CHAPTER 2

IMPLICATIONS OF CORPORATE TAXATION

I. MAIN FEATURES OF CORPORATE TAXATION

A: TAXATION STRUCTURE-ITS RATIONALISATION

a. INTRODUCTION

It is a trite observation that today taxation is one of the main factors for consideration in any legal transaction, and this is especially true of Company Law. Indeed, it is probably fair to say that in the last fifty years more companies have been formed because of the real or imagined taxation advantages than for any other single reason.

The writer is concerned here with the validity of corporate taxes as an instrument of finance for public treasury; as a regulatory tool for public policy and their significance in corporation finance. The taxes can well be integrated with the fiscal policy for achieving economic development, with reasonable degree of equality of income and economic power.

b. Different Forms for levying corporate taxes

In approaching the task of levying taxation, various countries have adopted any one or more of four different attitudes:

1. It might treat a company in precisely the same way as a natural person. Almost all the modern tax systems have taxed companies basically at a flat rate;

2. It might have torn aside the veil of incorporation, and without taxing the company at all have taxed the shareholders on

1. The raising of taxation is much more than purely financial operation. It affects the distribution of income and property and general level of expenditure on particular kinds of goods and services. The general level of taxation also affects the degree of activity of the economy as a whole - a matter of considerable importance to industry.

2. LCB Gower, Modern Company Law 3rd Edn 170

3. Two most potent variables of economic power are full employment and high real investment.

4. L.C.B. Gower, Modern Company Law, 3rd Edn 162-63
the company's profits, whether or not distributed to them;

3. It might have the same tax for companies as for other taxpayers, and the shareholders may not be taxed again on the distributions actually made to them;

4. It could apply a special tax to the company's profits, and then might or might not impose an entirely different form of tax on distributions made to the shareholders. The wisdom of legislation in exercising the policy of heavy taxation devised to skim off profits is based upon the assumption that the burden of tax falls upon the shareholders or others that derive benefit from the net income.

The Indian Tax System treats the company as a natural person, having specific apparatus for 'lifting the veil' of corporate personality and taxes shareholders. In essence, the Income Tax Act, 1961, is an agglomeration of many permutations and combinations. As usual, in such a case there is likely to exist a sharp divergence between business approach and taxation approach.

c. Business Approach and Taxation Approach

There are two main reasons for divergence between 'Business Approach' and 'Taxation Approach'.

1. The business approach is based upon micro-economics which calls for a fairly complete separation of tax and financial accounting.

2. The taxation approach has a macro-economic purpose. Its objective is revenue collection consistent with established national policies. One of the cardinal governmental economic policy has been the formulation of Tax Credit Certificates (Corporation Tax) Scheme, 1966. Such schemes are basically a

5. This solution would involve the profits being notionally apportioned among the shareholders, and in cases, where the company 'ploughs back' its profits instead of distributing them would be somewhat unfair on the shareholders except, perhaps in cases where the shareholders controlled the company and could ensure that distributions were made when they needed money.
supportive measure to the Industries (Development and Regulation) Act, 1951, thereby postponing the liability to the payment of income Tax. In Travancore Rayons Ltd v. ITO, the tax credit granted under section 280 ZB of the Income Tax Act, 1961 to the assessee, who manufactured cellulose film, was withdrawn by an order of rectification passed under rule 8 of the Tax Credit Certificates (Corporation Tax) Scheme, 1966 on the ground that cellulose film was not covered by item 24 of the First Schedule of the Industries (Development and Regulation) Act, 1951.

The petitioner company pointed out that the government of India would not have granted the licence for setting up a unit for the manufacture of cellulose film, if it did not fall within the First Schedule to the Industries (Development and Regulation) Act, 1951. The Kerala High Court while examining the meaning and scope of the relevant item - "Paper and Pulp including paper products" observed:

"...You are not only to look at the words, but you are to look at the context the collocation, and the object of such words relating to such a matter, and interpret the meaning according to what would appear to be the meaning intended to be conveyed by the use of the words under such circumstances".

The Kerala High Court further stated:
"...As the question involved a debatable point of law, there was no error apparent on the face of the record in regard to which an order of rectification would be passed, under rule 8 of the Tax Credit Certificates Scheme".

6. Chapter XXII B of the Income Tax Act, 1961 enumerates this scheme of 'Tax Credit Certificates' section 280Z dealing with 'Tax Credit Certificates to certain equity shareholder', 280ZA dealing with Tax Credit Certificates for shifting of industrial undertaking from urban area, 280ZB dealing with Tax Credit certificate to certain manufacturing companies in certain cases, 280ZC dealing with Tax credit certificate in relation to exports, 280ZD dealing with Tax Credit Certificates in relation to increased production of certain goods.

7. (1977) 109 ITR 43 (Ker)

8. Item 24 of the First schedule of the Industries (Development and Regulation) Act 1951 is entitled "Paper and Pulp including paper products".

9. Ibid 45-46. In this case the Kerala High Court quoted extensively from Crales on statute law (7th Edn) Ch.9,169-7 under the heading "Subject and Occasion of use of words may affect meaning".
Where public control of Corporate financial policy is desired, it is equally important that the basis of corporate financial policy is the profit of the business. It is important that the fiscal measures that are addressed to the corporation must have a close identity in the computation of profits so that they may be communicative and effective.

It is a well-established principle of taxation laws that a trader cannot be said to make a profit merely because he has been able to obtain an item of stock-in-trade for less than its market price. By contrast, corporate taxes emerge as a cost of conducting business. In CIT v. India Radiators Ltd the assessee was a controlled company for the purpose of the Act. According to the financial management policy of the company the bonus was paid in cash even to those employees of the company who were drawing more than Rs 1600 per month. The question before the Madras High Court was:

Whether the bonus paid is included in the word 'salary' so as to entitle the assessee-company for claiming deduction for the purposes of computing profits from business.

10. (1976) 105 ITR 680 (Mad). This judgment is one of the most pragmatic judgments delivered by the Madras High Court. The court held:

"The word 'Salary' would have to be understood with reference to the development of the law relating to bonus especially when there was no definition of bonus in the Income Tax Act. We may also point out that section 40(c) (iii) as it stood at the relevant period, was substituted for the original provision with effect from April 1, 1964, on the day when the payment of Bonus Act itself came into force". The Madras High Court went on to observe:

"Prior to the enactment of the payment of Bonus Act, 1965, the payment of bonus was considered to be not a deferred wage and it is payable only out of profits. But the enactment changed the character of the payment itself. While considering the validity of the Act, the Supreme Court in Jalan Trading Co.,(P)Ltd. v. Mill Mazdoor Sabha (1966) 36 Comp Cas 901(SC) considered the bonus paid as additional wages. This court considering the question of attachability of bonus under the C.P.C held in Ganapathia Pillai v. Swaminatha Pillai AIR 1969 Mad 440 that bonus is included in the wage and payment of bonus is a method of payment of wages". The learned counsel for the revenue pointed out that the definition of Salary and Wages in the Payment of Bonus Act excluded bonus from the Salary and Wages. 'Salary' is also defined in rule 2(h) of Part A to the Fourth Schedule to the Income Tax Act, 1961, as follows:

"2(h) "Salary" includes dearness allowance, if the
The Madras High Court very aptly observed:

"It is true that the Payment of Bonus Act, 1965 is applicable only to employees drawing salary or wage not exceeding Rs 1600 per mensem. ... But that does not mean that if an amount is paid as bonus it will have to be understood in any way different from the payment made to an employee, who is drawing less than Rs 1600. The recent development relating to the labour laws shows a change in the understanding of the nature of payment of bonus. It is no longer considered as a share of profits or gift or bounty made by an employer under his sweet will and pleasure. The employee by reason of his contribution or participation in the business of the employer is considered to be entitled for payment of the same, though the exact amount payable may depend on various circumstances. Having regard to this development, we are of opinion that even in regard to payment of bonus to employees drawing more than Rs 1600 the word 'bonus' would have to receive the same interpretation as it means to an employee, who is drawing less than Rs 1600 per mensem".

An important question of law and economics arises where taxation dealing with macro-economics keeps regard of income redistribution between the different categories of taxpayers. The House of Lords laid down the following principle in Ashton Gas Co v. Attorney General:

"The income tax is a charge upon the profits; the thing which is taxed is profit that is made, and you must ascertain what is the profit that is made before you deduct the tax—you have no right to deduct the income tax before you ascertain what the profit is. I cannot understand how you can make the income tax part of the expenditure".

Since this judgment of the House of Lords, most of the tax systems did not consider income tax part of the expenditure. The Supreme Court's judgment in Madhav Prasad Jatia v. CIT

10 contd., terms of employment so provide, but excludes all other allowances and perquisites".

Negativing this contention, the Madras High Court observed: (Ibid, 682)

"In fact, the specific exclusion from the definition of Salary or Wages would signify that but for such exclusion bonus would fall under the words "Salaries and Wages". Thus, after the payment of Bonus Act, the bonus paid is part of the Salary or Wages".

11. (1906) AC 10
12. (1979) 118 ITR 200
affirming the judgment of the Allahabad High Court, affirmed that the interest on moneys borrowed for payment of income tax do not constitute a business expenditure. Obviously, the same principle would apply even in cases where the income of the assessee is computed under the head "income from other sources", since the provisions to be followed are somewhat common, though not identical. Many High Courts took the same view. The Calcutta High Court held in *Mannalal Ratanlal v. CIT* that in the case of a taxpayer, carrying on business and who pays income tax in respect of the business profits assessed under the income tax law, the payment of income tax does not constitute a business expenditure nor is it a business or trading liability of the assessee, and consequently any interest paid or payable by the assessee on moneys borrowed for payment of income tax would not be admissible as a business expenditure under section 37(1) or section 36(1) (iii) of the Income Tax Act.

A recent decision of the Calcutta High Court in *East India Pharmaceutical Works Ltd v. CIT* has pointed out:

"A trader carries on business for the purpose of earning profits and not for the purpose of paying income tax. Though the earning of profits and the payment of taxes are not isolated and independent activities of the business, yet the expenditure incurred or laid out for the purpose of payment of income tax would not fall out of the scope of the expression 'for the purpose of the business'...".

13. (1973) 87 ITR 298 (All)
14. Bombay High Court held to the same effect in two cases, CIT v. Kishinchand Chellaram (1977) 109 ITR 569 (Bom) and CIT v. Bombay Samachar Pvt Ltd (1969) 74 ITR 723(Bom)
15. CIT v. M/S Indumati Ratnmal (1968) 70 ITR 353(Guj); Dalmia Dadri Cement Ltd, v. CIT (1972) 86 ITR 577 (Pb); Waldies Ltd v. CIT (1977) 110 ITR 577(Cal); CIT v. Calcutta Landing andShipping Co Ltd (1970) 77 ITR 575 (Cal)
16. (1965) 58 ITR 84
17. (1978) 114 ITR 591
Against this backdrop, section 80V was introduced by virtue of Taxation Laws (Amendment) Act, 1975 on the basis of recommendations of the Direct Taxes Enquiry Committee, 1971. It obliterates the well-grounded view that income tax does not form part of the expenditure. It provides that in computing the total income of an assessee, there shall be allowed by way of deduction any interest paid by him on any money borrowed for the payment of any tax due from him. Having regard to the unambiguous language of Section 80V, the Income Tax Officer cannot disallow the claim for deduction under this section on the ground that the payment of tax could have been made by the assessee by utilizing his own resources or otherwise. Moreover, section 80V itself encourages the assessee to borrow funds to pay the taxes due, the source of borrowing and the rate of interest are immaterial considerations for claiming this deduction.

It is, therefore, axiomatic that income-tax forms part of the expenditure. It is submitted that the induction of section 80V itself lends support to this basic premise that income tax forms part of the expenditure-it is only then that the norms of 'commercial expediency, to "encourage taxpayers to pay their taxes promptly", would get their application in its true perspective.

18. The pertinent observations in the final report of the Direct Taxes Enquiry Committee (popularly known as Wanchoo Committee Report after the name of its Chairman, K.W. Wanchoo, former Chief Justice of the Supreme Court), submitted to the government in December, 1971; at 96 are as follows:

"It has been suggested that allowing the interest on moneys borrowed for payment of tax as a deduction in computing the taxable income would encourage taxpayers to pay their taxes promptly even by borrowing. We recommend that the suggestion should be accepted and if necessary, a special provision should be made in this behalf. This would help the department in collecting revenue, including arrears and would be an added justification for levying heavy penalties in cases of continuing defaults".

19. It may be remarked that section 80V applies to all assesses alike and it is not confined to any particular source of income nor is it based on any principles of commercial expediency. It is submitted that the words "would encourage taxpayers to pay their taxes promptly" in the Report on the basis of which section 80V has been inserted, are a clear pointer to the norms of commercial expediency.
In this context, it is important to mention section 80A (8) of Income Tax Act, 1961, under which 15% of the interest on moneys borrowed by way of deposits from the public by a company (other than a banking company or a financial company) is disallowed, while computing the profits of the company. On the other hand, Companies Act, 1956 allowed, with effect from July 1980, even public sector companies and Statutory Corporations to invite deposits from the public to augment their working capital. Necessarily, the Company pays income tax out of the working capital. It is submitted that once interest on moneys borrowed for the payment of income tax is a deduction for the purposes of computing total income, there is no valid justification for disallowing 15% of the amount of interest on moneys borrowed in respect of deposits received by the company, as a deduction. It would be better to say that a company would not be able to pursue its business activities without gearing up its working capital, in the absence of which payment of income tax stands no meaning. The borrowing is intimately connected with the liquidity aspects in terms of public finance. It is, therefore, submitted that section 40A (8) which principally hampers the growth and efficiency of industrial or manufacturing units deserves no place in the fiscal legislation.

Another inevitable implication concerns section 40(a)(ii) Income Tax Act, 1961. Any rate or tax levied on the profits of a business or profession whether the same is calculated at a proportion of the profits, or otherwise on the basis of such profits is not deductible by virtue of section 40(a)(ii). It would be, perhaps, appropriate to trace the history of this

20. Sub-section (8) was inserted by Finance Act, 1975 w.e.f. 1.4.1976

21. It is important to note that hire-purchase finance companies, investment companies, loan companies, mutual benefit finance companies, chit fund companies are outside the purview of section 40A(8). A plausible question remains, much of public finance, as to whether industrial or manufacturing companies contribute less, as compared to these, to the gains of economy.
provision, and while doing so, two important cases come across, viz Travancore Titanium Product Ltd v. CIT, Kerala and Indian Aluminium Co Ltd v. CIT, West Bengal. In Indian Aluminium Case the Supreme Court expressed the view that the test adopted in Travancore Titanium case, that to be a permissible deduction there must be a direct and intimate connection between the expenditure and the business, i.e. between the expenditure and the character of the assessee as a trader, and not as owner of assets, even if they are assets of the business 'needs to be qualified by stating that if the expenditure is laid out by the assessee as owner-cum-trader, and the expenditure is really incidental to the carrying on of his business, it must be treated to have been laid out by him as a trader and as incidental to his business'.

In both the aforementioned cases the claim related to the deductibility of wealth tax or assets held by the assessee for the purpose of his business, while computing the assessee's income from business. While in Travancore Titanium the Supreme Court held in favour of the Revenue, in Indian Aluminium it held against the Revenue. The most forceful contention of the Revenue in Indian Aluminium was the difficulty in separating that part of the wealth tax which was levied on that part of the net wealth, which could be said to be used 'wholly and exclusively' for trade, from the rest of it. On this contention, the Supreme Court observed:

"Mr. Chagla appearing for the assessee drew our attention to the division into two heads, one of business assets and another of the 'other Assets', which is found in form 'A' prescribed by the rules for the Wealth Tax Return. This means that the wealth tax Act itself makes that part of the net-wealth separable, which can be utilized 'wholly and exclusively' for trade from the remainder of it".

Within a few months of the decision in Indian Aluminium the Income Tax (Amendment) Ordinance, 1972, was promulgated to amend the Income Tax Act, 1961, barring the amount of wealth tax

22. (1966) 60 ITR 277 (SC)
23. (1972) 84 ITR 735 (SC)
as a deduction in the computation of total income. The ordinance was later repealed and replaced by the Income Tax (Amendment) Act, 1972, by virtue of which the position established in Travancore Titanium was restored, thus a new sub-clause (ii a) in clause (a) of section 40 of the 1961 Act was inserted.

It is interesting and important to note that despite this amendment, the Supreme Court has emphatically made it clear that the principle laid down in Indian Aluminium is not vitiated. The thesis of Indian Aluminium 'Owner-cum-trader' is to be viewed in this prospective that in the case of income tax even that difficulty which could be envisaged by the Revenue in Indian Aluminium would have no place; it is the entire shareholding which generates income in the carrying on of a trade. It is, therefore, submitted that section 40(a)(ii) and 40(a)(ii a) does not deserve its place in the Income Tax Act, 1961.

The difference between business approach and taxation approach is intentionally by variance in the interpretation of the underlying concepts of income and expenditure.

a) A few items excluded from revenue in business accounting are treated as part of taxable income. These generally arise either from reimbursement of a capital outlay, or from destruction of a capital asset. Legal pronouncements have also declared some of the capital receipts as part of income.

b) Some business expenses are also disallowed in computing taxable income. The Income Tax Act lays down that any expenditure (excepting the nature specified in the Act, or in the nature of capital expenditure) shall be allowed in computing taxable income under the head 'Profits and gains of business'.

Though there is agalore of such provisions in the Income Tax Act, which are inevitably in the nature of business expenses, but are disallowed either in full or in part, but one of the most

24. The Supreme Court's decision in Mitsui Steamship Co., Ltd. v. CIT, West Bengal (1975) 99 ITR 7 (SC) rendered thereafter makes it clear beyond doubt.
controversial to date is the entertainment expenditure. The need for curbing expenditure has been increased recently to control inflationary pressure in the economy which is aggravated by lavish spending and ostentation. While introducing the Finance Bill, 1970, the Finance Minister stated:

"Those who enjoy the hospitality of their business friends should now no longer find their sense of gratitude diminished by the thought that a part of the hospitality is really paid for by the Exchequer."

It was in this context that sub-section (2B) was added to section 37 by virtue of the Finance Act, 1970. Immediately thereafter, there had been a good degree of resentment and this stringent measure was dropped by Finance Act, 1976. The insertions and omissions in regard to 'entertainment expenditure' clearly reveals the wobbling mind of the Parliament, which to date, has not been able to overcome it.

"Perhaps we ought not to blame Parliament for being in two minds about how to legislate in this matter. Perhaps, the nature of the expenditure itself accounts for the shifts and changes in legislative policy."

It is true that this abuse of business entertainment at the cost of the public exchequer was checked by English Parliament too by virtue of section 15(5) of the Finance Act, 1965. One of the

25. (1970) 75 ITR (St) 25-26

26. The long-drawn history can be summed up as follows:
The very first of such restriction on entertainment expenditure was introduced by the Finance Act, 1961 (vide section 6 of the Finance Act, 1961 with effect from April 1, 1962) in the shape of a proviso to section 10(2)(XV) of the 1922 Act. This proviso became sub-section (2) of section 37 of the 1961 Act, as the legislative parent of section 37 is section 10(2)(XV) of the 1922 Act.

In continuation of the legislative policy of curbing the indiscriminate allowance of entertainment expenditure, sub-section (2A) was introduced in section 37 of the 1961 Act by virtue of section 4 of the Taxation Laws (Amendment) Act, 1967 thus slashing further the entertainment expenditure by way of allowance. Thereafter, sub-section (2-B) was added by the Finance Act, 1970 which was subsequently omitted by Finance Act, 1976.

decisions of the House of Lords, Associated Newspapers Group Ltd v Fleming (Inspector of Taxes) pertains directly to the provisions of Section 15(1)(a) of the Finance Act, 1965, which in effect, disallowed the allowance "for any expenses incurred in providing business entertainment".

Lord Simon of Glaisdale observed:

"What was called 'expense-account living' had become notorious. Expenses, even 'wholly and exclusively' incurred in trading, were thought to ensure to raise certain individual taxpayer's real incomes net of tax in such a way as to offend against general notions of fiscal equity. ... Nor can there be any doubt about the method which the draftsmen chose to adopt in order to provide the remedy. Experience must have taught him that if a fiscal abuse is too precisely remedied, taxpayers with expert advice will find a means of evading the fiscal control. To counter this the draftsman may spread his net very wide at first, in order to make sure that nothing gets by which should not; and he will then re-examine to ensure that nothing has been caught in the net contrary to fiscal equity, and re-adjust accordingly".

The observations of Lord Reid are equally important in this context. The learned law lord observed:

"It must have been found to be impracticable for the tax authorities to separate entertainment which was reasonable from that which was not... In 1965, Parliament thought it necessary to take drastic action so that, as often happens in such cases, the innocent must suffer as well as the guilty".

The meaning and scope of the phrase "in the nature of entertainment expenditure," which occurs in sub-sections (2A) and

28. (1972) 2 All E.R. 574; (1973) AC 628 (HL). The question arose in that case, whether the Associated Newspapers Group Ltd., which employed a large staff of journalists who, for purposes of gathering news items suitable for publication in the company's papers, often found it necessary to provide drinks, meals, etc to the informants was entitled to claim deduction in respect of those expenses in arriving at its profits for income-tax purposes.

The House of Lords held that the company was not entitled to deduct the expenses in question, since they had been incurred in the provision of entertainment, and not in the course of the Company's trade which was to provide newspapers only.

29. (1972) 2 All E.R. 574, 586
(2B) of section 37 (of course the original (2B) was omitted by Finance Act, 1976 and now a new (2B) has been inserted by Taxation Laws (Amendment) Act, 1978) came up for consideration before various High Courts. The Full Bench of the Punjab & Haryana High Court in CIT v. Khemchand Bahadurchand have expressly dissented from Gujarat High Court in CIT v. Patel Brothers & Co. Ltd. The Gujarat High Court observed:

"No doubt entertainment is hospitable treatment of guests and every act of entertainment includes hospitality. But that would not warrant the converse position that every act of hospitality would constitute entertainment..."

