment Year	*Amount*
2002 – 2003	*12,00,000*
2003 – 2004	*1,06,50,000*
2004 – 2005	*1,20,50,000*
	2,39,00,000

> *The company with a view to avoid litigation and buy peace and to channelize the energy and resources towards productive work and to make amicable settlement with the Income Tax Department offers to surrender a sum of Rs. 56.49 lacs as income from other sources.*

In this context we also wish to bring on record the fact that Sh. V. K. Aggarwal, Promoter Director of the company had offered a sum of Rs. 1,82,51,000/- for taxation as "income from other sources" in the hands of the partnership firm M/s. Marketing Services. Sh. V.K. Aggarwal is the partner of M/s. Marketing Services and the firm is being assessed with the CIT XI, New Delhi, this income of Rs. 1,82,51,000/- was duly subjected to tax by CIT XI in the following manner:

Assessment Year	*Amount*
2001 – 2002	*Rs. 48,97,000/-*
2002 – 2003	*Rs. 40,68,000/-*
2003 – 2004	*Rs. 92,86,000/-*
	Rs. 1,82,51,000/-

It has also been stated that Sh. V.K. Aggarwal, Promoter-Director of the assessee company has utilized this offered sum of Rs. 1,82.51 lacs for inducting funds into the books of the assessee company as share application money. It has been stated further that the additional fund flow to the extent of Rs. 56.49 lacs (239 lacs – 182.51 lacs) which remain unexplained is now being offered for taxation by the company as its income from other sources. Subject to the condition that the offer of the surrender is by way of voluntary disclosure without admitting any concealment whatsoever or any intention to conceal and subject to non initiation of penalty proceedings and prosecution."

It appears that thereafter the assessee filed an application before the Addl. Commissioner of Income Tax under Section 144A soliciting directions for expediting the assessment proceedings and therein it indicated its willingness to be assessed on an amount of Rs. 56.49 lacs as its income under the head "income from other sources". It may be noticed that this figure represents the difference between the amount of Rs. 239 lacs and Rs. 1,82,51,000/-. After certain correspondence between the AO and the Addl.CIT, a letter was issued on 27th December, 2006 containing the directions of the Addl.CIT. The entire directions are reproduced in the assessment order and is, therefore, not reproduced here for the sake of brevity. It suffices to note that before the Add. CIT the assessee would appear to have scaled down the offer from Rs. 56.49 lacs to Rs. 40.74 lacs on the ground that the peak investment should be taken at Rs. 2,19,50,000/- instead of Rs. 239 lacs as calculated earlier. The AO, on the basis of the directions of the Addl. CIT called upon the assessee to furnish the relevant documents and information regarding the fresh offer of Rs. 40,74,000/-. The purpose appears to be merely to verify the reconciliation between the earlier offer of Rs. 56.49 lacs and the revised offer of Rs. 40.74 lacs. After having carried out the verification the amount of Rs. 40.74 lacs was added as "income from other sources" with the following

narration "*As per direction of the Addl. CIT Range-6 and further discussion with the assessee's A.R. a sum of Rs. 40,74,000/- is treated as income from other sources*"

4. There was no appeal against the aforesaid addition by the assessee. The addition of Rs. 40,74,000/- thus became final.

5. Subsequently the AO initiated penalty proceedings for furnishing inaccurate particulars of its income under Section 271(1)(c) of the Act. The gist of the assessee's reply was that the amount was offered as income only to buy peace and avoid protracted litigation and with the condition that no penalty or prosecution proceedings would be launched. It was further stated that the offer was made before any investigation was carried out into the matter and, therefore, was voluntary. Several authorities were relied upon in support of the submission. However, the submissions were rejected by the AO who, by the order dated 23.4.2007, imposed the minimum penalty of Rs. 14,16,600/- for furnishing inaccurate particulars of income to the extent of Rs. 40,74,000/-. The ultimate findings of the AO on the basis of which the penalty was imposed were as follows:–

> *"23. The reply furnished by the assessee has been considered & found to be unsatisfactory because of the following: -*
>
> > *a) In the return filed by the assessee the assessee has not offered the amount of Rs. 40.74 lacs for taxation voluntarily.*
> >
> > *b) The assessee has surrendered the above amount of Rs. 40.74 lacs during course of assessment proceeding when the impounded material was confronted to the assessee which was impounded during course of survey u/s 133A of the IT Act, 1961 on 16.12.2003 at the business premise of Marketing Services.*
> >
> > *c) The assessee has furnished inaccurate particulars of its income in the return of income filed on 27.10.2004 for the year under consideration.*
> >
> > *d) The satisfaction was recorded at the time completing assessment proceedings u/s 143(3) of the I.T. Act, 1961.*
> >
> > *e) The assessee has itself surrendered for tax, the addition sum of Rs. 40,74,000/- which it was asked to explain the source of share application money. Moreover, admitted facts need not to be proved by the Assessing Officer, as in this case, the assessee itself admitted the concealment of income to the extent of Rs. 40,74,000/- by offering the amount for tax.*
>
> *In view of the above facts and circumstances of the case, I am satisfied that it is a fit case for imposition of penalty u/s 271(1)(c) read with section 274 of the IT Act, 1961."*

6. The assessee preferred an appeal to the CIT(Appeals) who rejected the submissions of the assessee and confirmed the penalty. A further appeal was preferred by the assessee to the Income Tax Appellate Tribunal ('Tribunal' for short) in ITA No.1896/Del/2010. The levy of the penalty was opposed on the ground that the surrender of income was made *suo moto* before any investigation, that there was no other evidence in the possession of the income tax authorities except the surrender, and that the levy of penalty without recording any finding on the merits of the assessee's plea was untenable. The Tribunal on examination of the facts and the rival contentions cancelled the penalty recording the following findings:–

(a) It was only after the directions of the Addl.CIT issued under Section 144A that the assessee's offer was accepted and the assessment was finalized;

(b) There was no material against the assessee to show any concealment and this fact has been admitted by the AO himself; there is not even any indication in the penalty order as to the particular credit in respect of which the penalty was being imposed;

(c) The fact that the assessee surrendered the income only when it was confronted with the documents found in the survey does not adversely affect its case.

(d) The assessee did not admit that it had concealed the income to the extent of Rs. 40,74,000/-; it had made it clear in the letter dated 22.11.2006 that the surrender was made without any admission of concealment or intention to conceal.

(e) The offer was made in a spirit of settlement of the dispute with the revenue and no investigation was carried out by the AO to prove concealment.

In support of the aforesaid findings the Tribunal referred to several authorities.

