

KEY ISSUES IN INCOME TAX ASSESSMENTS

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Proviso to section 36(1)(iii)

- Proviso to section 36(1)(iii) reads: any amount of interest paid in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized in the books or not) for period beginning from the date on which the capital was borrowed for acquisition of the asset till date on which such asset was first put to use – *shall not be allowed as deduction*

Proviso to section 36(1)(iii)

- History behind the insertion of proviso
 - CIT v. Tata Chemicals Ltd. 256 ITR 395 (Bom)
 - in that case Hon. High Court has held that interest on capital borrowed for acquiring the assets for extension of business, even if relates to a period before the asset is put to use is allowable as deduction.
 - The factors considered by Hon. Court was unity of control, common administration and fund management, functional integrity between two units and so on.
 - SLP of department also dismissed by the Supreme Court.
 - Other judgements are 251 ITR 61(Guj), 150 ITR 195 (Kar) and so on.

Proviso to section 36(1)(iii)

- Care to be taken during the Audit
 - AS 16 Borrowing Cost
 - Whether any specific borrowing made for acquisition of assets (Term Loans) (Para 6 of AS 16)
 - General borrowing attributed to the qualifying assets (Para 12 of AS 16)

Proviso to section 36(1)(iii)

- AS 16 – Borrowing Cost also includes commitment charges
- Section 2(28A) defines interest to mean *interest payable in any manner in respect of any moneys borrowed or debt incurred and includes any service fees or other charges in respect of the moneys borrowed or debt incurred or in respect of credit facility which has not been utilized.*
- The proviso refers to the interest for the period from the date of borrowal to the date on which the asset is put to use

Proviso to section 36(1)(iii)

- Section 37(1) of the Act – Residuary provision
 - The proviso is inserted in section 36(1)(iii) and not under section 37(1).
 - The general provision under section allows an expenditure incurred wholly and exclusively for the purpose of business.
 - *Interest paid still can be claimed under section 37(1) of the Act.*
 - Refer Bombay Steam Navigation Co. P. Ltd. (SC) 56 ITR 52

Proviso to section 36(1)(iii)

- Expenses for raising borrowing viz., Stamp duty, registration, processing fees, lawyer's fees etc.
 - Definition of interest u/s 2(28A) and AS 16.
 - Still claimable u/s 37(1) – refer India Cements Ltd. (SC) 60 ITR 52

Proviso to section 36(1)(iii)

- Meaning of the term 'Asset' for the purpose of this proviso.
 - The term asset would not include stock in trade. It should be restricted to the fixed assets.
 - Use of word 'capitalized in the books or not' suggest application of the proviso to fixed assets only.
 - The word put to use also suggest applicability to the fixed assets put to use and remained in use and not to the stocks which are *used and consumed*.

Section 14A – Expenditure in relation to exempt income.

- Sub-section (1) – no deduction be allowed of expenditure incurred by the assessee in relation to income which does not form part of the total income under this Act.

Section 14A – Expenditure in relation to exempt income.

- History – Supreme Court had considered the allowability of expenses in one and indivisible business in the following cases:
 - CIT v. Indian Bank Ltd. 56 ITR 77
 - CIT v. Maharashtra Sugar Mills Ltd. 82 ITR 452
 - Waterfall Estate Ltd. v. CIT 219 ITR 563
 - Rajasthan State Warehousing Corpn. 242 ITR 450

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Section 14A – Expenditure in relation to exempt income.

- To nullify the effect of the Hon. Court's judgement, this section have been introduced in the statute with retrospective effect i.e. from 1st April, 1962.
- Subsequently, there are host of decisions / judgements on this issue, the recent one being the judgement of Hon. Bombay High Court in the case of Godrej & Boyce Mfg. Co. Ltd. v. DCIT 328 ITR 81

Section 14A – Expenditure in relation to exempt income.

- Care to be taken during the course of audit:
 - Identify whether any direct expenses in relation to earning the exempt income. For eg. Interest on money borrowed for the purpose of making investments
 - Indirect expenses – Identify the indirect expenses which can be attributed to the earning of exempt income, For eg. rent, taxes, salaries, audit fee etc.
 - Work out the disallowance u/s 14A most objective basis so as to leave no room for AO.

Section 14A – Expenditure in relation to exempt income.

- Highlights of the Judgement:
 - The provisions of section 14A and Rule 8D are constitutionally valid.
 - The basic object is to disallow the expenditure incurred in relation to earning the exempt income.
 - The applicability of sub-section (2) & (3) and Rule 8D would apply from Asst. Year 2007-2008.
 - Daga Capital (SB) is no more good law now.

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Section 14A – Expenditure in relation to exempt income.

- The basic principle of taxation is Net Income. Expenses incurred can be allowed only to the extent relatable to earning of taxable income.
- Test elaborated in Walfort's case (326 ITR 1) – there has to be a proximate cause for disallowance having direct nexus with the exempt income. Once the test of proximate cause based on the nexus is established, disallowance would have to be effected u/s 14A.

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Section 14A – Expenditure in relation to exempt income.