On the contrary, the Full Bench of the Punjab & Haryana High Court stated:

"...To construe the provision otherwise and to hold that hospitality which is not lavish may be expended without any financial limits would in effect be frustrating the very purpose of the Legislature in enacting sub-section (2) and sub-section (2A) and defeating the larger legislative intent of curbing excessive business entertainment at the cost of the public exchequer. Beyond the prescribed limits, business entertainment is left to the discretion and the personal cost of businessmen themselves, and is not to be defrayed by public revenue".

30. In CIT v. Patel Brothers & Co., Ltd (1977) 106 ITR 424, the Gujarat High Court laid down the following broad tests as guidelines to determine the nature of entertainment expenses:

"(a) If the provision of food, drinks or any amusement to a client, constituent or customer is on a lavish and 'extravagant' scale, or is of wasteful nature, it is entertainment per se.

(b) If the provision of food or drinks to a client, constituent or customer is in the nature of bare necessity or by way of ordinary courtesy, or as an express or implied term of the contract of employment spelled out from long-standing practice or custom of trade or business, it will not amount to entertainment.

(c) If the provision of food or drinks to a client, customer or constituent is in a liberal and friendly way, it may amount to entertainment having regard to the place, item and cost of such provision. Customer or

(d) The provision of amusement to a client, constituent by way of hospitality or otherwise will always be entertainment".

The Kerala High Court took a contrary stand in CIT v. Veeriah Reddiar (1977) 106 ITR 610(Ker), it observed:

"The intention of Parliament in employing the additional words 'expenditure in the nature of' in sub-sections (2A) and (2B) of section 37 of the Income Tax Act, 1961 restricting the allowance for expenditure on entertainment
The Kerala High Court also took the same stand, as that of Panjab & Haryana High Court, in CIT v. Veeriah Reddlar. It observed:

"In order to fall within the scope of the two sub-sections, the expenditure in respect of which the allowance is claimed need not be 'entertainment expenditure' in the strict sense of the term and it is sufficient if it partakes of some of the main characteristics of 'entertainment expenditure'."

A recent decision of the Madras High Court CIT v. Prasad Process (P)Ltd., has followed the Gujarat High Court's judgment in CIT v. Patel Brothers & Co. Ltd. The Madras High Court has observed:

"Hospitality, such as offering a cup of tea or coffee to a customer, is not to be confused with entertainment. The words 'in the nature of' preceding the words 'entertainment expenditure' do not make the latter an expression with an expansive meaning so as to include expenditure which is akin to but not quite the same thing as entertainment expenditure. It could have been so if the statute had first defined 'entertainment expenditure' and then proceeded to use the words 'in the nature of entertainment expenditure'."

The Finance Act, 1983 has inserted an Explanation 2 below section 37(2A), thus an inclusive definition of 'entertainment expenditure' aims at roping in all types of hospitality—elementary or special—into the ambit of entertainment expenditure. This Explanation has been made effective retrospectively from 1.4.76. It supersedes the Gujarat High Court's decision in CIT v. Patel Brothers & Co.Ltd.

30 contd. by an assessee, is to cast the net sufficiently wide so as to bring within the scope of the two sub-sections, all types of expenditure in respect of which there can be said to be certain elements which invest them with the nature of entertainment expenditure."

31. (1981) 131 ITR 336 (P&H)
32. (1977) 106 ITR 424 (Guj)
33. (1977) 106 ITR 610 (Ker)
34. (1983) 13 Taxman 387 (Mad)
35. Ibid
36. (1977) 106 ITR 424 (Guj)
It is submitted that the insertion of Explanation 2 below section 37(2A) is a retrograde step. It has been well-settled by now that in deciding whether a particular item constitutes entertainment expenditure, the concerned authority must consider all the attendant facts and circumstances, including the nature and object of expenditure, similar practice in the particular line of business carried on by the assessee, the size of the expenditure in earlier years, the business trends and prospects as a whole, the cross-section of society from which the customers come, and any other relevant commercial and business factors. 'Hospitality' and 'entertainment' are two different terms. It is further submitted that the Parliament could not take pride by enacting this retrograde step, taking refuge under the penumbra of English Law, which banned in 1965 the allowance for all business entertainment, save those necessarily incurred by people whose business it was to provide entertainment. Perhaps, the words 'in the nature of occurring in the Statutory expression 'any expenditure, in the nature of entertainment expenditure' have been responsible for this galore of litigation.

Does the Parliament by enacting Explanation 2 now intended to include specifically even 'non-entertainment expenditure' too within the statutory bar? If it is so, then this was not the appropriate drafting method to bring about the desired result. After all, taxation takes note of the business realities as 'it finds them and only makes such inroads as are absolutely necessary for the purpose of disallowance and against the accepted postulates of commerce and accountancy. It could have been more appropriate to clearly discern an area of business hospitality which stands within the concept of business expenditure. It is submitted that either Explanation 2 to section 37(2A) be omitted or an exception be made that where the expenditure on hospitality of a commercial character is a necessary concomitant of the business itself, such an expenditure would not be regarded as entertainment.

37. Balamurugan, J., has stated in CIT v. Prasad Process (P) Ltd (1983) 13 Taxmann 387 (Mad),

"Entertainment is a word of ordinary speech. Even those who know very little English can understand what entertainment, entertainment tax, variety entertainment and other cognate expressions mean. Consequently it is no use rushing to the dictionary 'to get', at the meaning of the word 'entertainment' simply because the statute does not provide a select definition of it."
expenditure.

Further, the Finance Act, 1983 has made certain inroads by virtue of sub-sections (3A), (3B), (3C) and (3D) to Section 37. Those business expenditures which were allowable have been disallowed. Sub-section (3A) lays down that where the aggregate expenditure on any of the following items exceeds Rs 1,00,000, 20% of such excess shall not be allowed as deduction in computing the income chargeable under the head "Profits and gains of business or profession".

(i) advertisement, publicity and sales promotion; or
(ii) running and maintenance of aircrafts and motor cars; or,
(iii) payments made to hotels.

However, sections 37(3C) and 37(3D) and Explanation to section 37(3B) provide that partial disallowance of 20% shall not apply in specified cases. Indubitably, there seems hardly any justification for such disallowance. Only one point would suffice to hold that no consistent approach warrants the validity of sub-section (3A). Advertisement, publicity and Sales promotion outside India is outside the purview of disallowance, whereas these activities in India would invite disallowance. It is important to note that this cut of 20% would take place on the balance of such amounts, after disallowance being already made applicable by virtue of sections 37(2A), 37(3), 40(c) and 40A(5).

38. The specified cases are:

a. advertisement, publicity and sales promotion outside India in respect of the goods, services or facilities which the assessee deals in or provides in the course of his business;
b. running and maintenance of motor cars in any branch, office or agency, maintained outside India for the promotion of sale outside India of such goods, etc;
c. in the case of an assessee engaged in the business of operation of aircraft or running motor cars on hire, expenditure incurred on running and maintenance of such aircraft or of such motor cars;
d. remuneration paid to employees of the assessee engaged in the activity of advertisement, publicity and sales promotion;
e. that part of expenditure in respect of advertisement publicity and sales promotion, maintenance of cars and payments made to hotels which is disallowed under any other provision of the Income Tax Act.
It is submitted that with such a huge gamut of disallowances and restrictions, the Corporate management becomes more prone to stultify the norms of financial discipline. If the past is any guide, managerial remuneration witnessed a series of restrictions in the fiscal legislation, but it is common knowledge that the provisions could not deter the corporate world.

Advertisement is a necessary concomitant of a business, without which the business may not flourish. Such an advertisement publicity or sales promotion are desirable activities in the case of a domestic company or a company which has made arrangements to declare and pay dividends within India, whereas in the case of a foreign company declaring its dividends outside India such expenditure made inside India attracts disallowance and expenditure made outside India goes without any cut. It is submitted that such a differentiation for the same nature of activity completely obliterates the norms of commercial expediency. Sub-section (3A) would be more counter-productive rather than swelling the coffers of the exchequer.

B: OBJECTIVES OF CORPORATE TAXATION

EQUALITY, CERTAINTY AND ECONOMY

We have come a long way since the days of Adam Smith who enunciated the four canons of taxation. The wizards of public finance added four more canons. These eight canons of taxation are:

- Simplicity,
- equality,
- diversity,
- elasticity,
- certainty
- flexibility,
- economy and convenience.

A recent Supreme Court decision in CIT v. Simon Carves Ltd.

(1976) 105 ITR 212(SC). In the instant case, in the original assessment of the respondent a non-resident company carrying on business as construction engineers, for the assessment year 1959-60, the ITO invoked rule 33 of the Income Tax Rules, 1922 and applying one of the three methods permitted therein, computed its income through or from certain contracts (business connection) in India, at Rs 16,16,005. Subsequently, the ITO reopened the assessment under section 147(b) of the Income Tax Act, 1961, and applying a different method permissible, determined the income at Rs 64,51,933. The Supreme Court held:

"Where the order making the original assessment was a legally correct order and was not vitiated by any error, the case would not be one which would fall within the ambit of section 147(b) of the Act of 1961 or section 34(1)(b) of the Act of 1922..."."
throws much light on the need for intelligible and simple taxation laws. In essence, three canons—Equality, Certainty and Economy (ECE) are the three basic canons of any fiscal legislation. The Supreme Court held in Simon Carves:

"...The ITO ordering reassessment does not sit as a court of appeal over the ITO making the original assessment. Nor is it open to the ITO ordering reassessment to substitute his own opinion regarding the method of computing the income for that of the ITO who made the original assessment, especially when the method of computation adopted at the time of original assessment was permissible in law. The fact that the adoption of a different method of computation would have resulted in higher yield of tax would not in such a case justify the reopening of the assessment.

Although it is part of their duty to ensure that no tax which is legitimately due from an assessee should remain unrecovered they must also at the same time not act in a manner as might indicate that scales are weighted against the assessee".

While the aforementioned eight canons are equally valid even today, perhaps it is necessary to specify the objective of taxation more clearly. Professor Wheatcroft in one of his illuminating articles suggests the following objectives for corporate taxation:

1. Raising the money to meet government expenditure.
2. So constructing the tax system to ensure as far as practical and consistently with other objectives, that taxes are collected efficiently and at the lowest cost both to the government and tax-payers.

40. Ibid, Headnote
41. G.S. A.Wheatcroft, A taxation policy for Growth (Taxation Economics, Macmillan, 1969)
42. A Bombay High Court judgment in CIT v. Babulal Narottamdas (1976) 105 ITR 721(Bom) throws much light on this fiscal principle of efficient collection of taxes, and particularly at the lowest cost both to the government and the taxpayer. In the instant case, on July 20, 1949, the company at its annual general meeting, passed a resolution to give a sum of Rs 15,000 per year as additional special remuneration to the managing agents from January 1, 1949. In a suit filed by some shareholders of the company, the trial court declared that the resolution passed by the company was illegal and void and issued a permanent injunction against the company restraining it from paying the amount to managing agent. The High Court, by its final decision dated November 25, 1955, declared that the resolution passed by the company was valid and
3. Regulating the private sector economy to maintain the desired level of employment and to iron out "Booms" and "Slumps".

4. Regulating the activities of particular areas of the private sector which are thought to be more or less desirable in the national interest on economic grounds.

5. Regulating the distributions of incomes and wealth as between different types and classes of citizens.

6. Regulating the activities of citizens which are thought to be more or less desirable on social grounds.

42 contd, set aside the decree passed by the trial court.

The case came up under tax laws on the grounds of accrual of income, as to whether the income accrued to the managing agent in November, 1955, when the High Court pronounced its judgment, or effective from the date of the resolution of the company gave effect to it. The Bombay High Court held: "As there was no question of any controversy between the company on the one hand and the assessee on the other, merely because a third party raised a dispute as regards the liability of the company to pay the amount, it could not be said that the date of accrual of such income was postponed to a future date when the rights were finally adjudicated upon by a court of law".

43. The courts have often regulated the activities of citizens desirable on social grounds, coupling it with the theory of intention. In Smt. Padmavati Jaykrishna v. CIT (1975) 101 ITR 153(Guj) the assessee sought to deduct interest on amounts borrowed for payment of income tax & wealth tax on annuity deposits, under section 57(iii) of the Income Tax Act 1961, on the ground that if she had not borrowed the money she could have had to liquidate her shareholdings and thus would have lost one of her sources of income. The Gujarat High Court held: "It could not be said that the result of the borrowing was saving of dividend income from shares because by borrowing loans the assessee had saved her income not only from one source, namely, the shareholding but from all other sources as well from which she must be receiving income. Saving of income from shares was an incidental result of borrowing loans and that incident did not supply any evidence of "purpose"...".

The following inference drawn by the Gujarat High Court based on the findings in reference from the Tribunal perhaps weighed against the assessee.

"...At the relevant time it was obligatory to make annuity deposit and the earning of interest through such deposit was merely incidental. The interest on the borrowed amount was, therefore, not deductible under section 57(iii)"

The legislature has used the words "for the purpose of making or earning such income in section 57(iii) which has inevitably a narrower compass as compared to the words "for the purposes of the business or profession" used in section 37."
7. So constructing the tax system that it spreads the burden fairly and equitably between the tax-payers.

8. Last, but by no means least, to encourage members of Parliament and electors to vote for him and his party.

Wheatcroft synthesises these eight objectives broadly into four groups:

1 and 2 are fiscal;
3 and 4 are economic;
5 and 6 are social; and,
7 and 8 are political.

Many of them interact and frequently more in opposite directions from each other; equity, in particular, if often the victim of administrative convenience or economic pressures. Equity may seem to be a plausible victim of economic pressures but to sacrifice it for administrative convenience is inexorable. One of such administrative cobwebs owes its origin to the blanket ban on the concept of reopening of accounts. Unlike English Law, under Indian law, the "theory of relating back" or 'cause of action' has not been considered.

As regards the concept of reopening of accounts, the Supreme Court has observed in CIT v. A.Gajapathy Naidu that in the matter of ascertaining when a particular income accrued or arose, the question of re-opening of accounts is not relevant. Subba Rao, J., as he then was, delivering the judgment of the Supreme Court observed:

"No power is conferred on the ITO under the Act to relate back an income that accrued or arose in a subsequent year to another earlier year on the ground that the said income arose out of an earlier transaction ."

43contd. Perhaps the intention of the legislature might have been to make the area of deductions more precise and specific in character. It is submitted that the same words as in section 37 may be inserted in section 57(iii) replacing the existing ones. Moreover, a fortiori, section 80V, now already provides for deduction of interest on moneys borrowed for the payment of income tax.

44. (1964) 53 ITR 114 (SC)
45. Ibid, 119
Nor is the question of re-opening of accounts relevant in the matter of ascertaining when a particular income accrued or arose. Section 34 of the Income Tax Act, 1922 empowers the ITO to assess the income which escaped assessment or was under-assessed in the relevant assessment year, subject to the provisions of the section and following the procedure prescribed thereunder, he can include the escaped income and reassess the assessee on the basis of which the earlier assessment was made. But strictly speaking even in those cases there is no re-opening of the accounts of the assessee, but a reassessment is made or the mistake is corrected on the basis of the actual income accrued or received by the assessee. We do not see any relevancy of the question of re-opening of accounts in considering the question when an assessee acquired a right to receive an amount.

Whether accrual of income or of liability, precepts remain the same. Sikri, J., as he then was, delivering the judgment of the Supreme Court in CIT v. Swadeshi Cotton & Flour Mills (Pvt) Ltd., held:

"We are of the opinion that this system of re-opening accounts does not fit in with the scheme of the Indian Income Tax Act. We have already held in CIT v. A Gainapathy Naidu; that, as far as receipts are concerned there can be no reopening of accounts. The same would be the position in respect of expenses".

(1964) 53 ITR 134, 139(SC). The Allahabad High Court in New Victoria Mills Co.Ltd. v. CIT (1965) 61 ITR 295 (All) following the decision of the Supreme Court in CIT v. Swadeshi Cotton and Flour Mills Private Ltd., held that before a claim for non-statutory bonus can be allowed even on the mercantile system of accounting, the following conditions must be satisfied:

a) that the workmen are entitled to make a claim to profit bonus if certain conditions stood satisfied;
b) the workmen have to make a claim from year to year;
c) that such claim was made and it has either been settled amicably or by industrial adjudication; and

d) if there is a loss or if no claim is made, no bonus will be permissible.

On the other hand, in the case of statutory bonus created by sections 10 and 11 of the Payment of Bonus Act, 1965, the nature of liability is analogous to the liability for payment of sales tax. The Allahabad High Court has held in Ram Singh & Sons v. CIT (1981) 131 ITR 622:

"The liability is created by the statute itself and no formal order is necessary. The assessee is entitled to the deduction of such a liability in the year in which it arises. The fact that he has been following the mercantile system and has not made a provision for the liability in his accounts is immaterial. The test laid down for the allowance of non-statutory bonus cannot be applied to the statutory liability created by sections 10 and 11 of the Payment of Bonus Act, 1965".
It is submitted that the Indian Law now here bars the reopening of accounts. It is only a judge-made precept that 'reopening of accounts' does not fit in with the scheme of the Indian Income Tax Act. The normal function of a court while adjudicating between two parties is to declare a right where there is a pre-existing right or to determine a liability where there is a pre-existing liability. The right or liability as the case may be exists by itself and is not created by the judgment or decree of a court. There are a galore of provisions in the Income Tax Act which ordain the concept of 'reopening of accounts', for example, allowabiliy of 'Bad Debts'. The question remains, at which point of time the accrual of income becomes legally due.

Paton observes:

"Enforceability by legal process is subject to some qualifications, considered to be the sine qua non of a legal right. In its wider sense a legal right is one which is either enforceable or recognised, but a legal right, in its strict sense, is one which is an assertable claim, enforceable according to law".

Perhaps the Indian Law has given much credence to that legal right which in its strict sense is an 'assertable claim'. It is submitted that pre-existing right or pre-existing liability is simply declared to be 'assertable' by a court's law. In essence, the mercantile system of accounting presupposes that the income accrues at the end of each accounting year.

47. Paton, Jurisprudence, 4th Edn, 286

48. The Supreme Court has pointed out the difference between the mercantile system of accounting and the cash system of book-keeping in Morvi Industries Ltd v. CIT(1971) 82 ITR 835 (SC) in the following words:

"Under the mercantile system, credit entries are made in respect of amounts due immediately they become legally due and before they are actually received. Similarly, the expenditure items for which legal liability has been incurred are immediately debited even before the amounts in question are actually disbursed".

Briefly stated, it is a system which as the Supreme Court said in Keshav Mills Ltd v. CIT(1953) 23 ITR 230 (SC) "brings into credit what is due, immediately it becomes legally due and before it is actually received and it brings into debit expenditure the amount for which a legal liability has been incurred before it is actually disbursed"
In one of the leading pronouncements of the Supreme Court in Metal Box Company of India Ltd v. Their Workmen, the Supreme Court was primarily concerned with the scope of the concept of 'accrual of liability'.

Shelat, J., speaking for the Supreme Court observed as under:

"Even if the liability is a contingent liability, provided its discounted present value is ascertainable, it can be taken into account. Contingent liabilities discounted and valued as necessary can be taken into account as trading expenses if they are sufficiently certain to be capable of valuation and if profits cannot be properly estimated without taking them into account. Contingent rights, if capable of valuation, can similarly be taken into account as trading receipts where it is necessary to do so in order to ascertain the true profits."

49. (1969) 73 ITR 53 (SC)

50. In the instant case the Supreme Court was primarily concerned with the accrual of liability on account of bonus payable to the workmen under the Payment of Bonus Act, 1965. Two gratuity schemes were framed by the company, one for the workers and the other one for its officers. The first scheme for workers was introduced in 1960 and the second scheme for its officers in 1964-65. The company worked out on an actuarial valuation its estimated liability and made provision for such liability not all at once but spread over a number of years.

Accordingly, the company in the year under consideration, 1964-65, made provision against its liability, under the two schemes for Rs 18.38 lakhs, whereas the actual payment as gratuity to the workmen and officers was Rs 1,31,585 and Rs 87,295 respectively. The worker's Union contended that the company could deduct from the gross receipts only the sums actually paid during the year.

Shelat, J., speaking for the Supreme Court observed as under: (Ibid 62-63)

"...In the case of an assessee maintaining his accounts on the mercantile system, a liability already accrued, though to be discharged at a future date, would be a proper deduction, while working out the profits and gains of his business, regard being had to the accepted principles of commercial practice and accountancy...".

51. Ibid 64-65
It is submitted that to ignore the 'cause of action', as the Indian practice does, is totally unwarranted and unjustifiable. Questions of crucial importance arise, if the 'cause of action' is ignored. Could the law discriminate between employees who are under the canopy of some statutory law, for example, Payment of Wages Act or Payments of Bonus Act, and those who incidentally do not fall under this canopy? In the former case, the 'cause of action' immediately arises, as a result of which the mercantile system ordains that the concept of 'relating back' does not come in the way; whereas in the latter case the accrual of income or liability is said to take place when a competent authority has declared or adjudicated it to be so, with the result that the wages, compensation, arbitration or any award shall be deemed to result in accrual of income or liability, as the case may be, in the year in which such an adjudication or judgment has taken place; which could not be 'related back' to that actual period to which such a cause of action is intimately connected.

The taxing statute has to be applied in accordance with the legal rights of the parties to the transaction. When the transaction is embodied in a document, the liability to tax depends upon the meaning and content of the language used therein, and this must be determined in accordance with the ordinary rules of construction.

The Madras High Court upholding the 'doctrine of form' as compared to the 'doctrine of substance' has held in CIT v. S. Ramal Ammafi.