7. The contention of the revenue before us is that the Tribunal failed to appreciate the provisions of Explanation-1 to Section 271(1)(c) of the Act. We think that there is force in the contention. Section 271(1)(c) provides for levy of penalty for concealing the particulars of income or furnishing inaccurate particulars of the income. Explanation-1 is as below:–

> *"Explanation 1.--Where in respect of any facts material to the computation of the total income of any person under this Act,–*
>
> **(A)** Such person fails to offer an explanation or offers an explanation which is found by the Assessing Officer or the Commissioner (Appeals) or the Commissioner to be false, or

(B) Such person offers an explanation which he is not able to substantiate and fails to prove that such explanation is bona fide and that all the facts relating to the same and material to the computation of his total income have been disclosed by him], then, the amount added or disallowed in computing the total income of such person as a result thereof shall, for the purposes of clause (c) of this sub-section, be deemed to represent the income in respect of which particulars have been concealed."

In the case before us the revenue is right in contending that there was absolutely no explanation from the assessee in respect of the amount of Rs. 40,74,000/-; when the AO called upon the assessee to produce the evidence as to the nature and source of the amount received as share capital, the creditworthiness of the applicants and the genuineness of the transactions the assessee simply folded up and surrendered a sum of Rs. 56.49 lacs in its hands initially, which was later scaled down to Rs. 40,74,000/-. The assessee merely stated that with a view to avoid litigation and buy peace and to channelize the energy and resources towards productive work and to make amicable settlement with the income tax department, it surrendered the income under the head "income from other sources". In the absence of any explanation in respect of the surrendered income, the first part of clause (A) of Explanation 1 is attracted. It cannot be denied that the nature and source of the amount surrendered are facts material to the computation of the total income of the assessee. The Revenue is entitled to know the same and if the nature and source of the amount are not explained, it is entitled to draw the inference that the amount represents the assessee's taxable income. Though this principle was originally confined to the assessment proceedings, the Explanation has extended it to penalty proceedings also, presumably on the assumption that the furnishing of an explanation regarding the nature and source would have compromised the assessee's position. It is the assessee who has received the monies and is in the knowledge of all the facts relevant and material in relation to the receipt. Therefore, it should be in a position to offer an explanation and disclose the material facts regarding the same. The absence of any explanation is statutorily considered as amounting to concealment of income. In the absence of any explanation regarding the receipt of the money, which is in the exclusive knowledge of the assessee, an adverse inference is sought to be drawn against the assessee under the first part of clause (A) of the said Explanation. This appears to be somewhat in the lines of Section 106 of the Evidence Act, the principle behind which has been extended to the provisions of Section 271(1)(c) of the Act.

8. We are satisfied that the Tribunal fell into error in setting aside the penalty imposed by the AO and upheld by the CIT(Appeals). We accordingly answer the substantial question of law in the affirmative,

against the assessee and in favour of the revenue. The appeal of the revenue is allowed with no order as to costs.

INCOME TAX APPELLATE TRIBUNAL
DELHI "E" BENCH, DELHI

G.D. Agarwal, Vice President and A.D. Jain, Judicial Member

Appeal allowed.

ITA No. 1896(Del)2010 (Assessment Year: 2004-05).

Decided on: 18th November, 2011.

Present at hearing: Ved Jain & Rano Jain, CAs, for Appellant. R.S. Negi, Sr. DR, for Respondent.

JUDGMENT

Per A.D. Jain:– (Judicial Member)

This is assessee's appeal for the assessment year 2004-05 against the order dated 17.2.2010 passed by the learned Commissioner of Income Tax(Appeals), IX, New Delhi, confirming the penalty of Rs. 14,61,547/-, imposed on the assessee u/s 271(1) (c) of the Income Tax Act. The following grounds have been taken:–

1. *"On the facts and circumstances of the case, the order passed by the ld. CIT(A) is bad, both in the eye of law and on facts.*
2. *On the facts and circumstances of the case, the ld. CIT(A) has erred, both on facts and in law, in ignoring the contention of the appellant that no penalty is leviable as the appellant has surrendered the income suo-motto and as such there is neither concealment nor furnishing inaccurate particulars of income.*
3. *On the facts and circumstances of the case, the ld. CIT(A) has erred, both on facts and in law, in confirming the penalty as the additions was made only on the basis of surrender made by the assessee and not with reference to any documentary evidence.*
4. *On the facts and circumstances of the case, the ld. CIT(A) has erred, both on facts and in law, in rejecting the contention of the assessee that the levy of penalty is untenable no finding has been given on merit regarding concealment in the penalty order passed by the AO.*
5. *On the facts and circumstances of the case, the ld. CIT(A) has erred, both on facts and in law, in rejecting the contention of the appellant that the order passed by the AO levying penalty is untenable in the eye of law as no satisfaction, as required under the law, has been recorded by the AO in the assessment order."*

2. The facts are that the assessee company is engaged in the business of earning commission from sale of Heavy Machines and running of Hotel. During the year, it showed total receipts of Rs. 84,81,498/- as against Rs. 45,22,539/- of the immediately preceding assessment year. It declared net profit of Rs. 32,11,376/- against that of Rs. 9,59,880/- of the immediately preceding assessment year. A survey was conducted on 16.12.2003, in the case of Marketing Services, New Delhi. Some documents pertaining to the assessee company were found and impounded. These documents comprised of signed blank transfer deeds, MOA of companies, affidavits, share application forms, copy of bank account, copies of Income Tax returns and assessment orders. etc. These documents were forwarded to the AO of the assessee company. The AO found that the documents belonged to some companies/firms/ individuals, who had applied for the shares in the assessee company. The assessee was asked to explain as to why these documents had been lying with them and to prove the genuineness of the transactions and the credit worthiness of the persons and the source of the investment, by producing the persons. The assessee filed reply dated 22.11.2006. Therein, it was stated that the assessee had received share application money from different entities, amounting to Rs. 2,39,00,000/- during the past three years, as follows:-

Assessment year	Amount Rs.
2002-03	12,00,000/-
2003-04	1,06,50,000/-
2004-05	1,20,50,000/-
Total:	2,39,00,000/-

3. The assessee company offered to surrender a sum of Rs. 56.49 lakhs as income from other sources, statedly with a view to avoid litigation and to buy peace and to channelise the energy and resources towards productive work and to make amicable settlement with the Department. It was further stated that Shri V.K. Aggarwal, Promoter Director of the company had offered a sum of Rs. 1,82,51,000/- for taxation as income from other sources in the hands of the partnership firm, M/s. Marketing Services, which was being assessed with the CIT, XI, New Delhi; that this income of Rs. 1,82,51,000/- had been duly subjected to tax by the CIT,XI, as follows:–

Assessment year	Amount Rs.
2001-02	48,97,000/-
2002-03	40,68,000/-
2003-04	92,86,000/-
Total:	1,82,51,000/-

4. It was further stated that Shri V.K. Aggarwal had utilized this offered sum of Rs. 1,82,51,000/- for inducting funds into the books of the assessee company as share application money; that the additional fund flow to the extent of Rs. 56,49,000/-, i.e., the difference between Rs. 2,39,00,000/- and Rs. 1,82,51,000/-, which remained unexplained was, at that stage, being offered for taxation by the company as its income from other sources, subject to the condition that offer of the surrender was by way of voluntary disclosure without admitting any concealment or any intention to conceal and subject to non-initiation of penalty proceedings and prosecution.