- It is the duty of the assessee to compute the disallowance u/s 14A having regard to the facts of his case.
- The AO must determine the correctness of the claim made by the assessee based on the records maintained. If AO is able to determine the claim of expenditure, as made by the assessee, on objective basis, there is no need for AO to take recourse to method prescribed under Rule.

Section 14A – Expenditure in relation to exempt income.

- In the event, AO is not satisfied with the correctness of the claim, he must record his reason for the same.
- Sub-section (2) & (3) are intended to enforce and implement sub-section (1).

Section 14A – Expenditure in relation to exempt income.

- Other legal positions to be kept in mind.
 - If , based on the material, it is established that the investment was made out of non-interest bearing fund, no disallowance out of interest be made. (Hero Cycles 323 ITR 158) **However there can still be disallowance of indirect expenses as per Rule 8D.**

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Section 14A – Expenditure in relation to exempt income.

- If the benefit (exempt dividend) arising from the investment is out of interest bearing fund, interest has to be disallowed (Leena Ramchandran - 235 CTR 512 – Kerala High Court)
- If the interest free funds available to the assessee sufficient to meet its investment and at the same time the assessee has raised a loan, there could be a presumption as to the investments were out of the interest free fund (Reliance Utilities – 313 ITR 340 – Bombay High Court)

Section 14A – Expenditure in relation to exempt income.

- Share of profit from the partnership – section 10(2A)
 - CIT v. Popular Vehicle Services P. Ltd. (Ker) 325 ITR 523
 - Share of profit from the partnership does not constitute income u/s 10(2A) and therefore, section 14A(1) has an application and there will be a disallowance in respect of interest free loans given to the firm.
- Dharamsingh Popat (Mumbai H) 127 TTJ 61
 - Partnership being separate assessable entity under the tax law, income charged in the hands of partnership can not be said to be non-exempt. Therefore, disallowance under section 14A has to be worked out against the share of profit.

Cash Credit – Section 68

- Section 68: Where any sum is found credited in the books of an assessee maintained for any previous year, and the assessee offers no explanation about the nature and source thereof or the explanation offered by him is not, in the opinion of the AO, satisfactory, the sum so credited may be charged to income tax as the income of the assessee of that previous year.

Cash Credit – Unsecured loans

- Onus is on the assessee to prove the credit worthiness and genuineness of loans standing to the credit in his books
- To obtain details for proving genuineness of unsecured loan
 - Confirmation with address and PAN of the creditor.
 - Copy of return of income.

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Cash Credit – Unsecured Loans

- Copy of his bank statement (this can be furnish during the course of the assessment proceedings)
- Request can be made to the AO for issuing notice u/s 133(6) if the creditor denies assessee's request for the above referred documents.

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Cash Credit – Unsecured Loans

- Important Judicial pronouncements
 - Onus is on assessee to prove the genuineness and credit worthiness of creditor:
 - Roshan Di Hatti (SC) 107 ITR 938
 - Devi Prasad Vishwanath Prasad (SC) 72 ITR 194
 - Aravali Trading Co. (Raj) 220 ITR 622
 - Kamal Motors (Raj) 131 Taxman 155
 - Assessee can not be blamed or penalised for non-appearance of creditors after receipt of summons
 - CIT v. U M Shah Prop. Shrenik Trading Co. (Bom) 90 ITR 396

Cash Credit – Share Application Money

- Where the matter is related to the share application from investors through the banking channel, the assessee company has to prove the existence of the investor in whose name the share application money is received. The burden, then shift to the revenue to prove otherwise of the transaction.
 - Shree Barkha Synthetics Ltd. (Raj) 155 Taxman 289

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Cash Credit – Share Application Money

- In case of public issue, the company concern is not expected to know each and every details pertaining to the identity as well as financial worth of each of its subscriber. The company, however, should made available to the officer all information contained in the statutory share application documents.
 - CIT v. Divine Leasing & Finance Ltd. (Del) 158 Taxman 440

Cash Credit – Share Application Money

- Application money received from alleged bogus shareholders, then the department is free to re-open the individual assessment as per the law, but the amount of share money cannot be regarded as undisclosed income in the hands of the company.
 - CIT v. Lovely Exports P. Ltd. (SC) 216 CTR 195

Cash Credit - Gifts

- Important points to be taken care of :
 - Identification of donor, relationship.
 - Capacity & Credit worthiness of the donor.
 - Source of the funds gifted
 - Gift should be given out of natural love & affection and without any consideration.

Capital Gain v Business Income

- This is undoubtedly a hot issue of today popping up at almost assessment where capital gain is claimed to be a part of total income.
- The treatment is a subjective process and each and every case is to be judged on the basis of fact of each of the case.

Capital Gain v Business Income

- Important principles:
 - Treatment in the books
 - Maintaining two separate Demat accounts for investment and trading.
 - Use of funds – identification
 - Volume, frequency and regularity of transaction carried on –indicative of carrying on of systematic and organized activity with profit motive.

Capital Gain v Business Income

- Important Judicial Pronouncement:
 - Gopal Purohit (Bom) 228 CTR 582
 - Smt. Sadhana Nabera (Mum) 41 DTR 393
 - Janak Rangwala (Mum) 11 SOT 627
 - Management Structure & Systems (Mum) 41 DTR 426

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