"Another reason why the doctrine of substance is not available in discussions in revenue matters is that given the taxable event, the tax attaches on the event as it emerges or unfolds itself. It often happens that there may be more than one way of bringing about a desired result, and while one method may yield a tax advantage, the same result brought about by a different method might lend the person concerned in tax liability or reduction of tax advantage to a greater or a lesser degree...".

52. (1982) 135 ITR 292, 298
Even in England, where the concept of 'relating back' or 'cause of action' is applicable, the practice of tax courts have been in favour of ascertaining the form of transaction. Quoting from a House of Lord’s decision in Duke of Westminster’s case, as under:

"Even the doctrine of substance can only mean that a court having once ascertained the legal rights of the parties may disregard mere nomenclature and proceed to decide the question of taxability or non-taxability in accordance with the legal rights. The doctrine of substance does not, however, mean that the court may brush aside deeds, disregard the legal rights and liabilities arising under the terms of the said deeds, and decide the question of taxability or non-taxability upon the footing of the rights and liabilities of the parties being very different from what in law they were."

It is submitted that the Court could not rewrite the agreement, either express or implied, and substitute for the terms upon which the workers or the employees agreed to work with the employer, other terms as to which they have not even been consulted. Be it so, how the cause of action can be transmut-ed to a further assessment year. The only answer could be to adopt the concept of 'relation back', as prevalent in U.K. The postponement of the date of payment is a bearing only in so far as the time of payment is concerned, but it does not affect the accrual of income. To say this that the assessee gets vested with the right to claim that amount, only when the court declares or such a right adjudicated is a travesty of law. It is a pre-existing right, the court only signifies it. It is submitted once again, that the accrual of an income is not to be equated with the receipt of the income in mercantile system of accounting. Tax attaches on the event as it emerges or unfolds itself, synonymous with the cause of action.

In the case of any fiscal liability, there may be more than one stage at which it might be said to accrue. There is firstly, a charge or levy, then comes the assessment, and last comes the process of recovery. It is submitted that it is entirely within

53. (1935) 19 TC 490 (HL)
54. Cf. Ibid, 299
the choice of the assessee to make a provision for tax liability, at any of these successive stages, and whether he does make a provision or not, it has got to be allowed without question at any of these stages. Kanga and Palkhivala state in their learned work that under the mercantile system of accounting, liability under a fiscal statute should be allowed in the year in which the relevant taxable event takes place.

It is submitted that the writer fails to agree in as much as Kanga and Palkhivala state that "alternatively the assessee may claim a deduction in a subsequent year in which the tax is assessed and the demand is made, although the transactions may pertain to earlier years...". The writer attaches emphasis to the emergence to taxable event, 'stricto sensu'.

The following passage extracted from the judgment of the Supreme Court in Kedarnath Jute Mfg. Co. Ltd. v. CIT once again supports the view taken by the writer:

"...The moment a dealer makes either purchases or sales which are subject to taxation, the obligation to pay the tax arises and taxability is attracted. Although that liability cannot be enforced till the quantification is effected by assessment proceedings, the liability for payment of tax is independent of the assessment...An assessee who follows the mercantile system of accounting is entitled to deduct from the profits and gains of the business such liability which had accrued during the period for which the profits and gains were being computed ...".

The Learned authors have stated as under:

"The decision of the Supreme Court in Kedarnath Jute Manufacturing Co., Ltd. v. CIT (1971) 82 ITR 363 establishes that under the mercantile system of accounting a fiscal liability under a statute should be allowed as a deduction in the year in which the relevant transactions take place, although (i) the precise quantification of the liability in the form of an assessment and demand may come later, (ii) the assessee may contest the liability in appeal or other proceedings, and (iii) the assessee may have made no provision for the liability in his books".

56. Ibid, 366
b) WORST-SUFFERER - THE TAX ADMINISTRATION ITSELF

In recent times the Central Board of Direct Taxes is actively involved in the issuance of circulars, popularly known as 'CBDT circulars'. Two important questions arise in this regard:

1. Are there any guidelines or norms to be adhered to by the Board, while issuing such a circular?

2. Are these circulars binding on the appeal authorities or the assessing authorities?

*Tata Iron & Steel Company Ltd. v. D.V. Banat, ITO* reveals the dimensions of these issues. The petitioner company kept its accounts on the mercantile system of accounting. For the assessment year 1972-73 the company claimed a deduction of a sum of Rs 1,28,09,135 on the footing that the said amount represented its gratuity liability on an actuarial valuation, and this contention was accepted by the ITO in view of a circular dated September 21, 1970 issued by the CBDT, Government of India. This circular was issued on the basis of the judgment of the Supreme Court in *Metal Box Company of India Ltd v. Their Workmen*.

For the assessment year 1973-74, the company claimed an amount of Rs 2,77,22,991 in respect of gratuity liability on the basis of actuarial valuation. But before the assessment for that year could be completed, the CBDT issued another circular, dated September 26, 1974, by which the first circular was withdrawn and directions were given to complete all pending assessments in the light of the instructions given in the second circular.

57. (1975) 101 ITR 292 (Bom)

58. (1969) 73 ITR 53(SC). The Supreme Court said in the instant case that the provision of gratuity on a scientific basis (in the form of an actuarial valuation carried out every year) could be considered to represent a real liability of the employer towards the employees.

59. The second circular of the CBDT was as follows:

"... (2) The decision of the Board has been re-examined in the light of the judgment of the Supreme Court in the case of Bombay Dyeing and Mfg. Co., Ltd. v. CWT (1974) 93 ITR 603. In this judgment, their Lordships have confirmed their own views in standard Mills Co., Ltd. v. CWT (1967) 63 ITR 470, and have observed that the decision in Metal Box Company's case was rendered under a different Act and in a different context.

(3) In view of the later pronouncement of the Supreme Court in the case of Bombay Dyeing and Mfg. Co., Ltd., and on the other provisions of law contained in section 36(1)(v)"
"In the case of Bombay Dyeing and Mf3. Co. Ltd. v. CWT (1974) 93 ITR 603 (SC) on the basis of which the Board's second circular was issued, the only reference to Metal Box Company's case (1969) 73 ITR 53 (SC) was the following one sentence: "Metal Box Company's case was rendered under the Bonus Act."

As pointed out by the Supreme Court in the Metal Co an 'case, there appears to be two steps in the process of considering the tax liability for assesses similar to the company, the first step being to estimate the income which will permit deduction being made of the nature claimed by the company, and thereafter, to consider whether any further deductions are available under section 36(1) and similar provisions. Accordingly, as the Supreme Court tersely puts it, "section 36 deals with expenditure deductible from out of the taxable income already assessed" (i.e., calculated or arrived at) "and not with deductions which are to be made while making the profit and loss account, i.e., after the income is assessed but before considering the tax payable on such income. These observations appear to represent the true legal position under the Act."

The Supreme Court has on many occasions affirmed its stand that "no authority, however high placed can control the decision of a judicial or quasi-judicial authority. That is the essence

59 contd under which any sum paid by an employer by way of contribution towards an approved gratuity fund created by him for the exclusive benefit of its employees under an irrevocable trust alone was admissible, any allowance of such liability towards an unapproved gratuity fund under section 37(1) of the Income Tax Act does not arise. In view of this, the earlier instructions of the Board referred to above stand withdrawn with immediate effect.

(4) All pending assessments may be completed in the light of the present instructions".

60. Ibid, Headnote: The Bombay High Court further noted: (296) "It was contended for the revenue alternatively that section 36(1)(v) of the Income Tax Act, 1961, read with section 40(a) thereof and the Rules framed under the Act provide a complete code for such allowance and provision made for gratuity liability, that there was thus an implied bar against any other provisions, that this bar had not been considered by the Supreme Court in Metal Box Company's case and that to that extent the decision in Metal Box Company's case was per incuriam and not binding on the High Courts. This contention cannot be accepted".
of our judicial system. At least one norm is clearly discernible which is inevitably based on the first principle of law, that if the circular is beneficial in the interests of the assessee, then it should be given effect by the assessing authority. Giving full effect to this beneficial norm, the Bombay High Court held in CWT v. Gammon India Pvt. Ltd., as under:

"...In case the circular is not brought to the notice of the ITO at the stage of assessment and the circular is sought to be relied upon by the assessee for the first time in the proceedings in reference before the High Court, the court would be competent to give effect to the circular and direct the assessment to be made in accordance with the rules laid down therein with a view to conferring the benefit of that circular on the assessee".

Based on this norm, a circular of the CBDT executing an assurance given by the Finance Minister in the course of passing of any fiscal legislation by the Parliament, would bind the authorities concerned. Few of the High Courts have given full effect to this norm nullifying the revisional power of the Commissioner; or invalidating the partial modification of a

62. Ellerman Lines Ltd. v. CIT(l971) 82 ITR 913(SC); J.K.Synthe
tics Ltd.v.CBDT(1972) 83 ITR 335(SC). In Ellerman Lines the circular issued with a view to remove the difficulties faced in the matter of assessments of foreign Shipping Companies was held to be binding on the assessing authorities.
63. (1980) 130 ITR 471
64. Navnitlal C.Javeri v. K.K.Sen(1965)56 ITR 198 (SC)
65. The Gujarat High Court has held in Rajan Ramkrishna v. CWT (1981) 127 ITR as under:

"The benevolent circulars which are issued by the Board are binding on all the authorities employed in the execution of the Act even in cases where such circulars deviate from the legal position. Accordingly, where the assessment is made by the ITO on the basis of the Rules framed for purposes of valuation of shares and thereafter the Board issues circulars modifying some of the original instructions given in its earlier circular, the modifications suggested through the subsequent circular cannot be the basis for the Commissioner to revise the original orders of assessment merely because such a revision would benefit the revenue".
benevolent circular by a non-benevolent one to that extent, even if at the time of assessment the subsequent circular is available.

A very interesting question arose before the Kerala High Court in Peria Karamalai Tea & Produce Co. Ltd, v. CIT. The precise question was, whether the benevolent circular could be applicable to reassessment proceedings for those assessments which were completed much before the issue of the circular. The instant case concerned the provisions of the Companies Profits (Surtax) Act, 1964. The Board issued a circular that the development rebate reserve in excess of the limits prescribed under the statute must be regarded as part of the company's capital. This circular came into force on 11th January, 1971 and ceased to be in force on 9th September, 1974. The Kerala High Court held that the circular could not be applicable to reassessment made by the assessing officers for the assessment years, the original assessments for which had been completed much before the issue of the circular.

The question as to whether the circulars issued by the CBDT could be regarded as a clear pronouncement of law, came up before two High Courts. The Delhi High Court has had the occasion

66. In International Instruments Pvt.Ltd, v. CIT(1980) 123 ITR 11, the assessee-company took privilege of a circular in the matter of condoning genuine deficiencies relating to the creation of the requisite development rebate reserve. Subsequently another circular was issued, modifying partially the earlier circular with a view to make the earlier circular inoperative to that extent. The Karnataka High Court held:

"The modification of a circular by the Board cannot be treated as having retrospective effect with a view to nullifying or taking away the benefit admissible to the assessee under the original circular; the fact that the subsequent circular had come into operation at the time when the assessment is being made is immaterial for the purpose".

67. (1980) 124 ITR 899

68. Circular No. 54 F.No.7/2/68-TPL, dated 11th January, 1971; Cf. (1971) 79 ITR(St) 73
to express its views in J.K.(Bombay) Ltd. v. CBDT and Simon Carves (India) Ltd. v. CBDT and in both the cases holding in favour of the revenue, the Court held that a reasonable view expressed by the Board on a question of fact or of judgment would not come up for judicial review before the Court. On the other hand, the Madras High Court has held in Carborandum Universal Ltd. v. CIT as under:

"The CBDT is different and distinct from the Central Government and the powers given to the CBDT cannot be exercised by the Central Government and vice-versa."

69. (1979) 118 ITR 372 (Del)
In the instant case of J.K.(Bombay) Ltd. v. CBDT the circular (No. 187 dated 23rd December, 1975) pertaining to the scope of the deduction admissible under section 80H of the Income Tax Act, 1961 in respect of royalties, commission, fees, etc. received by Indian Companies from Foreign enterprises in consideration of the provision of technical services, etc was issued in order to clarify the provisions of law.

The Delhi High Court observed as under:

"The views expressed by the Board, as to the meaning of 'technical services' is both a question of law and a question of judgment. This is because the Board is the primary authority in giving meaning to the words "Technical Services". They have to construe these words not only as a question of law but in the case of doubt or ambiguity or with a view to implementing the objects of section 80H and in the light of policy considerations, they have also to exercise a judgment of their own in doing so. If this judgment has to be ordinarily of the Board and if this Court is not sitting in appeal over that judgment in judicial review, interference with the judgment of the Board would not be called for unless that judgment is apparently wrong. If a reasonable view is adopted by the Board, no reason would warrant interference with it."

70. (1979) 120 ITR 172 (Del). The Delhi High Court had again to consider the scope and legal effect of circular (No. 140 dated 6th July, 1974) in regard to the interpretation of the provisions of section 80MM of the Income Tax Act, and particularly, the meaning of the expression 'know how', the Court observed:

"A reasonable view expressed by the Board on a question of fact or of judgment, as contained in the circular would not come up for judicial review before the court."

71. (1966) 61 ITR 269 (Mad)
Perhaps the Supreme Court's judgment in *Gestener Duplicators Pvt. Ltd. v. CIT* favours the Madras High Court's view. In this case, the tax-payer claimed the allowances and deductions in respect of the contributions to Provident Fund having regard to the meaning of the term 'salary'. This claim was nullified by virtue of a circular of the Board by the ITO. On this, the Supreme Court held as under:

"The views or instructions of the Board cannot in any manner detract from the legal position arising on the proper construction of law by the authorities competent to interpret the same.

Circulars which are clarificatory in nature can to some extent be regarded as being in the nature of delegated or subordinate legislations like the income tax rules; but those circulars which are intended and issued for the purpose of removing the practical difficulties faced by the tax-payers and/or the tax authorities in the matter of implementation of the provisions of law are also in the nature of subordinate legislation".

**C: RATIONALISATION-LEGAL AND SOCIO-ECONOMIC ASPECTS**

The attitudes of management could be strongly influenced by the rigidities in tax laws and their administrative procedures. The Central problem of public finance has been always to design and construct the tax system in such a way that the economic effects are the most desirable (or the least undesirable) in relation to the society, in which it is to operate. Keith and John are of the opinion that tax aspects are a factor of crucial significance in financial management. Its consideration depends upon two factors:

a) the situation and the type of problem involved;
b) the relative burden of taxes.

Many important problems are there which need rationalisation under the tax laws. Few of them are:

1. Depreciation Allowance;
2. Depreciation and changing Price levels;
3. Inventory Valuations and changing Price levels;
4. Tax Incentives;
5. Inter-corporate Investments;

72. (1979) 117 ITR (SC)
73. J. Keith & L. John: Effect of Federal Taxes on growing Enterprise - Harvard University, (1954), 13-14
The depreciable asset may be looked upon as generating two income streams: One is a positive income stream of earnings, arising from the use of the asset. The other is the negative income stream, or diminution of capital, which results as the asset is worn out and declines in the value because of obsolescence. Our law of income tax has given scant regard to the positive income stream hitherto. It is very recently that some judicial pronouncements gave an impetus to the socio-dynamic legislation in this regard.

Yet quite a few matters of great controversy exist, for example:

a) Whether the transferee of depreciable assets is entitled to claim depreciation allowance before the conveyance is executed and registered in his favour?

b) Whether the unabsorbed depreciation which could not be carried forward to the year prior to the previous year, can be carried forward in the previous year?

c) Whether the depreciation allowance has necessarily to be deducted from profits, even if the assessee wants to defer his claim or refused to furnish the full particulars in that regard?

The Allahabad High Court in Additional CIT v. U.P. State Agro Industrial Corporation Ltd. has taken the view that the transferee of immovable property could be regarded as having become the owner of the property even before the sale deed is executed and registered in his favour. The Court observed:

"The time has now come when we may have to revise our views in some respects regarding the distinction which is being observed so far between tangible assets and intangible assets, while considering the question of depreciation allowance. We cannot forget that as time passes, it is not only that tangible assets that depreciate but also intangible assets like technical knowledge, become obsolete as progress is made in scientific research. Moreover, when technical know-how is acquired by incurring expenditure, there is no justification in denying appropriate deduction in respect of its cost while computing taxable profits if, it can be brought under the head 'plant'."

The aforementioned observations of the Karnataka High Court have been followed by Madhya Pradesh High Court in D&H Secheron Electrodes v. CIT (1981) 132 ITR 1(MP)

74. The Karnataka High Court observed in Nippon Electronics (P) Ltd. v. CIT (1979) 116 ITR 231, 239:
"The fact that the assessee is put in complete possession of the property without any reservation whatsoever and that the right to dispose of the same as the owner thereof coupled with a further right to realise any income from the property and appropriate the same would give rise to the inference that even when the conveyance is not executed and registered, the transfer of the ownership of immovable property would be regarded as having taken place."

Thus the Allahabad High Court taking a pragmatic view did not construe the word 'owned' used in Section 32(1) in a strict and conservative sense. This decision of the Allahabad High Court is distinguishable from the decision of the Supreme Court in R.B. Jodhamal Kuthiala v. CIT, wherein the Supreme Court observed:

"The mere acquisition of interest in the immovable property under Section 53A of the Transfer of Property Act would not constitute the acquisition of the immovable property itself and consequently the one who acquires such interest in the property and uses the same for the purpose of business cannot claim depreciation thereon".

It is submitted that even if we have a look at the Registration Act, Section 47 thereof permits the registration of a transfer to be made within six months from the date of execution of the conveyance, and wherever the registration is made subsequent to the execution of the conveyance deed, the registration when made relates back to the date of execution of the conveyance deed. Therefore, the judgment of the Allahabad High Court in Additional CIT. v. U.P. State Agro Industrial Corporation Ltd., is more pragmatic in its approach. However, keeping in view the galore of case-law on such an issue, it is submitted, that instead of the word 'owned' the word 'possessed', if used in section 32(1) of the 1961 Act, could have eliminated these problems.

75. (1981) 127 ITR 97 (All)
76. Ibid, Heanote
77. (1971) 82 ITR 570
78. Ibid, Heanote, The Delhi High Court has followed this instant case of the Supreme Court, by way of analogy, in D. Anand & Sons v. CIT(1981) 131 ITR 77, wherein the High Court held that the owner of a house property shall continue to be liable to income tax in respect of the notional income therefrom, even after the tenant has resolved to purchase the property and paid substantial part of the purchase price with the further condition that no rent shall be payable thereafter; the fact that the sale deed in respect of the property is executed, say after a year, would not absolve the owner of the property from liability to income tax.

79. Ibid
The second question relates to the scope of section 32 vis-à-vis sections 72 and 73. The gamut of case-law has sedimented around one important fiction enumerated in section 32(2), which reads as follows:

"...subject to the provisions of sub-section (2) of section 72 and sub-section (3) of section 73, the allowance or part of the allowance to which effect has not been given as the case may be, shall be added to the amount of the allowance for depreciation for the following previous year and deemed to be part of that allowance, or if there is no such allowance for that previous year, be deemed to be the allowance for that previous year, and so on for the succeeding previous years".

The Gujarat High Court held in CIT v. Gujarat State Warehousing Corporation as under:

"It is no doubt true that sub-section 2 of section 72 makes a reference to sub-section (2) of section 32. But simply because this reference is made, it does not follow that sub-section (2) of section 72 brings in even the deeming fiction for treatment, sub-section (2) of section 32 is in two parts and provides for two things. Its first part provides for carrying forward of unabsorbed depreciation and its second part provides for clubbing the said carried forward depreciation with the current year's depreciation and deeming the aggregate to be the current year's depreciation...".

On the other hand, the Allahabad High Court has taken a contrary view in Mother India Refrigeration Industries Pvt Ltd v. CIT as under:

"Depreciation allowance which is carried forward merges into depreciation allowance for the succeeding year. After such merger, the unabsorbed depreciation allowance is to be deemed to be direct allowance for the current year. If business losses have to be given priority over unabsorbed depreciation allowance, there is no good reason why depreciation losses which have been brought forward should not receive priority over current depreciation allowance".

At least on one point the Supreme Court clinched the issue in CIT v. Jalipuria China Clay Mines Pvt Ltd., that so far as the current year's depreciation is concerned, it is always to be treated as the first charge on profits and gains earned by an

80. (1976) 104 ITR, 1.9. This view of the Gujarat High Court has been followed by the Karnataka High Court in Mysore Paper Mills Ltd. v. CIT (1979) 117 ITR 132

81. (1971) 80 ITR 510

82. (1966) 59 ITR 555 (SC); AIR 1966 SC 1187
assessee from a particular business and before this charge is satisfied, it would not be possible to arrive at a correct figure of the net profits and gains which would be chargeable to tax. But serious doubts have been raised on the question of priority of unabsorbed depreciation allowance over other time-essence allowances under the Act. In Shree Ramesh Cotton Mills Ltd. v. CIT, West Bengal, the question was as to whether the claim for set off of unabsorbed depreciation brought forward from earlier years be postponed in order to avail other statutory concessions, which may otherwise lapse due to statutory time-limit.

The Division Bench of the Calcutta High Court held:

"The provisions of section 32(2) read with sections 72 and 73 of the Act and clause (v) of Annexure I of Appendix II to the Income Tax Rules, 1962, clearly show that unless the unabsorbed depreciation is adjusted in the next previous accounting year, it cannot be taken into account latter on for the purpose of computation of the total income of the assessee in any subsequent year".