5. Later, the assessee filed a petition u/s 144 A of the I.T. Act before the ACIT, for expediting the assessment proceedings. A copy thereof was forwarded to the AO. In the said petition, the assessee company showed its willingness to be taxed of Rs. 56,49,000/-, as the company's income from other sources.

6. Vide letter dated 27.11.2006 the ACIT called for some documents and information from the assessee. The Addl. CIT asked the AO of Marketing Services to submit a detailed report thereon. The AO was asked to supply the following documents:–

a) Photocopy of all the statements recorded during the course of Survey operation.

b) Copy of any communication reference regarding utilization of the offered sum.

c) Copies of all the returns along with Balance Sheet, P&L A/c, Partners capital A/c and other annexure in respect of M/s Marketing Services along with copies of returns of the partners for the assessment year 2001-02 to A.Y. 2006-07.

d) Copies of the assessment orders passed for the above assessment years and penalty order if any.

e) Copies of any other documents/evidence/record which might be useful for the purpose of framing assessment in the case of that assessee.

7. The AO of Marketing Services supplied the documents only partially, i.e., copies of return along with annexures and copies of assessment orders for the period from assessment year 2002-03 to 2004-05. He stated in his letter dated 13.12.2006, that his office did not have any statement recorded during the survey operations; that no other communication regarding utilization of the offered sum was available; and that further, he did not have any documents/evidence/records which might be useful for the purpose of framing assessment in respect of the assessee.

8. The assessee offered to surrender additional income to the tune of Rs. 14,24,00,000/-. Shri V.K. Aggarwal filed an affidavit stating that

neither he nor the other partners of the firm had taken benefit of the surrendered amount during the survey in the case of Marketing Services. Directions dated 27.12.2006 were issued u/s 144A of the Act. Therein, it was, inter alia, observed that the surrendered amount of Rs. 1,82,51,000/-, which had been subjected to tax in the hands of M/s. Marketing Services in the assessment years 2001-02 to 2003-04, had not been introduced in the books of account of the firm in the years in which it had offered for tax or thereafter; that there was also no document/information/detail to suggest that this surrendered amount had been invested elsewhere; that Shri V.K. Aggarwal had filed an affidavit to the effect that the amounts surrendered in the hands of M/s. Marketing Services had been utilized by him as share application money and no-where else; that it had also been explained that the funds of Rs. 1,82,51,000/- inducted in the books of the assessee company as share application money in different years, actually belonged to M/s. Marketing Services, in which, Shri V.K. Aggarwal, the Promoter Director of the assessee company was a partner and this amount had later on offered for tax by him in the hands of M/s. Marketing Services in different assessment years and the same had been also subjected to tax in the hands of the firm; that it had also been explained that since the funds to the extent of Rs. 1,82,51,000/- stood already inducted in the books of the company as share application money before it was offered to tax in the hands of M/s. Marketing Services, there could not be any occasion to again introduce the same amount in the books of the firm, M/s. Marketing Services; that in the said facts and circumstances of the case and in view of the fact that no adverse inference was possible to be drawn against the assessee company against the induction of share application money to the extent of Rs. 1,82,51,000/-, the source of the share application money to the said extent may be treated as explained; that more-over, the share application money to the extent of Rs. 1,82,51,000/- had already been subjected to tax in the hands of M/s. Marketing Services and it could not be taxed again in the hands of the recipient; that the AO was, as such, being requested to accept the assessee's explanation regarding the source of the share application money to the extent of Rs. 1,82,51,000/-, subject to ensuring again that the surrendered amount had been invested or utilized elsewhere, except as stated by the assessee; that as regards the balance amount of share application money of Rs. 40,24,000/-, the assessee had itself stated it as unexplained and had voluntarily shown its willingness to offer to surrender a further sum of Rs. 40,24,000/-, for tax; and that the AO may accept the assessee's offer subject to verification as suggested and bring the said amount to tax.

9. The AO, on verification, recalculated the surrendered amount to Rs. 40,74,000/-. The income of the assessee was assessed at Rs. 57,56,700/-.

10. In the penalty proceedings, it was the stand of the assessee that the penalty proceedings were not maintainable for the reason that the AO had not recorded his satisfaction of there being either concealment of income or furnishing of any inaccurate particulars of its income by the assessee; that the surrender had been made subject to the condition that no penalty be imposed, the offer to surrender the income having been made before any investigation into the matter; and that it could not be said that the surrender had been made only after concealment of income had been deducted by the Department.

11. The stand taken by the assessee was rejected by the AO, observing that the assessee had not offered the amount of Rs. 40,74,000/- for taxation voluntarily; that the surrender had come about during the assessment proceedings, when the impounded material had been confronted to the assessee; that the assessee had furnished inaccurate particulars of its income in the return of income filed; that the satisfaction had been recorded at the time of completion of assessment proceedings u/s 143(3) of the Act; that the assessee had surrendered additional sum of Rs. 40,74,000/- only when it was asked to explain the source of the share application money; and that by offering the amount for tax, the assessee had admitted the concealment of income to the extent of Rs. 40,74,000/-. In this manner, the AO imposed penalty of Rs. 14,61,600/- on the assessee company u/s 271(1)(c) of the I.T. Act.

12. By virtue of the impugned order, the ld. CIT(A) confirmed the penalty imposed, observing, inter alia, that the facts and circumstances of the assessee's case clearly established that the offer of surrender followed investigation made by the AO regarding share application money received by the assessee; that no case had been made out that the income had been offered for tax by the assessee of its own volition/investigation by the Department; and that also, the penalty proceedings had been duly initiated by the AO in the assessment order.

13. Before us, the learned counsel for the assessee has argued that the ld. CIT(A) has erred in confirming the penalty wrongly levied; that the ld. CIT(A) has erred in ignoring the assessee's contention that no penalty was leviable as the assessee had suo motu surrender6ed the income and that as such, there was neither any concealment of income, nor any furnishing of inaccurate particulars thereof by the assessee; that the ld. CIT(A) has failed to take into consideration the fact that the additions had been made only on the basis of surrender made by the assessee, without any reference to any documentary evidence; that the ld. CIT(A) has further failed to consider the assessee's contention that no finding having been recorded on merit regarding concealment in the penalty order, the levy of penalty is unsustainable; that the ld. CIT(A) has also erred in failing to accept the assessee's contention that the penalty order is untenable in law even because no satisfaction has required under the law has been recorded by the AO in the assessment

order; that the ld. CIT(A) has also wrongly ignored the fact that the observation in the penalty order to the effect that the assessee had itself admitted the concealment of income to the extent of Rs. 40,74,000/- was factually incorrect, inasmuch as, in the assessment order, the AO had quoted the assessee's letter, wherein it had been specifically stated that the offer of surrender was without admitting any concealment whatsoever or any intention to conceal and that the surrender was being offered with a view to avoid litigation and to buy peace and to channelise energy and resource towards productive work and to make amicable settlement with the Income Tax Department; that it has also erroneously not been taken into consideration that the AO did not carry out any investigation, much less brought on record any material or evidence proving concealment on the part of the assessee; and that further the ld. CIT(A) has also remained oblivious of the fact that under exactly similar facts and circumstances, no penalty was imposed in the case of M/s. Marketing Services. Attention has been drawn to the assessee's letter dated 22.11.2006 containing offer to surrender (pages 1 to 3 of its paper book, "APB" for short). Reliance has been placed on the following decisions:-

1. "*CIT v. Baroda Tin Works*", 221 ITR 661(Guj);
2. "*CIT v. Suresh Chandra Mittal*", 241 ITR 124(MP); and
3. "*CIT v. Suresh Chandra Mittal*", 251 ITR 9(SC).

14. The ld. DR, on the other hand, has placed strong reliance on the impugned order. It has been contended that it is squarely established on record, has rightly noted by the ld. CIT(A), that the offer of surrender was made only post investigation by the AO regarding the receipt of share application money of the assessee; that therefore, the offer to surrender again at all be said to have been made by the assessee voluntarily before investigation into the matter by the Department; that the penalty proceedings were duly initiated by the AO in the assessment order, as is amply clear from a perusal of the assessment order; that apropos the contention that no penalty was imposed in the case of Marketing Services, the facts in both the cases are entirely different; that therein income was revised voluntarily, after the survey was carried out, which is not the case herein; that also, in this case, the offer of surrender had been made only after the material was confronted to the assessee; and that apropos the reference to the material against the assessee (assessment order page 3, para 12), it is a subsequent development, when it already taken possession of the seized documents.

15. We have heard the parties and have perused the material on record. This material on record shows that the offer of surrender was only to settle the dispute and that while doing so, the assessee did not admit any concealment income. This is evident from the assessee's letter dated 22.11.06 (APB 1 to 3). Therein, it has been stated, inter alia, as follows:–

> *"The company with a view to avoid litigation and buy peace and to channelise the energy and resources towards productive work and to make amicable settlement with the Income Tax Department offered to surrender a sum of Rs. 56,49,000/- as income from other sources."*

16. The said amount of Rs. 56,49,000/- subsequently got reduced to Rs. 40,74,000/-, when peak was worked out at Rs. 219.5 lakhs.

17. The aforesaid offer of surrender was accepted only subsequent to it having been examined on a petition filed u/s 144A of the Act and on examining the records of the case. It is pertinent to mention here, as noted herein above, that vide letter dated 13.12.06, the ACIT, Circular 32(1), New Delhi, i.e., the AO of M/s.Marketing Services, had stated that his office did not have any statement recorded during the course of survey operation; that no other communication regarding utilization of the offered sum was available; and that further, he did not have any document/record/reference which may be useful for the purpose of framing assessment in respect of the firm.

18. In the order dated 27.12.06, issued directions u/s 144A of the Act, the ACIT observed, inter alia, as follows:–

> *"On the basis of above stated facts and circumstances of the case and most particularly in view of the fact that no adverse inference is possible to be drawn against the assessee company regarding induction of share application money to the extent of Rs. 182.51 lacs, the source of share application money to the extent of Rs. 182.51 lacs, the source of share application money to the extent may be treated as explained. Moreover, the share application money to the extent of Rs. 182.51 lacs has already been subjected to tax in the hands of M/s Marketing Services and it can not be taxed again in the hands of the recipient. The AO is, therefore, requested to accept the assessee's explanation regarding source of share application money to the extent of Rs. 182.51 lacs. However, it may be ensured again that the surrendered amount has nowhere been invested or utilized except as stated by the assessee. As regard the balance amount of share application money to the extent of Rs. 56.49 lacs (revised to Rs. . 40.24 lacs vide letter dated 14.12.2006), the assessee has itself treated the balance share application money as unexplained and voluntarily shown its willingness to offer to surrender a further sum of Rs. 56.49 lacs (Revised to Rs. . 40.24 lacs vide letter dated 14.12.2006) for tax. The AO may accept the assessee's offer subject to verifications as suggested above and bring this amount to tax. Before accepting the revised offer, necessary verification made by the AO about its correctness. He should also ensure that the assessee has paid the taxes along with interest on the additional surrendered amount of Rs. 56.49 lacs (revised to Rs.*

> *40.24 lacs vide letter dated 14.12.2006). As regards giving direction to the AO that this additional surrendered amount should not be treated as concealed income and giving further direction to the AO regarding non-initiation of penalty prosecution proceedings. I decline to give any direction to the AO in this regard as the assessee company itself has treated the balance amount of share application money as its unexplained money and offering it for tax. Moreover, no such direction in my opinion for non initiation of penalty proceedings can be issued to the AO as before initiating penalty proceedings, he has to satisfy himself and come to a definite conclusion that whether the assessee company has concealed the particulars of income or filed inaccurate particulars of income. All the powers regarding initiation of penalty proceedings are vested in the AO and I cannot step into the shoes of AO. In view of these facts, I decline to give any direction in respect of initiation of penalty proceedings. As regard initiation of prosecution proceedings, I again decline to give any direction as the initiation of prosecution proceedings are at the instance of Chief Commissioner/Commissioner of Income Tax."*

19. It was only there-after that the offer had been accepted by the AO and the assessment had been finalized.

20. It is evident from the above obtaining facts that there was entirely no material on record against the assessee to show any concealment on its part. Moreover, this fact was also admitted by the AO himself in the assessment order (page 3, para 12 of the assessment order). So much so that there is no indication in the penalty order as to the credit in respect of which the penalty was being imposed. The only material fact remaining, thus, was that the assessee had offered the amount for taxation to buy peace and there was no material on record implicating the assessee for concealment.