Thus the Calcutta High Court laid down this principle that in cases where the unabsorbed depreciation of a particular year is carried forward and there is income assessable to tax for the immediately following year, the assessee cannot claim the carry forward and thereby postpone the claim for set off of unabsorbed depreciation brought forward from earlier years against the income of the current year with a view to obtain the other tax concessions which might otherwise lapse. In precise, the assessee is not entitled to defer his claim for set off of the brought forward depreciation allowance to a future period.

It is submitted that the deeming fiction of sub-section (2) of section 32 has become an obstacle in the carry-forward and set off of losses, to this extent that the unabsorbed depreciation allowance shall be 'deemed to be part' of the current depreciation, and if there is no such current depreciation for that previous year, then the unabsorbed depreciation allowance shall 'be deemed to be the allowance for that previous year, and so on for the succeeding previous year'.

83. (1979) 116 ITR 366
84. Ibid, 366
The law has gone much ahead from the days of *Sahu Rubbers Pvt. Ltd. v. CIT* in which it was held that in order to claim adjustment in the assessment year of unabsorbed depreciation of an earlier year, the assessee must establish that the business in respect of which it was allowed, continued in the previous year relevant to the assessment year, and if that business is no more in existence, unabsorbed depreciation cannot thereafter be adjusted in the assessment of future years in respect of a different business. Thus in *Sahu Rubbers* a limited effect was given to the legal fiction contained in the proviso principally because the fiction was provided for in the enactment by way of proviso.

Thereafter, the Bombay High Court had to consider the same question in *CIT v. Estate & Finance Limited*. The Division Bench of the Court observed:

"When enacting the provision regarding carry forward and set off of unabsorbed depreciation under section 32(2) of the Income Tax Act, 1961, the legislature could have imposed a condition that unabsorbed depreciation could be set off against the profits of a subsequent year only if the business in relation to which depreciation was allowed continued to exist in such year. The absence of such restriction has to be construed in favour of the assessee...".

Expressly dissenting from *Sahu Rubbers*, the Allahabad High Court held in *CIT v. Virmasi Industries (P)Ltd.*, as under:

"It is also not necessary that the business in the succeeding year must have some depreciable assets so that even if there is no depreciation allowance available to the assessee in the succeeding year by fiction the unabsorbed carried forward depreciation of the earlier year shall be deemed to be the depreciation allowance of the succeeding year and shall be an allowable deduction out of the business profits...".

85. (1963) 48 ITR 464 (Bom)
86. It is important to note that the difference between the proviso to section 10(2)(vi) of the Act of 1922 and section 32(2) of the 1961 Act is not a difference in mere phraseology; since the provision contained in section 32(2) is an independent provision, being not in the nature of a proviso to any provision computing depreciation.
87. (1978) 111 ITR 119
88. Ibid
89. (1974) 97 ITR 461, 464 (All)
The Karnataka High Court has also taken the same view in Additional CIT v. Kapila Textiles Pvt. Ltd., as under:

"Even if the relevant business is not carried on during the current year in question, the brought forward depreciation allowance could be set off against the income attributable to the current year, including the deemed items of business income specified in section 41 of the Income Tax Act, such as remission of liability, balancing charge, etc."

Since the income tax is a tax on 'net' income, recovery of the capital outlay must be permitted in computing taxable income. The moot question is how to time these costs and how to set the base. So long as the overall quantum of depreciation is restricted to the actual cost, total freedom should be allowed to a business enterprise to claim the allowance in one or more years of its choice. Once the law has come out to be so pragmatic as in CIT v. Official Liquidator, New Era Mfg. Co. Ltd. that even if that relevant business or those relevant depreciable assets are not existing, unabsorbed depreciation allowance would be allowed against any other business profits, then one cannot escape from this conclusion that the assessee should have the entitlement of postponing or deferring his claim for the unabsorbed depreciation allowance. If it could not be so, the very essence of various time-essence incentives and allowances, for example, investment allowance or 'tax holiday' incentives gets defeated entirely.

Moreover, section 32(2) creates many anomalies by itself, for example, once unabsorbed depreciation allowance is being 'deemed' to be a part of 'current depreciation', then by virtue of which sanctity the unabsorbed business losses could have precedence over unabsorbed depreciation allowances. The judgment of the

90. (1981) 129 ITR 458. The Bombay High Court has also taken the same view in two cases, Shri Laxmi Printing & Dyeing Works Pvt. Ltd. v. CIT (1968) 70 ITR 148 and Hindustan Chemical Works Ltd. v. CIT (1980) 124 ITR 561


92. The Kerala High Court has also taken the same view in CIT v. Official Liquidator, New Era Mfg. Co. Ltd. (1977) 109 ITR 262 that the brought forward depreciation allowance of a company could be set off against its deemed business profits even after the business of the company has been discontinued, and the income of such a company is sought to be assessed in the hands of the Official liquidator.

93. The writer is conscious of this important fact that business losses being time-essence for the purposes of carry forward and set off, this precedence has its own utility.
Allahabad High Court in *Mother India Refrigeration Industries Pvt. Ltd. v. CIT* is a pointer towards this anomaly. It is submitted that in order to do away with this grave restriction on the limits of carry forward and set-off, the words 'and deemed to be part of that allowance' and 'be deemed to be the allowance for that previous year, and so on for the succeeding previous years' could be omitted substituting the deeming fiction as under:

"...the allowance or part of the allowance to which effect has not been given, as the case may be, shall be added or carried forward to the amount of the allowance for depreciation for any of the following previous years".

The third question relates to the scope of the conditions for availing depreciation allowance enumerated in section 34(1) of the 1961 Act. It states that the depreciation allowance shall be allowed only if the prescribed particulars have been furnished. But if the assessee wants to defer his claim for depreciation allowance with a view to avail the time-essence concessions, for example, Tax Holiday incentives, as a consequence of which he does not furnish the prescribed particulars, then is it obligatory upon the assessee to furnish such prescribed particulars, or so to say, that he is not entitled to defer his claim for depreciation allowance?

At least two judgments are directly on the point. In *Ascharai Lal Ram Parkash v. CIT* the Allahabad High Court held:

"The assessee cannot, by not furnishing the prescribed particulars, prevent the ITO from granting the depreciation allowance. The ITO may make his own valuation of the assets and determine as a question of fact, the amount of allowance to be granted".

The facts of *Dasaprakash Bottling Co.* decided by the Madras High Court need a closer scrutiny. In its assessment for 1970-71,

94. Ibid
95. Section 34(1) states:
   "The deductions referred to in sub section (1) of sub section (1A) of section 32 shall be allowed only if the prescribed particulars have been furnished..."
96. (1968) 90 ITR 477 (All)
97. (1980) 122 ITR 9 (Mad)
the assessee's return did not contain the prescribed particulars for availing depreciation allowance; even otherwise the assessee did not claim any depreciation allowance. The profit and loss account did not contain any deduction, on account of depreciation. The ITO thereupon, issued a notice to give specific reasons in writing, as to why depreciation was not claimed and the prescribed particulars not furnished. The notice also stated that if the assessee failed to furnish the required information, there would be an exparte assessment. In response to this notice, the assessee furnished the particulars relating to depreciation under protest, presumably to avoid any exparte assessment or penalty proceedings.

In the letter dated 22.3.71, the assessee clearly stated that the depreciation allowable under the Act has not been claimed in as much as it felt that it was not necessary having regard to the facts and circumstances of the case, to furnish the prescribed particulars.

However, the ITO allowed a depreciation of Rs 1,27,589. The Madras High Court Held:

"It is a far cry from section 34 to state that unless the prescribed particulars had been furnished, the allowance for depreciation could not under the law be granted. Reading Sections 32 and 34 together, we consider that the allowance of depreciation is available to the assessee in all cases".

Moreover, the Madras High Court relied upon the following passage extracted from the Allahabad High Court's judgment in Ascharajlal Ram Prakash v. CIT:

"In the form of return, there is a section which refers to the various particulars required under section 34(1), when a claim is made for depreciation. Now, merely because the form of the return provides for a place where the statement of such particulars should be set out does not mean that in the absence of such statement the ITO has no power to allow depreciation...".

98. As already mentioned, it would be prudent many a times to avail those allowances or incentives, for example, investment allowance or tax holiday incentives, which are time-bound with a priority as compared to such an allowance which has no time-limit.

It is important to note that in *Dasaprakash Bottling Company's case*, the learned counsel for the assessee submitted before the Madras High Court, that there is an earlier decision of the Special Bench of Madras High Court in *CIT v. Muthu Karuppan Chettiar*, wherein it was pointed out:

"When claiming a deduction an assessee must give the particulars required by proviso (a) of section 10(2) of the Act. This he admittedly failed to do, and therefore, he was not in a position to claim the deduction... The assessee is not entitled in law to the deduction".

Curiously enough, the Madras High Court in *Dasaprakash Bottling case* laid stress on the point, that though the figures had not been furnished in the return as such, still the figures were furnished by the assessee and the fact that it was done under protest was of no significance, as far as the requirements of section 34 are concerned.

Certain important issues of much importance arise in this connection, which are as under:

1. Whether the ITO becomes empowered to have an 'exparte assessment' by virtue of section 144, when the assessee clearly states to defer his claim for depreciation giving satisfactory reasons thereof;

2. Whether the ITO could allow for depreciation even when the assessee did not furnish the prescribed particulars, or does so under protest.

Indubitably, the genesis of the mechanism of section 144 is 'failure'. Once a notice issued under section 142(1) has been replied, and that too complying the frontiers of law, it amounts to lawful compliance. It is submitted that an assessee could have the privilege of 'self-denial' of a statutory deduction available under law, since it merely amounts to a good measure for tax planning. Paton states in his celebrated work as under:

1. Ibid
2. (1939) 7 ITR 29, Section 10(2) of the 1922 Act corresponds to section 34(1) of the 1961 Act.
"The American Restatement of the law of Property defines a privilege as a legal freedom on the part of one person as against another to do a given act or a legal freedom not to do a certain act".

The observations of Shah, J., while delivering the judgment of the Supreme Court in A. Raman & Co., are of instructive value, which are as under:

"The law does not oblige a trader to make the maximum profit: that he can out of his trading transactions... Avoidance of tax liability, by so arranging commercial affairs that charge of tax is distributed is not prohibited".

In this context, the following observations of Chagla, J., as the learned judge then was, in Navinchandra Mafatlal, subsequently affirmed by the Supreme Court, are also much pertinent, which are as under:

"If a case appears to be governed by either of two provisions, it is clearly the right of the assessee to claim that he should be taxed under that one which leaves him with a lighter burden".

Whereas in the case of a conditional benefit granted by the machinery of law, compliance with such conditions becomes the necessary concomitant for such a 'claim' in order to avail the benefit, the converse of it does not enjoin upon the assessee to comply with such conditions. Moreover, the Income Tax Act, 1961 itself provides, a fortiori, that section 44C lays down that for calculating the admissible deduction on account of head office expenditure in the case of non-resident company, depreciation allowance shall not be considered.

It is, therefore, submitted that an amendment by way of a clarificatory provision may be introduced by way of a proviso to section 32(1)(ii) as under:

"Provided that the assessee may, before the expiry of the time allowed under sub-section (1) or sub-section (2) of Section 139, whether fixed originally or on extension, for furnishing the return of income for the assessment year in respect of which he

4. 67 ITR 11, 17 (SC)
5. 27 ITR 245 (Bom)
6. 42 ITR 53 (SC)
desires to defer his claim for depreciation allowance, furnish to the ITO a declaration in writing that the provisions of this clause shall not apply to him for that assessment year or assessment years; so, however, that the assessee may, by notice in writing furnished to the ITO before the expiry of the time allowed under sub-section (1) or sub-section (2) of section 139, whether fixed originally or on extension, for furnishing the return of income for any such subsequent assessment year, revoke his declaration and upon such revocation, the provisions of this clause shall apply to the assessee for that subsequent assessment year and thereafter."

In case the words "at the option of the assessee" may be inserted in the operative part of the section 32(1) itself, before the words "subject to the provisions of section 34*, within commas, the same result could be achieved without adding the aforementioned proviso. Therefore, in the interests of rationalisation of law, it may be more convincing to insert only these words "at the option of the assessee".

**DEPRECIATION AND CHANGING PRICE LEVELS**

To encourage and promote industrial development, the present system has tried to revamp the losses through any one or more of the following devices:

1. Wear and tear allowance;
2. Obsolescence allowance;
3. Revalorisation allowance;
4. Replacement allowance;
5. Initial allowance.

Based on first principle of fiscal legislation, there is a common denominator to all these allowances, that the 'decision has ultimately to be taken on commercial considerations by the assessee himself and by no one else, as to avail the allowance.

7. In *India Nut Co. Ltd. v. CIT* 39 ITR 234, 246 the assessee discarded a piece of machinery because of obsolescence, even though it may be capable of giving some more years of service. The High Court held:

"...the decision has ultimately to be taken on commercial considerations by the assessee himself and by no one else and the wisdom of the discarding cannot be questioned by the Income Tax Authorities, of course, if they come to the conclusion that discarding was a device to evade income tax, they can disallow the claim of the assessee on this ground, but that can be done only upon the factum of discarding rather than advisably or desirability of discarding of a particular
Admittedly, depreciation is expenditure and expenses incurred 'in carrying on the affairs of a concern include 'depreciation' among them as usual expenses. The provision for depreciation does not depend upon what the business 'can afford', as the debt therefore is an essential one, constituting not an appropriation of, but a charge against profits for the period in question.

Factually, the trader's problem in inflation traverses far ahead of these conceptual norms, for example, a machine which he bought for Rs 100 ten years ago would now cost about Rs 300 or even more, but the capital allowances have provided no more than Rs 100. Accordingly, he has to find an extra Rs 200 to replace the asset and in the end his business has no greater 'real value' than before. How then can the Rs 200 represent taxable profit?

7 contd. asset, if it otherwise falls under section 32(1)(iii).  
8. The Calcutta High Court had to consider an important question of law in Indian Leaf Tobacco Development Co., Ltd., v. CIT (1982) Tax 65(3)-158, as to whether depreciation is expenditure so as to be entitled to weighted deduction under section 35C of the 1961 Act. Quoting extensively from Pickle's Accountancy, 4th Edn. 0701-0702(Ibid, 158), the court observed:

"Depreciation may be defined as the permanent and continuing diminution in the quality, quantity or value of an asset. The purchase of an asset, generally, is nothing more than a payment in advance for an expense. A simple example of this is seen in the purchase of buildings. By such purchase the purchaser expends a certain sum in advance, as a result where of he will save the cost of rent in the future, but at the end of a period of years the building will become valueless. Thus, the purchase outlay is the equivalent to paying rent in advance for a period of years."

9. According to Rule 5 of the Income Tax (6th Amendment) Rules, 1969, depreciation, unlike the previous Rule on the subject, does not depend upon the period of user and depreciation would be allowed for the fullyear even if the asset is used only for very short period during the year provided that the said asset continued to be the asset of the business or profession on the last day of the said previous year.
Interestingly enough, in this regard, the Tucker Committee in England discountenanced the theory that a proper system of computing profits must necessarily take into account changes in the value of money\textsuperscript{11}. Their main plank for discarding the theory of 'change in monetary value' was based upon the 'preferential treatment' norm. The Committee observed as under:

"...one objection common to all schemes, namely, that they involve giving preferential treatment to the owners of businesses against other classes of tax-payers".

In essence, the Tucker Committee did not favour, either

\textsuperscript{10} Taxation of Trading Profits Committee Report (UK), 1955—popularly known as Tucker Committee Report, 1955, 102

\textsuperscript{11} In paragraph 132 of their Report they summed up their general conclusions as follows:

\textsuperscript{12} a) whether the proposed schemes are based upon revalorisation or upon the creation of a reserve for replacement, in essence, they all amount to a proposal that a business should be relieved altogether from tax on some part of its true profits, that is to say, upon its profits as computed on ordinary accountancy principles.

b) In fact this relief from tax would not apply to all businesses but only to those which require to replace fixed assets or stocks. To that extent therefore the treatment asked for would be of a preferential nature.

c) whether a business qualified for this preferential relief, it would do so irrespective of the value of the business to the national economy.

d) none of the schemes of revalorisation or of reserves for replacement gives any relief or assistance in relation to a new business or to the expansion of an existing business.

e) all such schemes would involve considerable extra clerical work both on the part of the Inland Revenue and the tax-payer.

f) our suggestion for a system of flexible initial allowances is the only solution which meets the objections, we have enumerated".

\textsuperscript{12} Ibid, Cmd. 8189, para 100
the 'Revalorisation' or 'Replacement' Allowance. It said that it amounts to a proposal 'that a business should be relieved altogether from tax on some part of its true profits' and, in fact, this relief from tax 'would be of a preferential nature'. Protagonists of 'historic cost accounting' — another name for 'Revalorisation' claim that historic cost depreciation is a stabilising factor of inflation since, at a time of rising prices, the tax claim combined with the heavy demands on the funds of business tend to reduce both investment and distributions, while when prices decline, the opposite effects occur and have a moderating influence. But, the Tucker Committee states, that this analysis may attribute an exaggerated importance to the level of dividend distributions as an agent of inflation.

Replacement allowance (excluding any element of improvement) has its own inherent demerits. As it would be given in addition to the regular annual depreciation allowances on the new asset, which would continue to amortise its historical cost, down to scrap or sale value, such a 'replacement' allowance shall have the 'minimal' utility. The foremost objection is the impossibility of producing a scheme that would do justice as between assets already replaced and assets to be replaced in the future and secondly, the grave practical difficulties of defining 'replacement' or of isolating the element of replacement in any process of renewal.

Such a practical difficulty could be exhibited by a recent judgment of the Calcutta High Court. In Burraukh Coal Co., Ltd. v. C.I.T. the assessee-company claimed depreciation under Rule 5 of

13. The more limited objective of current replacement cost is achieved by 'revalorisation'. By revalorisation, it means the process of adjusting figures computed on historic cost principles, to take into account changes in the value of money. The adjustment may take the more complicated form of adjusting the cost of individual items by an index figure relating to current level of costs to those of the year of purchase. Most schemes favour the use of a 'price level', index to effect the adjustment. Another name given to 'revalorisation' is 'historic cost accounting'. The most important argument in favour of 'historic cost accounting' is the system which offers greater certainty.
the Income Tax Rules, 1962, as amended, at the rate of 100% on coal, tubs, cap lamps and haulage ropes for the assessment year 1970-71. Prior to the amendment of Rule 5, these assets were not considered as depreciable assets, as a consequence of which only the value of replacement and renewals was allowed as revenue charge. Thus under the amended rule, part of the amount claimed was in respect of assets actually brought into use during the year of account, in regard to which depreciation was allowed by the ITO. On the balance representing cap lamps, ropes and safety lamps brought into use since the inception of the colliery, the ITO rejected the claim for depreciation. This was subsequently affirmed by AAC.

The assessee contended that the replacement only kept the original capital asset alive and thus the original capital asset did not lose its identity inspite of the replacements. It was also submitted for the assessee that the allowance of replacement costs earlier would be immaterial as the replaced assets were substituted for the original assets on which no depreciation had been allowed earlier.

The Calcutta High Court relied heavily on the following observations of the Tribunal:

"Depreciation was allowable only on capital assets and not on assets the cost of which had been allowed as business expenditure, and the assessee had failed to give any details as to the original assets which had not been replaced but were used during the relevant year".

contd. Much is not in favour of this 'historic cost accounting'. In order to keep pace with the variations of a price index that must itself vary at short intervals are bound to be burden-some as well as confusing; particularly so in the case of the small businesses.

If some relief is given by way of 'revalorisation' to capital intensive industries, it would be unreasonable not to extend it to businesses with capital tied up in 'work-in-progress' and even to investment companies, that hold part of their capital in money and claims on money. On the other hand, if that extension is made to businesses with capital tied up in 'work-in-progress' and investment companies, then it would breed more inflation, as it would be necessary to take into account the reduction of the burden of fixed interest charges.

13. Ibid, 112
14. Ibid, 112
15. (1982) 135 ITR 804 (Cal)
16. Ibid, 809
Thus the Calcutta High Court held that the Tribunal was right in holding that the depreciation under section 32(1)(ii) of the Income Tax Act, 1961 read with rule 5 of the Income Tax Rules, 1962 was not admissible.

Essentially, this judgment is in line with the observations made by the Tucker Committee that "none of the schemes of revalorisation or of reserves for replacement gives any relief or assistance in relation to a new business or to the expansion of an existing business". Grave practical difficulties of defining 'replacement' or of isolating the element of replacement in any process of renewal are involved.

The Tucker Committee was strongly in favour of 'Initial Allowance' besides, of course, 'Depreciation Allowance'. The Committee stated:

"Our suggestion for a system of flexible initial allowances is the only solution which meets the objections we have enumerated".

Unlike the replacement allowance, the initial allowance avoids the great practical difficulty of distinguishing between improvement and replacement. Indian tax system too, favours initial depreciation allowance. In essence, the Income Tax Act, 1922 and then Income Tax Act, 1961 have favoured both the initial depreciation allowance and investment allowance. Certain important variables are common to both these allowances, as under:

17. Ibid, paragraph 132; Supra fn. 11
18. Supra fn.11
20. Initial allowance was introduced, for the first time in 1946, avowedly as part of a new scheme of taxation designed to encourage reequipment and modernisation in productive industry. This initial allowance is given independently of the annual depreciation allowance.

The initial allowance was suspended after some time, the reason given being that the heavy calls which the defence programme would make on the engineering industry made it desirable to reduce the pressure of civilian demand for plant and machinery.
1. Both avoid the enormous difficulty of distinguishing between improvement and replacement.
2. Neither is directed to establish a just measure of true profit, than that which would prevail but for the allowance.
3. Each is a form of tax remission, intended to provide a stimulus to investment in certain kinds of fixed assets.