21. Further, the observation, in the penalty order, to the effect that the surrender was made only when the assessee was confronted with the documents found in the survey, does not adversely affect the case of the assessee at all, these documents, being in respect of share capital ways. Still further, the observation in the penalty order to the effect that the assessee had itself admitted the concealment of income to the extent of Rs. 40,74,000/- , is found to be factually incorrect. The assessee's letter dated 22.11.06 (supra) clearly mentions that "the offer of the surrender is without admitting any concealment whatsoever or any intention to conceal". It amply stands made out from the facts on record that the amount of Rs. 40,74,000/- was surrendered to settle the dispute with the Department. It did not, in any way, represent any concealment on the part of the assessee. Otherwise too, the AO did not carry out any investigation, nor was any material brought on record to prove

concealment on the assessee's part. Then, no penalty was imposed on M/s. Marketing Security, under a similar set of circumstances.

22. In "*CIT v. Baroda Tin Works*", 221 ITR 661(Guj) (supra), it has been held that the fiction created u/s 68 of the I.T. Act, by itself, cannot be extended to penalty proceedings to raise a presumption about concealment of such income.

23. In "*CIT v. Suresh Chandra Mittal*", 241 ITR 124(MP)(supra), it has been held as follows:–

> *"Though it is true that the assessee had not surrendered at all and that he had done so on the persistent queries made by the AO but once the revised assessment was regularized by the Revenue and once the assessing authority had failed to take any objection in the matter the declaration of income made by the assessee in his revised returns and his explanation that he had done so to buy peace with the Department and to come out of vexed litigation could be treated as bona fide in the facts and circumstances of the case."*

24. "*CIT v. Suresh Chandra Mittal*", 241 ITR 124(MP) (supra), has been affirmed by the Hon'ble Supreme Court in "*CIT v. Suresh Chandra Mittal*", 251 ITR 9(SC)(supra).

25. In "*Chikkam Subharao v. C.S. Rao*, AIR 1971 SC 1542, it has been held that before penalty can be levied, the implication of the statement made must be clear and conclusive; and that there should not be any doubt or ambiguity about the alleged admission.

26. In "*CIT v. Mining Co.*" 102 ITR 830(AP) and in "*Sir Shadilal Sugar & General Mills Ltd. vs. CIT*", 168 ITR 705(SC), it has been held to the effect that the mere fact that the assessee has agreed to higher income is not a proof of admission of concealment by the assessee.

27. Further, in the following cases, it has been held that where the assessee, for one reason or the other agrees or surrenders certain amount for assessment, the imposition of penalty solely on the basis of assessee's surrender is not called for:–

1. "*CIT v. M. George & Bros.*", 160 ITR 511(Ker);
2. "*CIT v. Narang & Co.*", 98 ITR 426(Del);
3. "*Krishan Lal Shiv Chand Rai v. CIT*", 88 ITR 293(P&H).

28. In view of the above, the grievance raised by the assessee is found to be justified and is accepted as such. The order under appeal is, therefore, cancelled and the penalty imposed is deleted.

29. In the result, the appeal filed by the assessee is allowed.

Order pronounced in the open court on 18.11.2011.

2013 TRI 287 (H.C. Bom.)

HIGH COURT OF BOMBAY

J.P. Devadhar and M.S. Sanklecha, JJ.

The Commissioner of Income Tax-II
v.
Shri. Akil Gulamali Somji.

FACTS/HELD

1. **Failure To obtain JCIT's approval renders section 153C Assessment order void**
2. Pursuant to search & seizure action u/s 132 on the premises of a third party, certain documents belonging to the assessee were found and seized pursuant to which a notice u/s 153C was issued to the assessee and assessment u/s 153C r.w.s. 144 were framed. In passing the assessment orders, the AO (ITO) omitted to obtain the consent of the JCIT as mandated by s. 153D. Before the Tribunal, the assessee argued that the failure to obtain the JCIT's consent rendered the assessment a nullity. The Tribunal (137 ITD 94) upheld the plea on the basis that as the heading to s. 153D refers to a "prior approval" and uses negative wording and the word "shall", compliance of s. 153D is mandatory and cannot be waived by the assessee. Reliance was also placed on Clause 9 of the Manual of Office Procedure which makes it clear that an assessment order under Chapter XIV-B can be passed only with the previous approval of the JCIT and that the approval must be in writing and stated to have been obtained in the body of the assessment order. On appeal by the Department to the High Court, HELD dismissing the appeal:

    Though the question raised proceeds on the basis that approval of the JCIT was given as he had corrected the draft assessment order and the changes were incorporated by the AO in the final assessment order, the finding of fact was recorded by the Tribunal is that no prior approval of the Joint Commissioner was taken before the

ITO passed the order. In view of the above, there is no reason to entertain the proposed question and the appeal is dismissed.

Appeals dismissed.

Income Tax Appeal (L) No. 1416 of 2012 with Income Tax Appeal (L) Nos. 1417, 1418 & 1419 of 2012.

Decided on: 15th January, 2013.

Present at hearing: Vimal Gupta, Sr. Advocate with Padma Divakar, for Appellant. None, for Respondent.

JUDGMENT

PC:–

In all these appeals by the revenue the following question of law has been formulated for consideration by this court.

> Whether on the facts and in the circumstances of the case and in law the ITAT did not err in holding that no approval could be said to have been given when in fact the Joint CIT has duly applied his mind and corrected the draft assessment order and the changes were incorporated by the AO in the final assessment order?

2) The question of law as framed proceeds on the basis that the approval of the Joint Commissioner of Income Tax under Section 153D of the Income Tax Act, 1961 has not been obtained. This is factually incorrect as the impugned order dated 30/3/2012 in Para 7 records as under:

> "In an alternative submission, the learned D.R. requested to set aside the file to the A.O. or learned CIT(A), so that defect in not obtaining the approval of the Joint Commissioner of Income Tax can be cured".

3) Admittedly the finding of fact was recorded by the Tribunal that no prior approval of the Joint Commissioner was taken before Income Tax officer passing the order. In view of the above, we see no reason to entertain the proposed question. Hence, the aforesaid appeals are dismissed with no order as to costs.

INCOME TAX APPELLATE TRIBUNAL
PUNE "B" BENCH, PUNE

I.C. Sudhir, Judicial Member and D. Karunakara Rao, Accountant Member

Appeals allowed.

ITA Nos. 455 to 458/PN/2010 (Assessment Years : 2001-02, 2002-03,2003-04 & 2004-05).

Heard on: 15th February, 2012.

Decided on: 30th March, 2012.

Present at hearing: Sunil Ganoo, for Appellant. Ann Kapthuama, for Respondent.

JUDGMENT

Per I.C. Sudhir:– (Judicial Member)

In these appeals, the assessee has questioned first appellate order mainly on two issues. Firstly the validity of assessment order in absence of approval of the Joint Commissioner of Income Tax as provided u/s. 153D of the Act and secondly, the validity of addition of the amount made by A.O. u/s. 69C of the Act on account of unexplained expenditure of interest and brokerage paid by the assessee and other additions.