Development rebate, which for certain purposes could be said to be the precursor of investment allowance, was to be in addition to the normal depreciation and obsolescence allowance. This allowance coming on the horizons of fiscal legislation by virtue of Finance Act, 1955 had had a chequered history. In the beginning it is the only damaging point against either, investment allowance or initial depreciation allowance. It is often said that these allowances distorts the true relationship between the profits of the year of allowance and those of succeeding years. Initial allowances are being labelled as an 'interest-free' loan. Rather, it is more than a loan in the sense that the remission given by the revenue is reclaimable, only against future tax.

Development rebate was introduced for the first time by the Finance Act, 1955. It was intended to act as an incentive to the business houses by authorising the assessee to deduct certain percentage of the actual cost of certain new capital assets as a revenue expenditure in one lump-sum.

This allowance has had a chequered history as under:

The Finance Act 1955 inserted clause (viib) to section 10(2) of the 1922 Act providing for an outright allowance of 25% of the actual cost of new machinery, if it was wholly used for the purposes of business.

The Finance Act, 1958, introduced substantial amendments in this clause, as under:
1) In order to avail this allowance, the assessee was required to create a 'development rebate reserve' equal to 75% of the development rebate to be actually allowed, by debiting to the profit and loss account of the relevant previous year, and crediting to the aforesaid reserve account. The only exception were the Electricity Companies.
2) The reserve had to be retained in the business and could not be frittered away by distributing dividends or profits, or remitting outside India as profits, or for creation of any asset outside India. The period of retention of such a reserve was ten years.
3) Such a machinery or plant could not be sold or otherwise transferred to any person, other than the government within a period of ten years.

The Taxation Laws (Amendment) Act, 1960 excluded office appliances and road transport vehicles from the scope of this allowance.

The Finance Act, 1961 introduced three important amendments as under:
1) The rate of development rebate was reduced from
this allowance was to be allowed in one year irrespective of the sufficiency or otherwise of the profit in that year. This anomaly was removed by the Finance Act, 1958, as a result of which the whole or part of the development rebate which could not be absorbed due to insufficiency or lack of profits in the year of acquisition or installation of the machinery, could be carried forward for a period of 8 years.

Many shortcomings were pointed out by several chambers of commerce in the practical application of the provisions of section 10(2)(vi b). The Direct Taxes Administration Enquiry Committee was of the following opinion on the generality of development rebate:

"In cases of companies which acquire new machinery entitled to development rebate but which incur overall losses within the statutory period of ten years during which the various conditions in regard to the rebate operate, the rebate should not be withdrawn, if such a withdrawal results in the levy of tax."

The wording used in section 10(2)(vi b) "New machinery and plant installed" being differently interpreted by the assesses and the department gave rise to considerable litigation. In

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22 contd. 25% to 20% in respect of machinery or plant installed after 31.3.1961.

ii) on amalgamation of two companies, or succession of a firm by a private company, the following conditions had to be fulfilled in order to avail the rebate.

a) All the property of the amalgamating company or of the firm immediately before the amalgamation or succession became the property of the successor company;

b) All the liabilities of the amalgamating company or of the firm immediately before the amalgamation or succession became the liabilities of the successor company, and

c) All the shareholders of the amalgamating company or the partners of the firm immediately before the amalgamation or succession became shareholders of the successor company.

23. Direct Taxes Administration Enquiry Committee Report, 1958-59 (popularly known as Tyagi Committee Report), 40

24. The department's view of 'installation' of an asset appeared to be that it should be fixed to earth. Accordingly, it did not allow any development rebate for motor vehicles, tractors, etc.
CIT (Central) Bombay v. Saraspur Mills Ltd. and CIT v. Lever Bros. India Ltd., it was held that 'installed' does not necessarily mean 'fixed in position'. If an asset is 'inducted' or 'introduced' and used for business purposes, it would be entitled to development rebate.

On the other hand, the Tyage Committee stated:

"We feel that development rebate should not be admissible for such conveyances like cars etc., in respect of which the personal use is often indistinguishable from their business use... Development rebate should also be allowable in case of mobile plant and machinery... No such rebate should, however, be allowed on trucks and tractors used in businesses other than mining".

All the aforementioned recommendations were accepted, but the onslaught of certain jurisprudential aspects continued. The words 'owned' by the assessee deprived the assessee to take benefit of this allowance under 'hire-purchase' transactions. To obviate this hardship, the Board instructed the Department to adopt the same basis for allowing development rebate, as in the case of depreciation allowance, that is to grant the development rebate in the first year itself on the estimated full initial value of the asset.

The Income Tax Act 1961 removed many anomalies existing hitherto, the most important amendment being that this allowance was extended to the merger of Indian Subsidiary Companies in a wholly-owned parent Indian Company. Even these amendments could not cope with the demands of the industry... a tribute to the dynamic approach of industrialisation in the country, with a new facelift provided by the Third Five Year Plan, particularly the Avadi session of the Congress in 1960, where for the first time,

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25. (1959) 36 ITR 580
26. (1959) 37 ITR 140
27. CBDT circular No. 27(20) IT/59 dated 26.6.59
28. The following further amendments were made with the advent of 1961 Act:
   i) The allowance was extended to machinery or plant purchased in one year but put to use in a subsequent year, for which suitable modifications were made in section 33(1)(a)
   ii) The allowance was extended to cases of amalgamation of more than two companies. Moreover, it was allowed to public companies as well which was hitherto only available to private companies taking over the firms.
the concept of 'mixed economy' was accepted in principle. Immediately thereafter, the Finance Act, 1964 inserted sub-section (1A) to section 33, extending the scope of development rebate to second-hand machinery or plant.

On the other hand, the government had second thoughts about the utility of this rebate, despite a series of innovations in its mechanism. The Finance Act, 1964, inserting a new sub-section (5) to section 33, delegated the powers to the Central Government to withdraw this allowance by prior notification of at least three years.

A subsisting anomaly even after numerous amendments in 1961, persisted that only Indian subsidiary companies could merge with their Indian holding companies for availing this allowance. The Finance Act, 1966 removed the words "and the subsidiary is an Indian company" at the end of the Explanation to sub-section (3), with the result that the benefit was extended to amalgamation of companies in general. Then came the bidding, day of remorse good-bye to development rebate on 28.5.1971.

28 contd.  iii) The 'retention period' of development rebate reserve was reduced from 10 years to 8 years. Likewise the restriction period for sale or transfer of assets on which development rebate was granted, was reduced from ten years to 8 years.

29. Certain conditions were imposed by the statute for the allowance as under:

1) Such machinery or plant was not used in India at any time prior to the date of installation by the assessee.

ii) It is imported into India by the assessee.

30. S.O.No.2167 dated 28.5.71. It is interesting to note that the Parliament could not bear this remorse good-bye for too long, and the old baby was again introduced by virtue of the Finance Act, 1974. But on a plain reading of section 32 and 33, it was made quite clear that either initial depreciation allowance or development rebate would be admissible to the assessee on the same machinery or plant.
Almost simultaneously the concept of initial depreciation allowance was again revived by virtue of Direct Taxes (Amendment) Act, 1974 with effect from 1.4.75, inserting clause (vi) in section 32A(1).

Nevertheless, the recommendations of the Tucker Committee allured the Indian Tax system, and the 'investment allowance' was introduced, for the first time, by virtue of the Finance Act, 1976, inserting section 32A in the 1961 Act. Despite quite a broad-based mechanism of section 32A, constraints without much justification persist, for example, section 32A(2)(b)(iii) puts a clog on the business and industry in general. The Parliament in its own wisdom often remains in sweet oblivion, while enacting fiscal provisions. The first principle of corporate finance is that an industry or business does not exist in vacuum, each one is inter-dependent. It is submitted, therefore, the words "not being an article or thing specified in the list in the Eleventh Schedule" may be omitted.

31. The scope of 'Initial Depreciation' as contained in the Direct Taxes Amendment Bill, 1973, was prima facie restricted, the allowance proposed to cover only the business of generation or distribution of electricity or any other form of power, or manufacture of articles specified in the proposed Ninth Schedule, in anticipation of the abolition of Development rebate. (Cf. 91 ITR 41-43 statutes section). However, the select Committee recommendations thereon had a salutary effect, having included small-scale industries within its scope, made the allowance broad-based (Cf 94 ITR 65-67, Statutes section).

32. Ibid, Supra fn. 11

33. Section 32A(2)(b)(iii) runs as under:

"In any other industrial undertaking for the purposes of business of construction, manufacture or production of any article or thing not being an article or thing specified in the list in the Eleventh Schedule"
INVENTORY VALUATIONS AND CHANGING PRICE LEVELS

The sharp changes in the price levels have also brought for immense consideration the methods of valuing inventories. Increases in the value of inventories (i.e., stock-in-trade held as a normal part of conducting business over the taxable year) are included in the company’s operating profits. Sometimes, these reported net profits exceed economic net income by a wide margin. This tendency breeds inflation.

A question often arises whether the stock on hand at the end of the year is to be valued at the closing price or at the initial purchase price. Yorston and Smyth indicate the following three methods of valuing of closing stock:

1. First-in-First-out, (FIFO)
2. Last-in-First-out, (LIFO)
3. Average cost.

In regard to these 3 methods, the authors have stated thus:

1. 'First-in-First-out'

The assumption underlying this method is that the oldest stock is used or issued first, or that sales are made in the order of their purchase or production.

2. 'Last-in-First-out'

This method assumes that the items of stock purchased last are the first to be issued or sold.

3. 'Average cost'

On this basis issues of stock are valued at the weighted average cost of the stock on hand at the beginning of the purchases, less any issues already made.


Suppose that at the end of 1969, an automobile dealer has a stock of ten cars, acquired at Rs 20,000 each. In 1970 he acquired 20 additional cars at Rs 25,000 and sells ten cars at Rs 40,000 each. His stock at the end of 1970 is 20 cars. Under the LIFO method profits for 1970 are 10 (40,000-25,000) or Rs 1,50,000, while under the FIFO method, equal to 10 (40,000-20,000) or Rs 2,00,000. Since prices have risen, FIFO profits are larger.
LIFO gives smaller profits in periods of rising prices and smaller losses when prices fall. It thus makes for a more stable tax base over the business cycle than does FIFO. Under the FIFO system, the increase in the value of stocks over an accounting period is counted as an element of taxable profit. Conversely, if prices fall over a year, the reduction in the value of stocks is reflected in taxable profits too. On the other hand, the essence of LIFO accounting is that stocks should be deemed to be used up in the reverse order to that in which they are bought. If, therefore, the volume of stocks is the same at the beginning and end of the accounting period, there will be no inventory profit recorded over the year, however much prices rise.

In UK, the Tucker Committee devoted some attention to the problems of stock valuation in connection with inflation. The Committee observed:

"There are no general provisions in the existing income tax Acts which lay down how trading stock is to be valued in computing profits for tax purposes."

While conceding to the complex enormity involved in recommending any one method, the Committee observed as under:

1. For tax purposes, there is a special importance in precise ascertaining the income of the year in question, for rates change,

2. Considering the immense variety and complexity of businesses, of business processes, of their conditions and circumstances, it is impossible to recommend any one method. Let us take two instances: viz of pharmaceutical products industry, and a metal fabrication industry as the extreme cases. In the first case, it is important to know the dates at which the various items of stock were acquired and the order of their disposal. In the other case, the concern is to ensure that it has in hand a volume of sufficient stock to meet his customer's requirements; notwithstanding the facts regarding the history of separate items which have gone to make up his raw material, and the order in which he draws upon them.

38. Ibid, 143
It is also to be remembered that the term 'stock' does not refer to 'stock-in-trade' or to 'raw material' only, as a matter of fact the term 'inventory' has been used here in terms of public finance, apt to include 'dividend stock' or 'capital' of the company. At least in one of the recent judgments of the Supreme Court, *Hyde Products Pvt. Ltd. Bombay v. CIT, Bombay*, the enormity of these two systems LIFO or FIFO was under consideration. This judgment also throws light on the far-fetched implications of these methods of valuation of stock. The relevant facts were as under:

With respect to the assessment year 1974-75, the relevant previous year being calendar year 1973, and the material date being 1.1.1973; after finalising the accounts for the calendar year 1972, the directors transferred a sum of Rs 29,77,000 to the general reserve. Thus, with this accretion the general reserve of the assessee-company as on 1.1.1973 stood at Rs 86,07,712. Thereafter, the directors did not make any provision for 'proposed dividend' in the accounts at the end of the calendar year, 1973. On the other hand, there was a note on the balance sheet:

"The directors have recommended dividend for the year 1972 at the rate of Rs 10/- per share free of tax. The dividend, if approved by the shareholders at the forthcoming annual general meeting, will be paid out of general reserve, and so separate provision has been made therefore in the accounts".

Being passed as such by the shareholders, the company claimed that the entire general reserve, which stood at Rs 86,07,712 as on 1.1.1973 should be taken into account while computing the capital of the company for Surtax purposes. But the ITO reduced the general reserves by the sum of Rs 3,10,450 (the sum of dividends declared by the shareholders and soon thereafter paid out of the said general reserve) and only the balance of Rs 82,97,262 was added in computing the capital.

The counsel for the company urged that for determining whether the entire general reserve or reduced general reserve should be taken into account for capital computation, either the FIFO principle should be adopted; if not, only a proportionat

deduction should be made and the balance should be includible in capital computation, particularly because the payment of dividend has been from a Conglomerate fund.

The following reasoning based on the FIFO method was put forward by the learned counsel for the assessee-company:

"Once from out of the current year's profits a certain sum is transferred to the general reserve, it merges into the latter and the general reserve so augmented becomes a conglomerate fund, and if out of such conglomerate fund any sum is recommended or paid out as dividend, it will be difficult to say that such payment has come out of the portion of current year's profits that has been transferred and merged and there is no reason why the principle 'Last-in-First-out' should be invoked for drawing the inference that the payment has been made out of the current year's profits.

Tulzapurkar, J., while speaking for the Supreme Court, held as under:

"It is not possible to accept either of these contentions. It is true that under section 205(1) of the companies Act, 1956, it is open to the directors to recommend and the shareholders to approve payment of dividends either from the current year's profits or from the past year's profits. It is also true that on transfer of a portion of current year's profits to the general reserve the augmented general reserve becomes a conglomerate fund but having regard to the natural course of human conduct of hard-headed men of business and commerce, it is not difficult to predicate that the dividends would ordinarily be paid out from the current income rather than from the past savings, unless the directors in their report expressly or specifically state that payment of dividends would be made from the past savings".

It is submitted that this judgment of the Supreme Court, Hyco Products Pvt,Ltd, Bombay v, CIT Bombay needs reconsideration. After acceding to both the main contentions advanced by the assessee, the Supreme Court could onlysay that such an authorisation to pay out of the past savings ought to have been made expressly by the Directors, notwithstanding this fact that the approval

According to the learned counsel for the assessee-company, under section 205(1) of the companies Act, 1956, dividend can be paid from out of the current year's profits or profit of any previous financial year or years and there is no presumption in law or in commercial accounting that a dividend has to be paid either from the current year's profits or from the past year's profits.

Ibid, 238. The counsel for the assessee-company also cited two Bombay High Court decisions, CIT, Bombay City v, Bharat Bijlee Ltd,(107 ITR 30) and CIT Bombay v, Marrior (India)Ltd, 1 (IT 35) in this connection.
for such an act was given by the shareholders in their annual general meeting. It is, moreover, established beyond doubt that no one method could pervade all the business processes, and it ultimately depends on business exigencies.

The only foremost requirement is that the method of accounting adopted by the assessee should conform to the recognised principles of commercial accounting. At the same time, "the law does not oblige a trader to make the maximum profit that he can out of his trading transaction". To do proper justice to the subject matter an initial reference to the U.K. report on company law reforms is pertinent. Following is the passage received as a memorandum from the Institute of Chartered Accountants, by the Jenkins Committee on Company Law Reforms.

"In most businesses, the amount carried forward for stock-in-trade and work-in-progress as on the balance-sheet date has a material bearing on the amount of profit or loss for the period ended on that date. The basis normally used to determine the amount is cost less any part thereof which properly needs to be written off at the balance-sheet date. There are, however, various methods of computing cost and alternative methods of arriving at the amount, if any, to be written off and there are various special bases which are regarded as appropriate in some business. Circumstances vary so widely that no one basis is suitable for all types of business nor even for all undertakings within a particular trade or industry".

43. Ibid
44. In Garden Reach Workshop Ltd. v. CIT (1981) 132 ITR 814 (Cal) the assessee was following the Mercantile system of accounting. Upto the accounting year ending on September, 30, 1956, the assessee had been valuing its work-in-progress at 'cost'. It changed its method of accounting and valued thereafter the work-in-progress at "cost or realisable value, whichever was less" and when its expenditure in the execution of any contract exceeded the amount realisable under the contract, the assessee wrote off the difference in its books at the end of the year. The Calcutta High Court held: "As there was no material to show that the method of accounting adopted by the assessee conformed to the recognised principles of commercial accounting and the Tribunal had not found any overriding reasons for the change, the rejection of the method of accounting adopted by the assessee was valid".
45. Per Shah, J., CIT v. Raman & Co. 67 ITR 11,17 (SC)
46. Company Law Committee Report, 1962 (Jenkins Committee Report), Paragraph 370, 144-45
The Jenkins Committee observed on it as under: 47

"We agree with these views. It must, however, be recognised that the choice of a particular basis for the statement of stock may result in the stock being included in the accounts at an amount much lower or higher than if another basis had been used. The basis will reduce or increase accordingly the profit taken to date and will cause differences in the trend of profits disclosed from year to year. We think, therefore, that shareholders ought to be concisely but adequately informed as to the basis used. Any departure from the basis previously in use and the effect of any such change should also be brought to the notice of shareholders if the effect is material. Where a company employs many different bases of computation, to require an explanation of each of them to be given would result in the provision of a mass of detail which would be of little or no value to the members. In such a case, the directors should be required to provide as intelligible a summary as they can".

iv. TAX INCENTIVES

A fundamental requirement of economic development is an increased rate of capital formation relative to that of population expansion. Herein lies the viability of corporate sector having the requisite potential of capital formation. Taxation has an important role to play in providing savings, or to discourage luxury consumption. Many of the difficulties which obstruct the economic progress of low-income countries call for solution by the public sector; yet the institutional and social settings of such countries complicate and constrain the task of budgetary policy.

Underdeveloped countries are obliged increasingly to give a crucial role to taxation, for taxation is on the whole 'safer' than borrowing or deficit financing; these too may have to be resorted to, but taxation must come first. Underdeveloped countries usually lack good savings institutions, and hence borrowing as a method of savings mobilisation cannot be of much avail. Perhaps it is in this institutional and social setting, that the tax holiday under section 80J does not include 'borrowed money' in the computation of capital. Such borrowing leads to more pressure on the banking institutions, which is not conducive for

47. Ibid, 145
48. Musgrave and Musgrave: Public Finance in theory and Practice, 737
49. Ambirajan, S. The Taxation of corporate Income in India, 268
the economy.

The concept of 'capital employed' remained the question of forensic public finance during almost these two decades. Ultimately, the Parliament transferred the relevant rules lock, stock and barrel, to the substantive fabric of law. A new sub-section (1A) was inserted in section 80J by virtue of the Finance Act, 1980, with retrospective effect from 1.4.72. In resultant, the Parliament superseded all those judgments which gave sanctity to borrowed money.

It is submitted that the Parliament could not find solace, as the ghost of Century Enka still haunts the labyrinth of the legislation. Money borrowed becomes one's money over which he has full control to utilise or spent, in whatsoever manner he likes. Paton states in his pioneer work as under:

"Possession, unfortunately, is used both in a popular and a legal sense. The simplest view to take is that possession in fact means physical control of an object with intent to exclude others... If the law had contented itself with making the notion of possession sharper or more clear-cut, there would not be much difficulty. But for reasons of convenience and policy the law has introduced anomalies so that now each legal system has its own particular exceptions. But it seems to be historically more accurate and to conclude to greater clarity if we regard the law as building on the notion of physical control and introducing such refinements as it desires than if we regard the legal conception as having nothing in common with the popular one".

50. The expression "capital employed" used in section 80J has been in focus for litigative purposes during these two decades. Rule 19A, Income Tax Rules 1962, which was introduced in 1967 for the purpose of computing 'capital employed' in an industrial undertaking provided for computation of 'capital employed' as on the first day of the computation period. 'Computation period' was defined in Explanation 1 to sub-rule (2) as the period for which profits and gains of the industrial undertaking were computed under section 28 to 43A of the 1961 Act. Rule 19A (3) provided for deduction of borrowed money and debt owed by the assessee as on the first day of the computation period from the aggregate of the assets computed in the manner provided in sub-rule (2). Much controversy generated on the scope of sub-rule(2) which stipulated that the aggregate amount representing the value of the assets as on the first day of the computation period would be the basis for computing the 'capital employed'. In other words, this sub-rule, in effect, ignored the additional capital employed after the first day of the previous year, but before the close of that year.

51. The forerunner remains the Calcutta High Court's judgment in Century Enka Ltd.v, ITO(107 ITR 123 Cal)

The concept of 'reconstruction' embedded in section 80J(4) also attracted a good deal of controversy. The judicial pronouncements give a clear impression that there is need for defining the term 'reconstruction'. The courts have laid down certain norms on the basis of which it cannot be termed a case of reconstruction. If the new industrial undertaking, being a separate and independent production unit, can be carried on separately without losing its identity, and the original undertaking retains its original character, then it shall be entitled to relief under section 80J, even though:

1) articles produced in the new undertaking which are being used in the assessee's business, were formerly used to be purchased from the market.

2) separate undertaking manufactures the same product as the old undertaking, where the old undertaking retains its original character.

Section 80J(4)(1) states:

"This section applies to any industrial undertaking which fulfils all the following conditions, namely:

i) it is not formed by the splitting up, or the reconstruction of a business already in existence;..."

The leading judicial pronouncement on this subject remains the judgment in Textile Machinery Corporation Ltd. v. CIT, West Bengal (107 ITR 195 (SC)). The assessee-company set up a steel foundry division, which manufactured some castings. Formerly these castings were purchased from the market for use in jute mill division. The assessee-company claimed relief under section 15C (corresponding to section 80J of the 1961 Act) of the 1922 Act.

The Calcutta High Court held that the new industrial undertaking is not a separate unit, and therefore, it is not entitled to relief.

Setting aside the judgment of the Calcutta High Court, the Supreme Court held that the new industrial undertaking is 'separate' and 'independent' production unit, that the commodities produced are commercially tangible products, and the undertaking can be carried on separately. The fact that the articles produced by the new units are used in the business of the assessee would not weigh against holding that these are new and separate undertakings. Hence the new industrial undertaking was entitled to relief under section 15C.

Goswami, J., who delivered the judgment of the Supreme Court in Textile Machinery Corporation held that the decision in CIT v. Naya Sahitya (84 ITR 567 Del) does not represent the correct legal position, hence it cannot be applied.
iii) separate undertaking manufactures the same product as in the existing old unit, but with a much higher capacity.

iv) separate undertaking manufacturing the same type of goods as the existing one, and then dismantling the old one.

Indubitably, there is a common denominator to all these aforementioned points that if a new industrial undertaking is an independent and separate unit, then it could not be labelled as a case of 'reconstruction' and therefore, it would be entitled to the section 80J relief, even though it may produce the same goods as the old one was producing, or the newly produced goods are being used by the assessee's old unit. This clog of 'splitting up' or 'reconstruction' attains its vulnerable dimensions in the provisions of section 80HH. It is submitted that this condition impedes the very spirit of the tax incentive.

Yet another tax incentive which had been a matter of controversy in the recent past is Export Market Development Allowance.
Section 35B enumerating this allowance as a deduction of a sum equal to one and one-third times the amount of such expenditure incurred during the previous year on account of advertisement, publicity, travelling outside India, or to maintain branch office outside India, has been discontinued by virtue of the Finance Act, 1983. Due to its poor legislative drafting entailing loopholes for manipulating the quantum of allowance, there could be no other way for the Legislature except to disperse with it. On the other hand, the Legislature being conscious of the 'foreign exchange reserves' could not throttle the spirit of 'Export market development allowance', as a result of which section 80 HHC dealing with 'deduction in respect of export turnover' has been inserted simultaneously by the same Finance Act, 1983. The obnoxious loophole prevailing in section 35B has been plugged by virtue of an Explanation to section 80 HHC which reads as under:

"'export turnover' means the sale proceeds of any goods or merchandise exported out of India, but does not include freight or insurance attributable to the transport of the goods or merchandise beyond the customs station as defined in the customs Act, 1962".

These aforementioned words "...but does not include freight or insurance attributable to the transport of the goods or merchandise beyond the customs station..." have been inserted on the basis of case-law coming up under section 35B. Moreover, the actual export of goods was not a condition precedent for claiming allowance under section 35B as held in Indian Hotels Co.Ltd. v. ITO - a decision of Bombay Income Tax Appellate Tribunal which had the implied approval of the Supreme Court. Whereas under section 80 HHC

59. In a recent judgment of the Delhi Income Tax Appellate Tribunal, Eastern Bulk Services v. ITO(1983)15 Taxman 12 (Delhi-Trib) the assessee-firm was carrying on business as ship-brokers, was deriving commission income in foreign currency by arranging for cargo to foreign ships, from port to port, both in India and abroad. It claimed weighted deduction under section 35B on administrative expenses like telex charges, foreign travelling expenses, salary, etc. incurred by it during the course of its business. The entire expenditure was allowed for weighted deduction by the Tribunal.

60. In Indian Hotels Co.Ltd.v.ITO(IT Appeal No. 467 Bom) of 1975-76 dated 30.9.1976 The Bombay Bench of ITAT held that the words 'advertisement' and 'publicity' have been used in section 35B evidently not in any technical or narrow sense, and, therefore, it would be proper to give them the general meaning as understood in the common parlance.
exports out of India any goods or merchandise, has been made a condition-precedent.

v. INTER-CORPORATE INVESTMENTS

The growth of inter-corporate investment is a logical and integral part of corporate growth. Whether growth takes place from 'inside' or by 'combination' (inter-corporate investments), the general objective is the lowering of costs, but in addition, the production may be improved in quality, marketing process may be brought under better control, economy in buying raw materials may be attended through bulk purchases, administration may be had through specialisation of function.

It has been the accepted practice that the share of inter-corporate investment in financing the new venture is more prominent. On the abolition of managing agency system on 1st April, 1970, a vacuum was likely to be created in industrial finance in India. Further, with the institutionalisation of savings, the gap, popularly known as 'Macmillan gap' in industrial finance was likely to persist in India. Inter-corporate investment assumed the risk of filling this gap and guiding the growth of small or new ventures. Foreign Collaboration which is yet another form of inter-corporate investment (investor in this case being a foreign company) generates growth in the economy. Its contribution to the 'external economies' by employing indigenous goods and services is stimulus to ancillary activities.

With this backdrop in view, section 80M of the 1961 Act enumerates deduction to the extent of 100% in respect of income by way of dividends received by a domestic company from a domestic company, subject to certain channelized directions of manufacturing activities undertaken by such domestic companies. On the other hand,

61. Source: The Economic Times, dated 29.9.1979. The P.A. was filed by the Commissioner before the Bombay High Court, but it was rejected. Thereafter, the Commissioner filed a petition for special leave to the Supreme Court and the said petition was dismissed by the Supreme Court.

62. The specialised institutions may sometimes be persuaded to assist in the fund-raising activities of the company, but the main initiative comes from the promoting group itself,
deduction only to the extent of 60% of income by way of dividends is permissible if the company does not pursue activities in channelized directions. In such a case, the tax burden can be exemplified as below:

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Description</th>
<th>Total Income</th>
<th>Total Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Income of the wholly owned subsidiary</td>
<td>100.00</td>
<td>-</td>
</tr>
<tr>
<td>2.</td>
<td>Tax @ 65%</td>
<td>65.00</td>
<td>65.00</td>
</tr>
<tr>
<td></td>
<td>Balance of distribution surplus</td>
<td>35.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assuming 100% is declared as dividend to the parent company, the income thus</td>
<td>35.00</td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Deduction @ 60% u/s 80(M) =</td>
<td>21.00</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Tax @ 65%</td>
<td>9.00</td>
<td>9.00</td>
</tr>
<tr>
<td>5.</td>
<td>Assuming section 104 penal tax is opted by the company: Penal tax @ 37% on 26.00</td>
<td>10.00</td>
<td>10.00</td>
</tr>
<tr>
<td></td>
<td>Total amount taxed =</td>
<td>84.00</td>
<td></td>
</tr>
</tbody>
</table>

Thus, the total tax burden in the case of such a wholly-owned subsidiary could be 84% of the profits. Even if section 104 penal tax could not be opted, the tax burden would have been 74%. It is submitted, therefore, that such a differentiation based on the nature of manufacturing activity may be removed, and this deduction may be allowed to the extent of 100% in all cases.

Wanchoo Committee went to the extent of dispensing away with the existing galore of differentiation among various types of companies in the following words:

"We feel that there be no difference in the matter of income tax between widely-held and closely-held companies...We recommend that a uniform rate of income tax of 55% be prescribed for all domestic companies, whether public or private, widely-held or closely-held, and industrial or non-industrial".

It is important to note that the Parliament is yet to implement this recommendation, which itself reveals the veracity of it. The writer only submits that for the purposes of inter-

63. Wanchoo Committee Report, para 2.5
corporate investments the differentiation in the incentive pattern based on the nature of manufacturing activity, whether in the channelised or approved directions or otherwise, does not stand the scrutiny of a fast-developing economy. Such non-viable constraints distort the economy and are rather a leverage to inflationary tendencies.

The most severe criticism against such a submission made by the writer would be that it would aggravate the 'concentration of economic power'. It is submitted that the counter to it could be in two ways. One, those economies which are recognised as developed today owe much to the liberal formulations towards 'inter-corporate investment'. In France, inter-corporate dividends are exempted up to 95% of the total amount of the initial cost of participation held by the receiving company. In U.K., dividends received by one domestic company from another domestic company are exempted to the extent of 100%. In West Germany, concessions are particularly given to holding companies, that the profits and losses of the subsidiary are considered as profits and losses of the parent company. In U.K., too, such concession is extended by the provision of 'subvention payments'. On the other hand, Bhoothalingam is of the view that except for dividends received from subsidiary companies, all other inter-corporate dividends should be regarded as no different from return on investment of any other kind and fully taxed in the normal way. This statement has no justification as section 80M goes much ahead of it and it grants income by way of dividends received by a domestic company from another domestic

64. Essentially, these subvention payments are an incentive to lower down the tax burden, by granting subsidy or postponing the timing of burden.

65. Bhoothalingam - Final Report on Rationalisation and simplification of Tax Structure, 31:

In the Interim Report on 'Rationalisation and Simplification of the Tax Structure', para 4.15, the wizard of public finance says:

"A corporation or a company when it has surplus funds which it wants to deploy in a particular activity has the choice of undertaking the activity itself or creating a new organisation. If in economic terms, one method is better, there should be nothing in the tax laws which should discourage that particular method. In other words, the position of a company which undertakes a particular activity itself should not be different from that of a company in a like situation which prefers to undertake the same activity
company in general.

Second, the Companies Act, 1956, along with the MRTP Act, 1969, has already taken much care of such a situation as not to entail the "concentration of economic power". In essence, "concentration of economic power" is antithesis of the concept of "public interest". It is important to note that deep inroads have been already made in the mechanism of Companies Act, 1956, since 1964 in order to safeguard the public interest. It is really a tribute to the resilience of Companies Act, 1956, that though controlling concentration of economic power is not directly within the ambit of the Act, yet the induction of the concept of 'public interest' served the desired purpose.

65 contd... by organising a wholly owned subsidiary company. The profits which it derives from the wholly-owned subsidiary should then be treated in the same way as its own profits, i.e., it should bear the appropriate rate of tax once but not more than once. In such a situation, there would be justification for excluding the whole of the dividend received from a subsidiary company from the total income, provided of course the subsidiary company has paid tax before distributing the dividend.

66. The department of Company Law Administration has tightened up the operation of Section 372, Companies Act, 1956, which lays down the investment norms, while dealing with holding-subsidary alliance or in the vertical combination. Section 43A reading together with section 372 makes clear that these provisions are equally applicable to those private companies which are deemed to be public.

67. This concept has received statutory recognition in sections 89(4), 205(3), 211(3), 221, 224(1), 250, 303, 326, 352 and 396 in the Companies Act, 1956.

68. With the induction of the concept of 'public interest' in 1963 in the Companies Act, 1956, it has become clear that 'inter corporate investment' would not be permitted, if there is a reasonable suspicion that such investment is prompted by a desire to gain control over the management of companies. (Report of the Monopolies Inquiry Commission, Vol.I, 142)

As early as in 1948, the High Court of Bombay interpreted the expression 'public interest' in Emperor v. Jesingbhai (1948) 50 Bom LR 544 as under:

"It is an expression of wide connotation and has got several implications. As the expression will take its colour from the context in which it is used, the object behind the legislative intention within which it is used and the mischief it seeks to suppress, all these factors will enter into the verdict in deciding what constitutes 'public interest' in the context of the legislation in which it is used."
There is only one apprehension that the investment company dealing in shares or debentures may not deserve the deduction to the extent of 100% on 'inter-corporate dividend' income. The apprehension seems to be well-founded. There are certain norms on the basis of which 'inter-corporate dividend' income becomes entitled for full or partial deduction. They are as under:

a) inter-corporate investment should not be used for purposes of speculation or cornering of the shares of other companies;

b) investment must fulfil all the requirements of sound investment;

c) investing company should make such investment out of its own savings;

d) such investment should not be at the cost of liquidity of the investing company.

Keeping in view the very first norm, the investment companies should meet the fate advocated by Bhootalingam, that such investments may be taxed in the normal way. It is, therefore, submitted that an Explanation may be added at the bottom of section 80M reading asunder:

"Where the gross total income of an investment company includes any income by way of dividends from a domestic company, there shall not be allowed any deduction from such income by way of dividends, while computing the total income".

It is submitted that this suggestion would go a long way in lowering down the inflationary tendencies in the industrial market.

vi. CAPITAL GAINS

The basic reason for the inclusion of capital gains in taxation is that capital gains increases person's taxable capacity by increasing his power to spend or save; and since capital

69. The following are the canons of sound investment:

1. Investment is considered a function of past changes in sales and of existing capacity in relation to sales.

2. Investment is expressed as a function of the expected net rate of return.

3. Investment is taken to be a function of the availability of internal funds, including after-tax profits and depreciation charges.
gains are not distributed among the different members of the tax paying community in fair proportion to their taxable incomes but are concentrated in the hands of property owners (property includes equity shares in companies), their exclusion from the scope of taxation constitutes a serious discrimination in tax treatment in favour of a particular class of tax payers.

Three main types of capital gains, according to the 'Income Theory' are:

a) 'Pure' gains;
b) gains associated with falls in interest rates;
c) gains associated with general price rises.

In this context of behaviouralism of capital gains in an inflation, the memorandum of dissent by three leading British economists, to the Report of the Royal Commission on 'The Taxation of Profits and Income' explicitly states:

"It is not our view that the tax code should be so devised as to insure taxpayers against the risk of inflation. Indeed, we should consider any such intention singularly inappropriate, for taxation must be regarded as one of the principal weapons in the armoury of the capital gains for combating inflation. In the event of a drastic depreciation, it might become necessary to revise the basis of all monetary obligations and commitments, including tax payments—as was done in Belgium after the First World War and in Belgium and France after the Second World War".

Ignoring the exceptional periods following in the wake of great wars or great economic depressions, capital gains are not to any important extent the consequence of either 'pure' gains or 'gains associated with falls in interest rates'. The great bulk of capital gains in normal periods of economy is the result of rising real incomes (higher profits and larger dividend payments). On the other hand, much greater bulk of capital gains is generated in abnormal periods of economy as a result of rising unreal incomes. As regards the differentiation between the two, theories of public finance fail to give a satisfactory answer, except this that the

70. Memorandum of dissent by Mr, N, Kaldor, Mr, M, L, Bullock and Mr, G, Woodcock, to the Report of the Royal Commission on 'The Taxation of Profits and Income' (1955) 369
spurt in prices tend to escalate the speculative and inflationary tendencies.

Musgrave and Musgrave state:  
"The equity case for full taxation of capital gains is tempered, however, by the impact of inflation. If capital gains are a reflection of an inflationary increase in

Musgrave and Musgrave states:  
"With regard to realized gains, most students of taxation hold that there is no good justification on equity grounds for preferential treatment. It should make no difference, in measuring taxable capacity whether capital income is (i) paid out currently as dividends, or (ii) permitted to accumulate and then realised by sale of the asset. Income is received in both cases and there is no basis on which to distinguish the two... Nor can it be argued convincingly that capital gains should be given special treatment because they frequently are not expected or 'regular' income, but are windfalls which happen to accrue without intention. This may be the case for some gains though not for others; and even where gains are unexpected, they nevertheless add to the recipient's taxable capacity. There seems little doubt on equity grounds, that realised capital gains should be treated as ordinary income.

But what about the treatment of unrealised gains? Since AGI is defined in cash terms and includes cash income only, unrealised gains are not taxed. This is clearly in contravention of the accretion principle. According to this principle, income as an index of tax paying ability should be measured as accretion to wealth. All increments should be included, whether realised (turned into cash) or not... whether the gain is realized or not is irrelevant to whether or not there has been an increase in economic capacity. Provided that realization is possible, the decision whether or not to realise is a problem in portfolio (asset) management and not in the creation of income.

But there are three important counters to taxation of unrealized gains:
1. Unrealised gains should not be taxed because in the absence of realisation one does not know whether they really exist.
2. Taxation of unrealized gains requires the owner to pay a tax even though he has not obtained cash with which to pay it.
3. For income to be received, it must be "separated" from the asset. This view, which had much legal support on the American scene, is hard to fathom from the economist's point of view. Separation is a matter of investment choice whereas income accrues when the asset value is increased.

The aforementioned matter has relevance only with respect to the American Tax System. In India, Wealth Tax Act, 1957 takes care of, so-called, unrealized capital gains... Cf. Ibid, 245-246

Public Finance in Theory and Practice (McGraw, 2nd Edn) 246
nominal values only, they should not be taxed. To produce a meaningful index of taxable capacity, it is evident that income should be defined in real terms, i.e., that changes in the price level should be allowed for in determining taxable income. This is of special importance with regard to changes in asset value. A rise in the money value of an asset which is matched by an increase in price level is an illusory capital gain and should not be considered income..."

The judicial pronouncements and the leading commentators on public finance admit the manifold dimensions of this problem of taxation of capital gains. Edges of the fiscal legislation are being made more blunt by creating machinations through the devices of short term and long term capital gains. It is important to note that there was no distinction between a short-term and a long-term capital gain, and all capital gains were treated alike under the Income Tax Act, 1922. It is only, for the first time, that a distinction was made by the Finance Act, 1962. It was said that such a differentiation in capital gains on the basis of 'period of retention' of a capital asset would help to check speculative tendencies. It is on this basis that section 115, Income Tax Act, 1961 allows concessional treatment in the case of long-term capital gains in the case of companies.

It is submitted that this differentiation between short-term and long-term capital assets is without any justification.

73. By virtue of this Finance Act, section 2(42A) of the 1961 Act provided that any capital asset held by the assessee for a period of less than 12 months immediately before its transfer would be regarded as a short-term capital asset. The Finance Act, 1968 raised the period of holding from 12 months to 24 months. Further, the Finance Act, 1973 raised the period of holding from 24 months to 60 months. Then the Finance Act, 1977 attempted to strike a balance between the period of 2 years followed upto 1st April, 1974 and a period of five years followed with effect from that date. Hence the period of 3 years was inserted by virtue of Finance Act, 1977, wherein it was stated that it would help to check speculative transactions in capital assets as a result of which abnormal rise in prices of capital assets would also be kept under control.

74. One of the most notable features of the 1961 Act is that the rate of levy of tax on capital gains is provided for in the body of the Income Tax Act itself and is not left to be enacted by the annual Finance Acts, which had been the practice hitherto.
It is paradoxical that such a differentiation could keep a check on the speculative tendencies. The three pioneers in the field of public finance state as under:

"No distinction should be made between short-term and long-term capital gains. Any such distinction is bound to be arbitrary and an invitation to tax avoidance. We do not share the view that long-term gains have any inherent claim to more favourable treatment than short-term gains."

The recent and the leading judicial pronouncement on the new horizons of capital gains tax-imponderable over imponderables, as the judgment of the Supreme Court in CIT v. B.C. Srinivasa Setty. This case related to the computation of capital gains arising out of the transfer of self-generated assets, for example, goodwill. This judgment has far-fetched implications, which itself reveals the inherent vitality of this concept of taxation. An important principle of law has been laid down in this case that the goodwill generated in a newly commenced business cannot be described as an asset for the purposes of section 45 because so many elements go into its making and the date of its acquisition or its cost cannot be known definitely.

In Lynx Machinery Ltd. v. ITO a case decided by the Bombay Income Tax Appellate Tribunal, this Supreme Court judgment was cited without much help. The Tribunal emphasised the distinction between an existing asset and an unborn asset, that the nature of a right in lease property is different from a right in a goodwill generated in a new business.

75. Memorandum of dissent by the British economists, Mr. N. Kaldor, Mr. H.L. Bullock and Mr. G. Woodcock to the Report of the Royal Commission on 'The Taxation of Profits and Income (1955).
76. (1981) 128 ITR 294 (SC)
77. (1983) 12 Taxman 102 (Bom Trib)
78. Ibid
79. The assessee-company took an lease for 30 years a plot of land from the Calcutta Port Trust on monthly rent basis, by paying a deposit. Later, it assigned its leasehold rights to another party for a consideration. Though the ITO did not consider any part of the consideration as capital gains, the Commissioner, acting under section 263, directed the ITO to treat the entire consideration as capital gains exigible to tax.

The Tribunal held that the Bombay High Court had held
Analysing the judicial decisions, one comes across a recent and quite important subject of 'Import Entitlement' in connection with taxation of capital gains. The Calcutta High Court has held in K.N. Daftari v. CIT that receipts on account of transfer of 'export entitlement' are taxable as capital gains. On the other hand, the Madras High Court held in CIT v. T. Kuppuswamy Pillai & Co., that such receipts are not taxable as capital gains. The Kerala High Court also follows the same view as that of Madras High Court. It is to be noted that the Supreme Court's judgment in CIT v. B.C. Srinivasa Setty justifies the reasoning taken by the Madras and Kerala High Courts, that the transfer of 'export entitlement' does not attract capital gains.

79 contd. in CIT v. Tata Services Ltd. (1980) 122 ITR 594, that an assessee's right under a lease agreement did constitute 'property' and was includible in the definition of 'capital asset'. The nature of this right was different from that of goodwill of a newly commenced business in as much as it was an existing asset and not an unborn asset.

80. (1977) 106 ITR 998 (Cal)
81. (1977) 106 ITR 954 (Mad)
82. Addl CIT v. K.S. Sheikh Mohideen (1978) 115 ITR 822 (Ker)
83. Ibid
84. It is another matter, whether such receipts would attract tax in general or not. There are certain judicial pronouncements on this aspect as well. In Agra chain Mfg. Co., Ltd. v. CIT (1978) 114 ITR 840 (All) the assessee, a registered firm, carrying on business of manufacture of iron bars, aluminium chains, exported aluminium chains under the special Export Promotion Scheme for engineering goods in lieu of which it was granted certain 'import entitlements'. These import entitlements were sold by the assessee to other manufacturers during the relevant years.