2. The Ld. A.R. preferred to advance his argument on legal issue. Since it goes to the root of the matter, we allowed the parties to advance their argument on the legal issue to adjudicate it first.

3. The contention of the Ld. A.R remained that while framing assessment u/s. 153 C of the Act against the assessee, the ITO has failed to obtain necessary approval of the Joint Commissioner of Income Tax to the impugned assessment orders as provided u/s. 153 D of the Act, hence assessment orders in question are bad in law and deserve to be annulled. He submitted that Sec. 153 C of the I.T. Act 1961 prescribes that the income of the person to whom notice has been served u/s. 153 C shall be assessed in accordance with the provisions of Sec. 153 A of the I.T. Act 1961. Therefore, the assessment has to be framed u/s. 153 A of the Act and not u/s. 153 C. The first proviso as well as clause (ii) of Second proviso to Sec. 153 B (1) specify the time limit for completion of assessment u/s. 153A in respect of person to whom notice is issued u/s. 153 C of the Act. Therefore, conjoint reading of Sec. 153 A, Sec. 153 B and Sec. 153 D makes it clear that the approval as prescribed u/s. 153 D is also required to be obtained in cases where notice u/s. 153 C had been served, the assessments are to be framed u/s. 153 A. The Ld. A.R. submitted that even the Memorandum explaining the provisions of Finance Bill 2007 speaks that approval u/s. 153 D is also to be obtained in case of other person as referred to Sec. 153 C. In support, he drew our attention to page No. 338 (Statute) of volume 289 ITR. He submitted that the word "approval" has been defined in Black's Law Dictionary -VIth Edition as the act of confirming, ratifying, assenting, sanctioning or consenting to some act or thing done by another. Approval implies knowledge and exercise of discretion after knowledge. The Sec. 153 D uses word "shall" which indicate that the provisions are mandatory especially when the Section further prescribes as "that except with the

prior approval of the Joint Commissioner no order shall be passed". Therefore in the absence of approval of Joint Commissioner, the order passed by the I.T.O. is not a valid and legal order and therefore has no legal force. He contended that in the eye of law an order passed without such approval is a nullity.

4. The Ld. A.R. submitted further that the provisions of Sec. 153 C of the I.T. Act 1961 are analogous to the provisions of Sec. 158 BD of the Act. The Manual of Office Procedure Volume II published in February 2003 by Directorate of Income Tax (Organization and Management Services) C.B.D.T. vide Page No.2 has prescribed procedure to be followed in case of Block Assessment. A copy thereof has been furnished. The Ld. A.R. submitted that approval of senior authority provided to avoid arbitrary, high pitched assessments being framed and hence the approval is mandatory. The object of enacting Sec. 153 D is one of general policy and hence it is mandatory. In support, he placed reliance on the decision of Hon'ble Supreme Court in the case of Kirshan Lal vs J & K, 1994-(SC2)-GJX-0264-SC.

5. The Ld. A.R. submitted that it is a well settled law that if the Statute prescribes that a particular thing is to be done in a particular manner, it is to be done in that manner only. An order passed without an authority is nullity and the same is to be annulled. He placed reliance on the decision of Hon'ble Bombay High Court in the case of *CIT vs. Mrs. Ratnabai N.K. Dubhash*, 230 ITR 495 (Bom.). He submitted that the assessment cannot be restored to the A.O to follow the prescribed procedure because the time limit to frame the assessment has already expired and extended time limit cannot be given otherwise the limitation provision will be frustrated. He submitted that in cases where the provisions of Sec. 153 D are not followed and if the assessments are set aside to remove the illegality, wide gates would be opened for the department to get extended time limit by passing orders without following the procedure prescribed u/s. 153 D and indirectly will get the extended time limit for completion of assessment. He submitted that it is a well settled law that what cannot be directly done cannot be done by following circuitous way. He referred decision of Hon'ble Bombay High Court in the case f *CIT vs. Mrs. Ratnabai N.K. Dubhash* (Supra) in this regard.

6. The Ld. D.R. on the other hand tried to justify the validity of assessment order in question. He submitted that Sec 153 D talks of only approval of the Joint Commissioner of Income Tax for assessment order passed u/s. 153A of the Act. He contended that even if for the sake of argument it is accepted that A.O failed in his mandatory duty of obtaining prior approval, we have to go back to legislative intent behind the relevant Section. The Ld. D.R. submitted that the purpose of approval is to avoid high pitched assessment and inconvenience to the assessee. This pre-supposes the participation of both the A.O and assessee in the

process of assessment. In the present case, all the assessments for 4 years has been passed u/s. 153 C read with Sec. 144 which itself implies that there was lack of co-operation from the assessee during the course of assessment proceedings on various counts. Similarly, even during the appellate proceedings, there has been no appearance of the assessee before the Ld CIT(A) and there was no compliance to statutory notices. The Ld. D.R. placed reliance on the following decisions to support her argument that A.O is well within the jurisdiction to continue with the proceedings from the stage at which the illegality has occurred:

1) *Guduthur Bros. vs ITO*, TC49R, 480 (SC)
2) *Gayathri Textiles vs CIT*, (2000) 243 ITR 674 (Kar)
3) *CIT vs Sara Enterprises*, (1997), 224 ITR 169 (Mad)
4) *CIT vs Sardarilal Bhashi* (1989), 179 ITR 307 (M.P)
5) *Prabhudayal Amichand vs CIT* (1989), 180 ITR 84 (M.P)
6) *CIT vs Damodardas Murarilal* (1996), 222 ITR 401 (M.P)

7. In an alternative submission, the Ld. D.R. requested to set aside the file to the A.O or Ld CIT(A), so that defect in not obtaining the approval of the Joint Commissioner of Income Tax can be cured. She submitted further that Tribunal is also not bound by constraints of limitation and therefore, it is prayed that the file may be set aside to the lower authorities for necessary action.

8. On query raised by the Bench, the Ld. A.R. submitted that the provisions of Sec. 153 D of the Act are mandatory. He submitted that it is a well settled law that in determining the question, as to whether the provision is mandatory or directory, the subject matter, the importance of the provision, the relation of that provision to the general object intended to be secured by the Act, are required to be looked into. He placed reliance on the following decisions:

1) *Re Presidential Poll* reported in 1974- [SC2]-GJX-0912-SC
2) *Govindlal Chhaganlal Patel vs The A.P.M.C.* reported in 1975-[SC2]-GJX-0313 SC.
3) *Krishan Lal vs State of J & K* reported in 1994-[SC2]-GJX-264-SC (SC)
4) *Dhirendra Nath Gorai and others v/s Sudhir Chandra Ghosh & others* reported in 1964-[SC2]-GJX-0060-SC.