The Allahabad High Court held that such receipts are taxable as trading receipts, and therefore, taxable as business income under section 28(iv).

The Calcutta High Court also took the same view in Jeewanlal (1929) Ltd. v. ITO (1981) 7 Taxmann 180 (Cal)
The theory of capital gains under the Income Tax Act, 1961, presupposes certain pre-requisites. One, the subject matter involves 'transfer' of capital asset. Two, the cost of acquisition of such an asset is determinable and conceivable. Both these requisites are cumulative. Questions of highly intricate nature are bound to arise in this field with the advancement of science and technology. Would it be proper to say that if the cost of acquisition is indeterminable, then the levy of capital gains tax does not apply?

The writer is of this opinion that in an incorporeal 'res', no yardsticks can be laid down to make the indeterminable a determinable one, though the science of law acknowledges right as 'incorporeal', whether it relates to an incorporeal or corporeal 'res'.

Paton analyses the concept of property in the following words:

"Once we speak of ownership of things which are not corporeal, where are we to stop? My reputation is a 'res' in a broad sense, but it would be straining language to say that I own that incorporeal res. It is perhaps a pity that the word 'ownership' was not confined to corporeal things and another term used where incorporeal res are concerned. It certainly is convenient to speak of ownership of a goodwill, but the goodwill is merely a mass of claims against another (or others) and a series of expectations that customers will continue to resort to the same firm... It is sometimes stated that the notion of an incorporeal thing is a refined conception of jurisprudence. It may be true that early law does not analyse with clarity, but interests in many incorporeal things are protected. Medieval law is rich in incorporeal things."

It is submitted that it is difficult to apply the ratio of Srinivasa Setty to 'export entitlement' cases. In order to make the position clear, perhaps a clause could be added in section 47 to the following effect:

85. Paton goes on to state further as under: 379-80

"...Unfortunately also, the ownership of corporeal things is sometimes spoken as corporeal ownership, as if ownership itself were tangible; ownership of incorporeal things as incorporeal ownership, as if it was the only type of ownership of this kind. Ownership is merely a relation between a dominus a res, and persons generally and relations can hardly be corporeal..."
"Sums received on the transfer of intangible assets, provided the assessee's endurance and skill created such an asset".

This submission derives strength from section 10(3) that non-recurring or windfall incomes are also exempted from the charge of income tax, provided such incomes are the result of one's own personal skill or ingenuity.

Yet certain procedural aspects also gathered much litigation, for example, the question of understated consideration. Section 52(1) had been under vigorous attack by the Revenue, where various High Courts held that in cases of 'bonafide' transfers section 52(1) does not apply, even though the transferred consideration may be less than the market value. Even though the

86. CIT v. G.Karthikeyan (1980) 124 ITR 85

87. Section 52(1) lays down as under:

"Where the person who acquires a capital asset from an assessee is directly or indirectly connected with the assessee and the ITO has reason to believe that the transfer was effected with the object of avoidance or reduction of the liability of the assessee under section 45, the full value of the consideration for the transfer shall, with the previous approval of the IAC, be taken to be the fair market value of the capital asset on the date of the transfer".

The Madras High Court observed in Sundaram Industries (P)Ltd. v. CIT (1969) 74 ITR 243 as under:

The first proviso to section 128(2) of the Income Tax Act, 1922 (corresponding to section 52(1) of the Income Tax Act, 1961) does not discourage or avoid honest transactions made out of love and affection or for other conceivable reasons on pain of being hauled up for having attempted to avoid or reduce the tax liability and on that basis made liable to tax on the difference between the consideration for the transaction and the fair market value for does it treat what is not an actual capital gain as a deemed capital gain. The court further said:

"Section 128(2) must be limited to escaped capital gain which is so in truth and in fact, and is not intended to bring about a fictional gain on an assumption and charge the same to tax.

The Karnataka High Court also took the same view in CIT v. T. Narayana Pai (1975) 98 ITR 422. In this case the CIT by virtue of his revisionary powers under section 263 applied section 52(2); that the consideration for the shares held by the assessee in a private company, which he transferred to the trust was lesser than the market value and, therefore, the consideration would be taken to be the market value itself. The shares were not completely paid-up, nor there were any ready buyers for the same. The court held that there was no material to come to the conclusion that the consideration for the transfer could be the market value itself.

The court held that there was no material to come to the conclusion that the consideration for the transfer could be the market value itself.
Supreme Court gave its final stamp on the scope of section 52(1) in two leading cases, ICI (India) Pvt. Ltd. v. CIT, West Bengal and CIT, West Bengal v. Calcutta Discount Co. Ltd., the controversy seems to be enlivened, as again the Supreme Court had the occasion to consider the same issue in K.P. Verghese v. ITO. It is interesting to note that all these cases were decided against the revenue.

In ICI (India) Pvt. Ltd., the assessee was a 100% subsidiary of ICI Ltd incorporated in the U.K. (hereinafter referred to as ICI for convenience). ICI advanced large amounts by way of losses to the assessee from time to time. This was done for subscribing to shares in three Indian Companies. Subsequently, the assessee transferred the shares in the aforesaid companies at par to ICI in satisfaction of the loans advanced by that company. The ITO applying section 52 charged capital gains.

Broadly, the case of the assessee was that ICI wanted to make investments in India in sterling currency. ICI devised a scheme by which it could make the investment as desired by it and by which it could also take advantage of the tax relief which could be availed off by the new enterprises under sections 15C and 56A of the Income Tax Act, 1922. As a result of ICI investments being held through the assessee instead of directly, ICI achieved an advantage of saving tax in U.K. amounting to £ 68,000 in the relevant years.

In 1959, the structure of Indian taxation regarding the grossing up of dividends was radically changed and by the Finance Act, 1959, the system of grossing up of dividends (under sections 16(2) and 18(5) of 1922 Act) was abolished and intercorporate dividends became liable to income tax at each stage. Thus, the dividends passing from the three companies through the assessee to ICI became liable to tax at two stages. This affected the net return of ICI on its investments in the three companies substantially. In these circumstances, it called upon the assessee to transfer to it the aforesaid shares at the issue price in satisfaction of the loans in accordance with the agreement.

88. (1972) 83 ITR 710 (SC)
89. (1973) 91 ITR 8 (SC)
90. Taxmann Vol. 63, No. 1 October, 1981 (SC)
It is abundantly clear that the intention with which a particular transfer is made and the object which is to be achieved by such transfer is essentially a question of fact the conclusion relating to which is to be arrived at on a consideration of the relevant material..."

In CIT, West Bengal v. Calcutta Discount Company Ltd the assessee-company floated a subsidiary company and transferred to that subsidiary company various shares held by it. In return the subsidiary company transferred to the assessee-company its shares of the value of Rs 1,38,81,173. The book value of the shares transferred by the assessee-company to its subsidiary was Rs 1,66,69,391. Thus the assessee-company sustained a loss of Rs 27,02,398 but it did not claim that loss in the return made on the ground that the transfer in question was made to its own subsidiary. The ITO valued the shares transferred by the assessee-company to its subsidiary at the market rate and on that basis came to the conclusion that the assessee-company must be deemed to have made a profit of Rs 1,02,40,546. In other words, according to the ITO, even though the assessee-company had not made any profits in fact, it must be deemed to have made a profit of Rs 1,02,40,546 solely on the ground that the market value of the shares transferred by the assessee-company to its subsidiary was more than their book value.

Hegde,J., while delivering the judgment of the Supreme Court held that the question is no more res integras. It is concluded by the decision of the Supreme Court in CIT v. A. Raman & Co, Shah, J. (as he then was), speaking for the court, stated the law as under:

"Counsel for the Commissioner contended that, if by resorting to a 'device or contrivance', income which

91. The two learned judges on the Division Bench of the Supreme Court in this case were Grover, A.N., Beg, M.H., JJ.

92. (1968) 67 ITR 11

93. Ibid, 17
would normally have been earned by the assessee is divided between the assessee and another person, the ITO would be entitled to bring the entire income to tax as if it had been earned by him. But the law does not oblige a trader to make the maximum profit that he can out of his trading transactions. Income which accrues to a trader is taxable in his hands; Income which he could have, but has not earned, is not made taxable as income accrued to him. By adopting a device, if it is made to appear that income which belonged to the assessee had been earned by some other person, that income may be brought to tax in the hands of the assessee, and if the income has escaped tax in a previous assessment, a case for commencing a proceeding for re-assessment under section 147(b) may be made out. Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. A taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income Tax Act. Legislative injunction in taking statutes may not, except on peril of penalty be violated but it may lawfully be circumvented.  

Kanga and Palkhivala are of the opinion that the provisions of section 52(2) are not constitutionally valid since they discriminate against those tax-payers in whose cases the market value may have risen between the date of the agreement to transfer and the date of actual transfer.

Severe impediments exists under the Income Tax Act, 1961, for example, section 50 lays down that for computing cost of acquisition in the case of depreciable assets, the fair market value of the asset on 1st January, 1964 shall be taken into consideration. It is submitted that it may be appropriate to fix the date of substitution, not with regard to a particular antique date but on a moving basis, say a period of five or seven years preceding the date of transfer. Another important point is that section 54E; though a very pragmatic approach has been enumerated by virtue of Finance Act, 1977, could be really pragmatic if the consideration of transfer may be allowed to invest in business assets, which are used for production purposes. It would be trite to observe that this measure may be more conducive in the interests of economy than the incentives given heretofore, for

example, investments in nationalised banks or equity shares of newly industrial companies.

Lastly, the theory of capital gains gets trapped in the jurisprudential cobweb, when this theory is read together with the theory of transfer. Section 2(47) of the 1961 Act lays down that 'transfer' in relation to a capital asset includes extinguishment of any rights therein or relinquishment of the asset. The vexed question is as under:

Whether existence of capital asset is necessary after such an act of relinquishment or extinguishment?

In CIT v. R.M. Amin the Supreme Court held that there was no 'transfer' of capital assets within the meaning of section 2(47) when a company went into voluntary liquidation. In other words, the Supreme Court held that existence of capital asset is necessary in order to constitute 'transfer', so as to bring within the ambit of 'extinguishment of any rights therein'.

The limitation on the convertibility of such specified productive capital asset used for business purposes may not be applied in the same manner as it is in the case of shares and securities, that is to say, the productive asset may be allowed for convertibility even within a period of three years, provided the original asset bears ample proof of convertibility.

In this instant Amin's case the assessee held 192 shares in a private company incorporated in Uganda that company was not a company falling within the definition of 'company' in section 2(17) of the 1961 Act. The company went into voluntary liquidation and during 1961, the previous year for the assessment year 1962-63, the assessee received Rs 1,84,326 in excess of the amount he had paid for those shares. The question was whether the excess of Rs 1,84,326 was taxable as capital gains in the assessee's hands under section 45 read with section 2(47) of the Act.

Khanna, J., delivering the judgment of the Supreme Court held:

"There was no transfer of capital assets within the meaning of section 2(47). When a shareholder received money representing his shares on the distribution of the net assets of the company in liquidation, he received that money in satisfaction of the right which belonged to him by virtue of his holding the shares and not by any operation of any transaction which amounted to sale, exchange relinquishment, transfer of a capital asset or extinguishment of any rights in capital assets. But for section 46(2) it would not have been possible to charge tax under the head 'capital gains' on the money or other assets of a company received by its shareholders on its
"When the assets of a company are distributed amongst the shareholders, either on a reduction of capital or in the course of the winding-up of the company, new rights are not created which is an ingredient implicit in the very concept of transfer, as laid down in the decision of the Supreme Court in CIT v. Madurai Mills Co., Ltd.);

Hence, the Supreme Court was of the view that the observations in CIT v. Madurai Mills Co., Ltd. reproduced below, made with reference to the provisions of the Indian Income Tax Act 1922, as amended by the Finance Act, 1956, held the field under the 1961 Act also:

"...when a shareholder receives money representing his share on distribution of the net assets of the company in liquidation, he receives that money in satisfaction of the right which belonged to him by virtue of his holding the shares and not by operation of any transaction which amounts to sale, exchange, relinquishment or transfer."

The current question becomes of importance when the company goes into liquidation and the assessee claims capital losses...
It is clear from the ratio of *R.M. Amin's case*, decided by the Supreme Court, that such a capital loss cannot be allowed on the ground that there was no transfer of capital asset by the assessee, as in a company going into liquidation, the words 'extinguishment of the rights therein' postulate the continued existence of the capital asset.

It is submitted that in order to resolve this impasse an Explanation to the following effect may be added below section 46,

"Explanation: Notwithstanding anything contained in section 2(47), where a shareholder on the liquidation of a company incurs capital losses, such losses shall be allowed as capital losses."

This aforementioned submission could be justifiably analysed in this sense too, that when section 46(2) creates a charge on the money received by the shareholder from the company in liquidation, then it should be equally responsive to the capital losses arising under such a situation.

**II SPECIAL FEATURES OF CORPORATE ASSESSMENT**

1) 'PERK' ASSESSMENT

There are two aspects of this intricate problem of perk assessment:

1. Allowability of the value of perk as business expenditure for the purposes of corporate assessment.

2. Assessment of the value of perk in the hands of the employee, sometimes a director-employee.

The Indian Income Tax Act, 1961, defines perquisite at two places, section 17(2) subserves the purpose for those assessee who draw salary, having employer-employee relationship. Section 40A(5) subserves the purpose for those assessee who receive such

3. Section 17(2) lays down:
   "Perquisites" includes -
   1) the value of rent free accommodation provided to the assessee by his employer;
   2) the value of any concession in the matter of rent...;
   3) the value of any benefit or amenity granted or provided free of cost or at concessional rate...;
   4) ...;
   5) ...".
perquisites by virtue of their profession. It is important to note that section 17 in its marginal heading emphasizes that the term 'perquisites' has been defined, and then further the term 'includes' occurs, which makes the ambit of this definition inclusive by its very nature. Section 17(2) is inclusive by its very nature, but Explanation 2 to section 40A(5) has no such appellation. On the other hand, Explanation 2 to section 40A(5) explains the meaning of the term perquisite. Whereas in section 17(2) the 'value' of the perquisite is the base, but in section 40A(5) the word 'value' is missing. In essence, the expenditure incurred by the employee for providing the perquisite to the employee may be much more than the bare value of the perk itself.

Few cases have come up on the meaning and scope of the words 'whether convertible into money or not' used in section 40 (a)(v) which was the predecessor of section 40A(5), which stated that any expenditure incurred by the company, which results directly or indirectly in the provision of any perquisite (whether convertible into money or not) to an employee, then subject to the ceilings laid down, such an expenditure shall be disallowed while assessing the corporate income. As a matter of fact, section 40A(5) is definitely an improvement over its predecessor, section 40(a)(v), since the terms 'salary' and 'perquisite' have been explained in section 40A(5) itself.

In CIT v. Commonwealth Trust Ltd the assessee-company contended that the house rent allowance given to its employees should not form part of the expenditure 'directly or indirectly' incurred for the purposes of computing the disallowed expenditure. The contention was that the words 'whether convertible into money or not' refer only to such perquisites which are not given in cash. Thus the question before the Full Bench of the Kerala High Court was as under:

Whether the term 'benefit, amenity or perquisite' must

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4. Explanation 2 to Section 40A(5) lays down:

"'perquisite' means -

1) rent-free accommodation provided to the employee by the assessee;

2) any concession in the matter of rent respecting any accommodation provided to the employee by the assessee;

3) any benefit or amenity granted or provided free of cost or at concessional rate to the employee by the assessee;

4) ...!

v) ..."
exhaust all advantages that an employee gets other than his salary, in view of the words 'whether convertible into money or not'.

The Kerala High Court remarked:

"It is seen to have been argued and successfully, in some cases that the words 'whether convertible into money or not' reflect on the nature of 'benefit, amenity or perquisite'. Such a qualification is said to be inappropriate in the case of a cash benefit. In other words, cash cannot be qualified by the term 'whether convertible into money or not' and, therefore, whatever may be the natural meaning of the term 'benefit, amenity or perquisite', any advantage in terms of money which may fall normally within anyone of these three must stand excluded. We notice that this argument succeeded before the

Karnataka High Court in CIT v. Mysore Commercial Union Ltd before the Calcutta High Court in CIT v. Kanan Devan Hills Produce Co.Ltd and before the Madras High Court in CIT v. Manju Shree Plantations Ltd...".

5. (1982) 135 ITR 19
6. Ibid 27-28
8. (1979) 119 ITR 431
9. (1980) 125 ITR 150. In this case of CIT v. Manjushree Plantations Ltd, the question before the Madras High Court was as under:

Whether the salary paid to an employee for the period of leave due to him can be regarded as a perquisite.

The court held that the leave allowance paid in cash would not constitute a perquisite, and consequently would not come up for disallowance in the assessment of the employer-company either under section 40A(5) or under section 40(C)(iii) of the Income Tax Act, 1961. The court drew support from its earlier judgment in CIT v. G.Venkataraman (1978) 111 ITR 444 (Mad) and a Calcutta High Court judgment in CIT v. Kanan Devan Hills Produce Co.Ltd (1979) 119 ITR 431 (Cal). It was of the view that the term 'perquisite' should normally be construed as taking within its scope only those benefits which are derived in kind.

The question of leave encashment also came up before the Madras Bench of the Income Tax Appellate Tribunal in N.B.Tendulkar v. ITO 1980 19 CTR (Trib) 271 and the Tribunal held that the entire amount received by an employee on his retirement attributable to the accumulated leave due to him is nothing but a capital receipt. However, this point of leave encashment has only academic importance, since the Finance Act, 1982 inserted section 10AA, putting it beyond doubt that neither in the case of an employee such allowance would form part of his total income, nor it shall be disallowed as an expenditure..."
The Full Bench of the Kerala High Court further held:

"...Evidently, the object of sub-clause (v) of section 40(a) is to persuade the employer to set a limit on the extent of the benefits of any kind that could be extended to an employee by an employer. The statute itself lays down the permissible limit of deduction in respect of salary and that would be incomplete unless a permissible limit of deduction is laid down in respect of other benefits that are extended to an employee. Though the words 'whether convertible into money or not' may at first sight appear to indicate that whatever is not convertible into money stands excluded from the scope of the term 'benefit, amenity or perquisite', that need not necessarily be so. The expression 'benefit, amenity or perquisite' may take in benefits in kind and in service and may take in also cash. If undue emphasis is given to the words 'whether convertible into money or not' and a restricted meaning is assigned to the term 'benefit, amenity or perquisite', that would mean that any cash allowance paid by the employer to an employee of any sum whatsoever will be entitled to deduction despite section 40(a)(v). Such a construction is irrational defeating the very purpose of section 40(a)(v). Hence, where an employee of the assessee is in the receipt of house-rent allowance, such an allowance would be covered by section 40(a)(v)."

In essence, the aforementioned judgment in CIT v. Commonwealth Trust Ltd., though rendered by virtue of section 40 (a)(v) - the predecessor of section 40A(5), justifies the provisions of the new section 40A(5), with particular emphasis on the separate Explanation thereto, enumerating the terms 'salary' and 'perquisite'.

9 contd, in the hands of the assessee-company, Thus the Allahabad High Court's decision in J.K. Cotton Spinning & Weaving Mills Co., Ltd v. CIT (1966) 62 ITR 836 to this extent that the leave encashment allowance paid to the employees would constitute an admissible business expenditure in the assessment of the assessee-company, gets an indirect statutory recognition.

10. Ibid, Headnote. The Full Bench of the Kerala High Court also held in the instant case as under:

"The definition of 'salary' in clause (4) of Rule 2 of Part A of the Fourth Schedule is incorporated in section 40(a)(v) by reason of Explanation 2. Therefore, when section 40(a)(v) uses the term 'salary', it has to be understood as excluding all allowances and perquisites other than dearness allowance. The sub-clause uses the term 'benefit, amenity or perquisite' as opposed to salary indicating that these together will exhaust what an employee obtains in return for his service...".

11. Ibid
Admittedly, the concepts of 'salary' and 'perquisites' are intertwined. It is important to note that four definitions of the term 'salary' operate under the Income Tax Act. It is with respect to salary that the quantum of perquisite is calculated. Often this vexed question has cropped up in context with the concept of 'Tax Expenditure', as to whether the number of definitions of the term 'salary' could be reduced — obviously a positive step towards rationalisation of the tax structure, without in any way detracting from the multi-dimensional objectives, which the Parliament has in view.

It is submitted that clauses (iii), (vi) and (vii) of section 17(1) dealing with gratuity, annual accretion to the credit of an employee participating in a recognised Provident Fund, aggregate of all sums comprised in the transferred balance of a recognised provident fund respectively could be omitted, as a substantial portion of all such amounts is already exempted by virtue of section 10. It would be a positive step in the direction of rationalisation of the tax structure. Similarly, the same treatment can be meted out to clauses (i) and (ii) of section 17(2). It is common knowledge that with the spate of CBDT Circulars these two clauses have lost much of their merits. Moreover, sub clause (c) of clause (iii) is not well-placed. Sub clauses (a) and (b) are in context of a director-employee or a substantial-interest holder in the company. There does not appear any valid reason for equating an employee with a director or a substantial interest-holder. Instead, doing away with clauses (i) and (ii) of section 17(2) and sub clause (c) of clause (iii), a general clause may be inserted on the lines of sub-clause (c) of clause (iii), only raising the limit of salary from Rs 1500 p.m. to Rs 2,000 p.m. as under:

12. Four definitions of the term 'salary' can be categorised as follows:
   i) First, for the purpose of subjecting to tax income, which falls to be assessed under the head 'salaries';
   ii) Second, for determining certain reliefs and fixing limits on contributions made by employers in the provident funds, etc., beyond which these would be included in 'salary';
   iii) Third, for ascertaining the value of perquisite provided in kind, which inter alia includes rent free or subsidised residential accommodation, and;
The value of any benefit or amenity granted or provided free of cost or at concessional rate by the employer (including a company) to an employee whose income under the head 'salaries', exclusive of the value of all benefits or amenities provided in kind, exceeds rupees two thousand per month.