9. The Ld. A.R. submitted that the Sec. 153D has been enacted for the benefit of general class of the assessees in whose case the assessments in pursuance of the search and seizure action are to be completed. Since the Section starts by negative words, the provision becomes mandatory, submitted the Ld. A.R.

10. He submitted that in absence of approval of the Joint Commissioner of Income-tax obtained on the assessment order in question, the assessment order be treated as null and void. He placed reliance on the following decisions:

1) *Balvant N. Vishwamitra and others vs Yadav Sadashiv Mule*, reported in 2004-[SC4]-GJX-0636 SC.
2) *Rajendra Kumar Verma vs D.G.I.T.*, reported in [2011] 9 Taxmann.com 85[All].
3) *M/s. Rolson International vs A.C.I.T*, reported in 2001[ID1]-GJX-1089 TBOM.
4) *Khubeshwar Prasad Singh vs State of Bihar*, reported in 2007-[SC2]-GJX-0241 SC
5) *C.I.R. vs SPL's Siddhartha Ltd* reported in ITATONLINE.org.

11. We have considered the above submissions and have gone through the decisions relied upon by the parties in view of orders of the authorities below and material available on record. The relevant facts are that during the course of search and seizure action on 29.7.2003 at the business and residential premises of Mr. Shriram Soni, certain documents belonging to the assessee were found and seized. Notice u/s. 153C was issued to the assessee and assessment u/s. 153C r.w.s. 144 have been framed for all the 4 A.Ys. under consideration. Before the Ld CIT(A), the assessment orders were questioned both on legal issue and on merits. On legal issue, the validity of assessment orders in absence of approval obtained u/s. 153 D of the Act of Joint Commissioner of Income Tax has been questioned. On merits additions made by the A.O were impugned. Since the assessee could not succeed in its appeal, the present appeals have been preferred in questioning the first appellate orders.

12. On perusal of the provisions laid down u/s. 153C of the Act, it is apparent that after issuance of notice u/s. 153C, the A.O having jurisdiction over such other person (against which incriminating material has been found during the course of search conducted on a person) arose or re-assess income of such other person in accordance with the provisions of Sec. 153A. Sec. 153B talks about time limit for completion of assessment u/s. u/s. 153A, whereas S. 153D, talks about necessity of prior approval for framing assessment in case of search or requisition. We thus fully concur with the submission of the Ld. A.R. that provisions laid down u/s. 153D are very much applicable in case of assessment of income of any other person (i.e. the person other than the person searched). Now the issue for our adjudication is as to whether absence of obtaining prior approval u/s. 153D of Joint Commissioner of Income Tax, assessment made u/s. 153 C will make the assessment void or voidable/curable. For a ready reference, provisions laid down u/s. 153D of the Act are being reproduced hereunder:

> "**153D**. No order of assessment or reassessment shall be passed by an Assessing Officer below the rank of Joint Commissioner in respect of each assessment year referred to in clause (b) of [subsection (1) of] section 153A or the assessment year referred to in clause (b) of sub-section (1) of section 153B, except with the prior approval of the Joint Commissioner]."

The above provisions u/s. 153 D have been laid down under the heading "prior approval necessary for assessment in cases of search or requisition". This heading itself suggests that obtaining prior approval the assessment in cases of search or requisition is necessary. We further note that the provisions u/s. 153D start with a negative wording "no orer of assessment or re-assessment" supported by the further wording "shall" makes the intention of the Legislature clear that compliance of Sec. 153D requirement is mandatory. No universal rule can be laid down as to whether mandatory enactment shall be considered directory or obligatory with an implied nullification for disobedience. As per the decision of Hon'ble Supreme Court in the cases of *Banwarilal Agarwalla vs State of Bihar*, AIR 1961 SC 849 (853); *Razas Bulland Sugar Co.Ltd., vs Municipal Board*, AIR 1965 (SC) 895 (899) & Others if object of the enactment will be benefited by holding the same directory, it will be construed as mandatory, whereas if by holding it mandatory, serious general inconvenience will be created to nascent persons without very much further object of enactment, the same will be construed as directory. But all these does not mean that language used is to be ignored, only that the prima facie inference of the intention of the legislature arising from the words used may be displaced by considering the nature of the enactment, its designed consequences flowing from alternative constructions. The wordings and language used in Sec. 153D of the Act and the heading "prior approval necessary for assessment in cases of search or requisition" under which, Sec. 153D has been provided do not leave an iota of doubt about the very intention of the legislature to make the compliance u/s. 153D a mandatory. There is no dispute that if a provision is mandatory, an act done in breach thereof will be invalid, but, if it is directory, the act will be valid although non-compliance may give rise to some other penalty if provided by the Statute. The general rule that non-compliance of mandatory requirements results in nullification of the Act is subject at least to one exception. If contain requirements or conditions are provided by a statute in the interest of a particular person, the requirements, or conditions although mandatory may be waived him if no public interest are involved and in such case, the act done still be valid even if the requirement or condition has not been performed. Here, before us, is not a case where consent of assessee will waive the condition of obtaining prior approval u/s. 153D of the Joint Commissioner of Income Tax by the A.O for framing assessment u/s. 153C/ 153A of the Act. Condition of prior approval of JCIT u/s. 153D has been put in public interest and not in the interest of a particular person. Thus it cannot be

waived by particular person. The use of word "shall" raises a presumption that a particular provision is imperative but this prima facie inference may be reverted by other consideration such as object and scope of the enactment and consequence flowing from such construction. The revenue has not been able to rebut the above inference by pointing out other consideration like object and scope of the enactment and the consequence flowing from such construction before us. Clause 9 of Manual of Office Procedure, Volume II (Technical) February 2003 issued by Directorate of Income Tax on behalf of Central Board of Direct Taxes, Department of Revenue, Government of India, reads as under:

> *"9. **Approval for assessment** : An assessment order under Chapter XIV-B can be passed only with the previous approval of the range JCIT/ADDL.CIT. (For the period from 30-6-1995 to 31-12-1996 the approving authority was the CIT.) The Assessing Officer should submit the draft assessment order for such approval well in time. The submission of the draft order must be docketed in the order-sheet and a copy of the draft order and covering letter filedin the relevant miscellaneous records folder. Due opportunity of being heard should be given to the assessee by the supervisory officer giving approval to the proposed block assessment, at least one month before the time barring date. Finally once such approval is granted, it must be in writing and filed in the relevant folder indicated above after making a due entry in the order-sheet. The assessment order can be passed only after the receipt of such approval. The fact that such approval has been obtained should also be mentioned in the body of the assessment order itself."*

Chapter XIVB also deals with assessment of search cases. Sections 153A, 153B & 153 C have been introduced to Chapter XIV "procedure for assessment" w.e.f. 1.6.2003 by the Finance Act 2003 whereas Sec. 153 D has been inserted to the Chapter w.e.f. 1.6.2007 by the Finance Act 2007. These provisions thus also deal with the assessment in case of search or requisition and when the assessment orders in the present case were passed the provisions laid down u/s. 153D were very much in operation. In the present case, assessments in question have been framed on 27.12.2007.

13. In the case of *CIT vs Ratnabai N.K. Dubhash (Mrs.)* (Supra), the difference between cancellation and amendment of assessment in view of the provisions of Sections 143, 144B, 153 and 251 of the I.T. Act 1961 has been dealt with. The Hon'ble High Court has been pleased to hold as under:

> *"In view of the above discussion, we are of the clear opinion that incases falling under section 144B of the Act, the quasi-judicial function of the Income-tax Officer as an assessing authority comes to an end themoment the assessee files objections to the*

draft order. The power to determine the income of the assessee thereafter gets vested in the Inspect-ing Assistant Commissioner to whom the Income-tax Officer is required to forward the draft order together with objections. The only thing that remained to be done by the Income-tax Officer is to pass a final order in accordance with the directions given by the Inspecting Assistant Commissioner. The function of the income-tax Officer to make the final assessment under section 144B(5) of the Act is more in the nature of a ministerial function because he can pass the order only in accordance with the directions of the Inspecting Assistant Commissioner. He cannot vary ordepart from the directions given by the Inspecting Assistant Commissioner. Moreover, the requirements of section 144B of the Act re mandatory. The Income-tax Officer has no option but to follow the same. He cannot make the final order on the basis of the draft order without forwarding the same to the Inspecting Assistant Commissioner along with the objections and without obtaining the directions of the Inspecting Assistant Commissioner. An assessment made by the Income-tax Officer in violation of the provisions of section 144B of the Act would be an assessment without jurisdiction. In the instant case, the admitted position is that on receipt of the draft order of assessment, the assessee did file objections and the Income-tax Officer completed the assessment himself on the basis of the draft order without forwarding the draft order and the objections to the Inspecting Assistant Commissioner and obtaining directions from him. Such an order, on the face of it, is beyond the powers of the Income-tax Officer under section 143 read with section 144B of the Act and, hence, without jurisdiction. The Tribunal, in our opinion, was, therefore, justified in its conclusion that the assessment was liable to be annulled. It was right in holding that the assessment order passed by the Income-tax Officer the instant case without reference to the Inspecting Assistant Commissioner had rightly been annulled by the Commissioner of Income-tax (Appeals). In view of the above, we answer the question referred to us accordingly in favour of the assessee and against the Revenue.

This reference is disposed of accordingly with no order as to costs."

14. In the case of *CIT vs SPL's Siddharth Ltd.* (Supra), before the Hon'ble Delhi High Court, the facts were that notice issued by the A.O u/s. 147 r.w.s 148 of the Act for re-opening the assessment for the A.Y. 2002-03 was set aside by the Tribunal on the ground that the requisite approval of Addl. Commissioner of Income Tax, which is mandatorily required, was not taken. Since 4 years had elapsed from the end of the

relevant A.Y, the A.O u/s. 151(1) of the Act was required to take approval of the competent authority. The Hon'ble Delhi High Court after discussing the issue in detail and the case laws cited before it has been pleased to approve the decision of Tribunal. In view of these decisions and the position of law provided u/s. 153D of the Act, we hold that the assessment orders impugned framed in absence of obtaining prior approval of the Joint Commissioner for the A.Ys. under consideration are invalid as null and void and are quashed accordingly.

15. The decisions relied upon by the Ld. D.R are having different facts and issue, hence are not helpful to the revenue. In the case of *Guduthur Bros. vs ITO* (Supra) the levy of penalty without affording a hearing to the assessee was questioned before the appellate authority, who set aside that order. The matter ultimately travelled to the Hon'ble Supreme Court and it was held that the ITO was well within his jurisdiction to continue the proceedings from the stage at which the illegality has occurred and to assess the appellants to a penalty, if any. Before the Hon' ble M.P. High Court in the case of *CIT vs Sardarilal Hasim* (Supra), the issue was regarding applicability of prescribed limitation u/s. 275 in a penalty order passed after the case is remanded by an appellate authority. The Hon'ble Court was pleased to hold that the limitation prescribed u/s. 275 of the Act is not applicable to the penalty order passed after the case is remanded by an appellate Authority. In the case of *Gayatri Textiles vs CIT* (Supra) non-obtaining of prior approval of I.A.C u/s. 271(1)(c) (iii) for direction for payment of penalty was held as procedurally defective. The provisions laid down u/s. 153D of the Act under consideration in the present case before us, are different as here the prior approval of Joint Commissioner is not required merely for direction for payment of the due amount of tax but overall approval of the assessment framed by the I.T.O. Thus, the cited decision is not applicable in the present case. In the case of *CIT vs Sara Enterprises* (Supra), the issue was as to whether the bar of limitation contained u/s. 275 of the Act would attenuate or curtail the powers of CIT, vested in him u/s. 263 of the said Act. The Hon'ble Madras High Court was pleased to hold that it is not hit by provisions of Sec. 275 of the Act. In *Prabu Dayal Amichand vs CIT* (Supra), the Hon'ble High Court of Madhya Pradesh with reference to Sec. 271(1)(c) of the Act was pleased to hold that a procedural irregularity not involving the question of jurisdiction can be cured. It is not helpful to the revenue in the present case because in the present case, the A.O was having no jurisdiction to frame assessment order without prior approval of JCIT as necessary requirement to comply with u/s. 153D of the Act. In the case of *CIT vs Damodhar Muralilal* (Supra), the Hon'ble High Court did not approve the view of the Tribunal in holding that in view of Clause (b) of Sec. 251(1) of the Act, the first appellate authority had no power of remand and therefore, the procedural illegality would not be corrected by recourse to remanding the case to the ITO. Here in the present case, as we have already discussed, and also cited the recent

decision of Hon'ble jurisdictional Bombay High Court in the case of *CIT vs Ratnabai N.K. Dubhash* (Mrs.) (Supra) and of Hon'ble Delhi High Court in the case of *CIT vs SPL's Siddharth Ltd.* (Supra) that requirement u/s. 153 D for obtaining approval of JCIT is not procedural only but a mandatory requirement, hence the cited decision by the Ld. D.R is not applicable in the case of present assessee. Under above circumstances, the issue raised regarding the validity of assessment orders in question without obtaining prior approval u/s. 153D of the Act is decided in favour of the assessee. The assessment orders in question are thus quashed as null and void.

16. In view of the above finding, on the validity of assessment orders in question, the other issue questioning the validity of additions/disallowances made by the A.O in the assessment orders in question does not need adjudication as the same has become academic only.

17. Consequently, appeals are allowed.

The order is pronounced in the open Court on March 2012.