It is submitted that the above-mentioned changes would strengthen further the provisions of section 40A(5), and the monetary value of the perquisites in excess of the prescribed limits would be disallowed in the hands of the employer company.

Another important aspect relating to the allowability of the perquisites as expenditure for the purposes of corporate assessment is in the case of a director-employee. The question is, whether section 40(c) or section 40A(5) would be applicable in the case of a director-employee. Whereas the former makes no differentiation between the limits of salary and perquisites, enumerating an upper limit of Rs 72,000 for a year, the latter enumerates an upper limit of Rs 60,000 for salary and Rs 12,000 for perquisites. Either the upper limit in totality, or separately for salary and perquisites would be beneficial in the interests of the assessee, would be clear from a special bench judgment of the Bombay Bench of the Income Tax Appellate Tribunal in Geoffrey Manners & Co. Ltd. v. CIT. In this case the total

12 contd. iv) Fourth, for determining the expenses, which are not deductible from the income assessable under the head "profits and gains of business or profession" in certain circumstances.

13. a) The first objective of the Parliament is to ensure that no payment made by the employer to an employee, being in the nature of 'salary', should escape the net of taxation.

b) The second objective is to ensure that the inclusion of items like gratuity and perquisites in the definition of salary does not cause undue hardship to an employee. Hence, rule 3 of the IT Rules, 1962, fulfils this need by defining the term 'salary' for the purpose of determining the monetary value of the perquisites in kind. In other words, it reduces the impact of including the perquisites in the definition of 'salary' under section 17(ii)(iv). On the same reasoning gratuity is exempt, within the defined limits, from tax under section 10(3), and allowance in the nature of entertainment allowance are exempt under section 10(13A).

c) The third objective is to regulate the reliefs provided to tax-payers, who derive income from salaries,
amount was Rs 56,972 having the break up as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>Rs 36,000</td>
</tr>
<tr>
<td>Rent</td>
<td>Rs 18,960</td>
</tr>
<tr>
<td>Depreciation on Furniture</td>
<td>Rs 2,012</td>
</tr>
</tbody>
</table>

It was evident that the total amount was less than the upper limit of Rs 72,000 permissible under section 40(c), but according to section 40A(5) the director-employee could have been trapped under the upper limit of perquisites of Rs 12,000. The Tribunal held that proviso to section 40(c) takes out the director-employee out of the mischief of section 40A(5).

Equitable distribution does not mean equal distribution. Upponi states:

"Equality is a mirage that no country has been able to achieve so far in an objective sense though, in a normative way, we can put into effect our notions of political economy for equitable distribution of income".

Coming to the second aspect formulated in the beginning, as to the assessment of the value of a perk in the hands of the employee, sometimes a director-employee, a very important question came up before the Bombay High Court in CIT v. H.D. Dennis. Mr. Dennis was an expatriate employee of Caltex (India) Ltd., being a citizen of USA. In addition to his salary, he was provided rent-free unfurnished residential accommodation by the employer-company. A portion of his tax liability in India in respect of the salary income from the employer-company was borne by the employer-company, so as to place him in the same tax position as

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13 contd., for example, annual accretions to the credit of an employee participating in a recognised provident fund,

14. I.T.A. No. 1296(Bom), 1976, reported in April, 1976, Taxation

15. Upponi, Tax Jurisprudence (Taxmann, 1982), 26-27

16. (1982) 135 ITR 1
an individual of like status employed in his home-country. The employer-company thus reimbursed to the assessee a portion of his tax liability in India and also bore the additional tax becoming payable by him on such reimbursement of the part tax. This was a part of the general policy of M/s Caltex, though there was no contract to this effect between the company and the assessee.

It is important to note that this Dennis case pertains to the position prevailing before the amendment in 1974. At that time Explanation 2 to rule 3, Income Tax Rules, 1962 defined 'salary' excluding dearness allowance etc. In terms of the above provision, the point which arose for consideration was whether the value of rent perquisite was to be taken either at:

1. 10% of the salary, or
2. 10% of the salary plus 10% of the tax borne by the employer.

It was common ground between the parties that the amount of tax borne by the employer-company was chargeable under the head 'salaries' under sections 15 and 17 of the Act. The only narrow point to be considered was whether this amount of tax borne by the employer was to be included in 'salary' as defined in Explanation 2 to Rule 3 for the limited purpose of determining

To the extent of the amount of the tax which would work out at the rates prevailing in his home-country on the amount of the remuneration earned in India, the assessee had to pay the tax. The excess of the tax liability in India was to be borne by the employer-company and so also the tax on tax becoming payable thereby.

The relevant particulars as regards the salary income and tax benefits relating to Mr Dennis for the accounting year, April 1, 1962 to March 31, 1963, were as under:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary from the employer</td>
<td>1,22,475</td>
</tr>
<tr>
<td>M/s Caltex (India) Ltd</td>
<td>1,86,254</td>
</tr>
<tr>
<td>Amount of tax borne by the employer</td>
<td></td>
</tr>
<tr>
<td>Other salaries (from Coril)</td>
<td>1,28,926</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>4,37,655</td>
</tr>
</tbody>
</table>

Explanation 2 to Rule 3 defined 'salary' for the said purpose as under:

"Explanation - for the purpose of clauses (a) and (b)...
2) 'salary' includes the pay, allowance, bonus or commission payable monthly or otherwise, but does not include the following, namely:

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17. [Footnote]

18. [Footnote]
the value of rent-free perquisite. The Tribunal held that the amount of tax liability of the assessee borne by the employer-company inclusive of tax on tax was not salary for the purpose of said Rule 3, and the same could not be taken into account in determining the value of perquisite. The Tribunal gave, inter alia some cogent reasonings as under:

"On the theory that the more specific excludes the general, if any sum paid by the employer fits into the specific definition of 'perquisites' as provided in section 17(2) (iv), then it must be understood as perquisites and not as, "profits in addition to any salary", as referred to in section 17(1)(iv)."

The Bombay High Court held:

"It is obvious from the aforesaid rules that the definition of 'salary' in Rule 3 is an inclusive one, and therefore, it is not restricted to what is included in the said definition. The device of inclusive definition is employed by the legislature with a view to enlarge the meaning of the ordinary words and hence the rule of interpretation of such definition adopted by the courts is to read the word defined so as to enlarge its meaning and not to restrict it to the words included in its inclusive part unless the context otherwise requires..."

18contd. i) Dearness Allowance or dearness pay unless it enters into the computation of super-annuation or retirement benefits of the employee concerned;

ii) employer's contributions to the provident fund account of the assessee;

iii) allowances which are exempted from payment of tax;

iv) any allowance in the nature of entertainment allowance to the extent such allowance is deductible under clause 2 of section 16.

With the amendment in 1974 under rule 3 salary includes pay, allowance, dearness allowance, bonus and commission payable monthly or otherwise, but does not include perquisites. Employer's contribution to the provident fund is also excluded.

19. The Tribunal gave the following reasons:

"(1) the legislature and the rule-making authorities did not intend to give the same meaning to the expression "salary" for purposes of section 17 of the Income Tax Act, 1961 and for purposes of Rule 3 of the Income Tax Rules, 1962. The definition of "salary" as given in Explanation 2 to Rule 3 is an independent definition and no analogy can be drawn from the separate definition of that term as given in section 17...

20. Ibid, 10-12
Therefore, the two definitions will have to be construed as co-extensive in their scope except so far as there is an express exclusion of some of the payments which otherwise go with the word "salary". If the legislature did not want to exclude the said allowances and contributions, it would not have been necessary to give a separate definition of salary under the said rule...".

Thus the Bombay High Court held that the amount of tax borne by the employer was to be included in 'salary' for the limited purpose of determining the value of perquisite. The court followed the established practice in England that if a salary is paid tax-free, the real salary of the employee is the actual salary received by him plus such sum that when the tax is levied upon the total amount, the net amount left after tax will be the amount of the salary. It matters not for this purpose that the tax is paid under a contract or voluntarily by the employer, according to custom.

Yet, another important aspect is the 'value of an option'. Indian fiscal legislation is yet to realise the ramifications of 'workers participation in management'. Though the relevant legislations, for example, Companies Act, 1956 and Industrial Disputes Act, 1947 are in the process of acknowledgement of this concept of 'industrial democracy', but the Income Tax Act, 1961 would have to give practical shape to such a phenomena. Where an

21. Jaworski v. Institution of Polish Engineers in Great Britain, 1950, 2 All ER 1191 (CA)

22. In North British Railway Company v. Scott (1922) 8 TC 332 (HL) a contract was entered into by the company with its employees to pay the salary free of income tax. The House of Lords held as under:

"If the employer did not set off this sum against the employee's salary, the latter would simply pocket his full salary, his debt to the revenue having been paid by another, not by himself, that is all".

23. In Hartland v. Diggines (1926) 10 TC 247 (HL) in accordance with custom, the income tax payable by the employee was paid by the employer-company. The House of Lords held:

"In effect what the employee has received is the money paid into his hands plus the immunity, i.e. the immunity from paying the tax. The substance of the matter was that the salary paid to the employee is not all that he received. He had received, in addition, money's worth to the extent of the sum which was paid in respect of that salary to the revenue...".
option is granted to an employee to purchase unissued shares or right shares in a company, such an option is a valuable right having a potential value. The value of the option would be the value of the perquisite, which would be the difference between the market value of the share as on the date of the acceptance of the option and the price at which the company offers the shares to the employee.

In *Abbott v. Philbin*, the House of Lords held that the option itself is the perquisite and not the shares that are acquired later in pursuance of the exercise of such an option. Perhaps the law could move ahead of the casting shadows by incorporating under section 10, as under:

"Value of perquisite by way of difference between the market value and the value at which the employee has been provided with an option to purchase shares in the company in which he is working."

It is submitted that it would be a positive step towards the concept of 'industrial democracy'.

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24. 39 TC 82 (HL). In the instant case the employee was offered shares at a price of £ 1 for every 100 shares in option to purchase 2,000 shares at the price of 68 s 6 d per share. The employee applied for 2,000 shares. Thereafter the price of the company's shares rose to 82 s per share and then the employee exercised his option to buy 250 out of 2,000 shares at the price of 68 s 6 d per share. The department taxed the assessee on £ 166 5 s arrived at as under:

<table>
<thead>
<tr>
<th>Market value of 250 shares @ 82s per share</th>
<th>£  s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduct i) option price @ of 856 5</td>
<td>1025</td>
</tr>
<tr>
<td>ii) cost of option @</td>
<td></td>
</tr>
<tr>
<td>£ 1 for every 100 shares, for 250 shares</td>
<td></td>
</tr>
</tbody>
</table>

Lord Reid delivering the judgment of the House held that this was a wrong method to arrive at the valuation. The correct method of arriving at the value of the perquisite was to estimate the market value of the option on the day such an option was exercised and accepted, and to deduct therefrom the price that the employee paid for it.
ii. EXPENDITURE, REVENUE OR CAPITAL

Indubitably, the splitting up of expenditure as revenue expenditure or capital expenditure has contributed much in its mite to the judge-made law. No definite answer can be given on this subject, as to when it would be ascribed as capital or revenue expenditure. The only important and decisive test is the agreement between the parties—its terms and the purpose for which such an expenditure being incurred. Obviously, the 'purpose' rolls into its net the theory of intention.

In one of the leading pronouncements, CIT v. Ciba of India Ltd., the expenditure made by the assessee-company on technical 'know-how' was held to be on revenue account. The relevant facts were that the assessee-company was an Indian subsidiary of the Swiss company, which granted to the assessee right and licence to use the patents and trade marks of the Swiss company. Some of the material clauses of the agreement were as under:

i) not to divulge to third parties any confidential information received under the agreement, without the consent of the Swiss Company;

ii) not to assign the benefit of the agreement or grant sub-licences of the patents and trade-marks of the Swiss Company, without its written consent;

iii) upon the termination of the agreement, for any cause, would end the use of the patents and trade marks and all copies of information, scientific data or material would be returned to the Swiss company.

In consideration of the right to receive technical 'know-how' the assessee agreed to make contributions of 5%, 3% and 2% respectively of the net sale price of the products sold by the assessee towards i) technical consultancy and technical service rendered and research work done; ii) cost of raw material used for experimental work; and iii) royalties on trade marks used by the assessee. The agreement was to remain in force for a period of five years, and was liable to cancellation by either party if the other party failed to observe the provisions of the agreement.

25. (1968) 69 ITR 692 (SC)
On these facts, the Supreme Court held that the contribution made by the assessee was on revenue account, because the assessee was not entitled, even for a limited period, to the patents and trade marks of the Swiss company. The Indian company was a mere licensee for a limited period in respect of technical knowledge, coupled with the right to use patents and trade marks. The most tangible argument which came to the rescue of the assessee—company was that the Swiss company did not part with any asset of its business and retained the control, explicitly or implicitly, over the patents and trade marks.

Various High Courts followed this Supreme Court's judgment, much to the relief of Indian Collaborators and chagrin to the Revenue; perhaps an incentive in its own wake for foreign collaborations.

Incidentally, the Bombay High Court following Ciba of India allowed all the expenditure incurred in connection with an exploratory mission abroad intended to finalise the collaboration agreement on revenue account in Anti-friction Bearings Corporation Ltd. v. CIT.

In CIT v. Associated Electricals Industries (India) P Ltd. (1975) 101 ITR 844 (Cal) though the new machinery acquired under foreign collaboration was not installed for the purpose of manufacturing electrical motors, and the production continued with the existing machinery, but the Calcutta High Court held that the amount paid by the assessee to the foreign collaborators under the agreement was a revenue expenditure. The department cited, without much help, an Andhra Pradesh High Court judgment in Hylam Ltd. v. CIT (1973) 87 ITR 310 (AP). In Hylam Ltd. v. CIT the assessee made two agreements with foreign collaborators. Under the first one, the assessee was given a licence to use the patents of the foreign company, during the entire life of the patents, in consideration of royalty based on a percentage of the assessee's turnover, subject to a ceiling of £5,000. Under the second agreement, technical
On the other hand, there are at least three High Court cases, in which the expenditure was held to be on capital account.

1. *Fenner Woodroffe & Co, Ltd. v. CIT*
2. *Mysore Kirloskar Ltd. v. CIT*
3. *CIT v. Southern Structural Ltd*

While giving the decision in *Mysore Kirloskar*, the Mysore High Court relied on an oft-quoted judgment of the House of Lords in *Rolls-Royce Ltd. v. Jeffrey*. Generally speaking, the criteria which are invoked in distinguishing between capital receipts and income receipts also serve to distinguish between capital expenditure and revenue expenditure.

Though this *Rolls-Royce case* was, on the 'receipt' basis, but the principles would be equally applicable to 'disbursement' basis. The facts of *Rolls-Royce* were that the company was incorporated in 1906 and had ever since carried on the trade of manufacturing and selling motor cars. During the First World War, the company began to manufacture air crafts engines, and the manufacture and sale of air crafts engines became the larger part of the company's trade. All this while, the company was also engaged in metallurgical research and in the discovery and development of engineering techniques and secret processes, and as a result of its extensive researches, had acquired a large fund of technical knowledge, which it called as its technical 'know-how'. A part of its technical knowledge was also patented.

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26 contd. assistance was to be provided for the construction of the plant, and the process of manufacturing, in consideration of a consultancy fee at a percentage of the net sales of the product.

The Andhra Pradesh High Court held that the royalty under the first agreement, and a portion of the consultancy fee relatable to the plant under the second agreement had resulted in 'enduring benefit' to the assessee, and were therefore capital expenditure.

27. *Ibid*
28. *(1978) 114 ITR 335*
29. *(1976) 102 ITR 665 (Mad)*. In the instant case the assessee received technical 'know-how' for the manufacture of leather belting, in consideration of fees based on a percentage of the invoice price of the product sold. The Madras High Court disallowed the payments, as the relatable expenditure brought in an enduring advantage-technical data and assistance.

30. *(1968) 67 ITR 23(Mys)*
31. *(1977) 110 ITR 890 (Mad)*
32. *(1978) 114 ITR 335*
However, with one or two exceptions, due to certain exigencies of the period immediately before the war in 1939, the company could not turn its 'know-how' to account except in its own manufacturing trade. But during the post-war period, 1946 to 1953, the company entered into a number of agreements with various foreign companies, under which, in consideration of lump sum payments, the company undertook to supply them necessary drawings and information to enable them to manufacture specified types of aircraft engines. It is important to note that proposals for the agreements had not been initiated by the company itself, but had come to it from various foreign companies.

The company received various sums under these agreements. It conceded that in so far as payments from royalties and sale of patent rights were concerned, they could be included in its assessments, but lump sums amounts could not be included. The Inspector of Taxes, however, did not agree and included the lump sum payments also in the assessments.

The company appealed to the Commissioners contending inter alia, that the lump sums paid to the company under the provisions of the licence agreements related to the sale of a capital asset, viz. 'know-how', and that a multiplicity of sales of portions of a fixed capital asset (know-how) could not of itself convert that asset or any part of it, into a revenue or trading asset and that therefore, lump sums received by it did not form part of trading income.

33. Dalmia Dadri Cement Ltd. v. CIT 74 ITR 484, 489
34. The contention taken up by the company was:
   a) that the business of the company consisted of manufacture and sale of motor cars and aero-engines and not of sale of know-how;
   b) that the metallurgical engineering research upon which the company had throughout its life been engaged was at all times directed exclusively to the more efficient production of motor cars and aero-engines and not at all to the earning of profits by selling or licensing the results of that research;
   c) ...
35. 'Know-how' had been considered as capital asset in Evans Medical Supplies Ltd. v. Moriarty 37 TC 540
The Commissioners held that all lump sums, however
described, received by the company under its agreements were capital
receipts. The Crown appealed to the High Court. Pennycuick, J.,
36 dismissing the appeal held as under:

"In my judgment... in each case the company, having a
capital asset consisting of technical knowledge, or
'know-how' communicated that asset to another party,
with the natural consequence that at least as regards
the territory of that party the asset must lose the
whole or the greater part of its value...".

The Crown took the matter in further appeal to the court
of Appeal, where the judgment of Pennycuick, J., was unanimously reversed, Lord Justice Pearce held as follows:

"It is clear that the policy of issuing licences for
royalties was deliberate and continuous, and that the
dissemination of technical knowledge to the licencees
was a desirable, or even an essential part of the issue
of licences. In each case there was no allocation of the
lump sum to the disclosure of technical knowledge. That
knowledge was but one of the benefits conferred by the
agreements. The training of staff and interchange of
employees was also of great importance. Can it be said
that the mere fact that the imparting of technical
knowledge was one of the considerations, and probably
a major one, the payment of the lump sum takes them
out of the category of trading receipts, when the rest
of the agreement is devoted to producing trading
receipts?"

36. Ibid, 480
37. Ibid, 485-86. Lord Justice Pearce further held as
under:

"The knowledge sold in this case is not some secret
of permanent value sold by an owner who is transferring
or terminating his business. Such a sale would clearly
be the sale of a fixed asset. The knowledge sold
in this case is in the main the transient by-product of
advancing engineering science. It accrues automatically
from the company's business of manufacture, and in a
comparatively short time it is superseded and loses
its value. It is ever growing, ever changing. It is
the kind of knowledge which can easily merge its
character of a fixed asset into that of a trading asset.
The secret knowledge is the more transient since it
becomes more quickly obsolete".
Upjohn L.J., distinguishing his judgment in Evans Medical, held as under:

"Apart from the fact that in each case the subject matter of the transaction was in part a disposition of 'know-how', the two cases bear but little resemblance to one another. There is indeed much difference even in the nature of the 'know-how' in the two cases..."

The company then appealed to the House of Lords, where also it lost. Lord Reid held as under:

"There is nothing in the case to indicate that capital asset was in any way diminished by carrying out these agreements...If it had not made these agreements, it would have got nothing from these countries, by making them it was able to exploit its capital asset by receiving large sums for its use there. In essence, what it did was to teach the 'licences' how to make use of the 'licences' which it granted".

Lord Radcliffe held:

"I appreciate its point that such monies are not derived from its own operations of manufacture and therefore, if assessable at all, must be attributable to a new and separate trade consisting of the exploitation of 'know-how' for reward. But this, with all respect, is a verbalism and I think that the Crown were right in saying that the company's new way of exploiting 'know-how' was no more than development of its direct manufacturing trade and did not rank, or need to rank, as a separate business..."

Thus an important principle of fiscal law was laid down by the House of Lords in this case. A transaction of purchase and resale which standing by itself may not have been in the nature of trade, may, by virtue of multiplicity of transactions, lose its capital nature, and the repeated transactions may jointly constitute a trade or may constitute a series of adventures in the nature of trade.

Ibid

38. Ibid
39. Ibid, 486. Upjohn, L.J., went on to observe: "In the Evans Medical case, the 'know-how' was the knowledge which would make large-scale manufacture of medical products possible in Burma. It consisted, not in secret medical compositions, but in secret methods of preparation of known products and in methods of storing and packaging, particularly in hot climates...The fundamental difference between the two cases rests, of course, in the manner in which the company has dealt with the disposal of its knowledge and experience in the manufacture of aero-engines. In the Evans Medical case 37 TC 540 the transaction was isolated and special... In this case it is not possible to reach such a conclusion. The lump sums were aid not onl to secure 'know-how' but
It is submitted that the principles to differentiate between capital disbursement and revenue disbursement are so vacillating that the courts could easily trap themselves into the cobweb of either 'enduring advantage' test or 'fixed capital' test. It is submitted that the right to use patents and trade marks or to use the advanced techniques of science and engineering cannot be equated with 'enduring advantage'. In this age of rapid strides in science and technology, the life of any research or innovation is too transient to label as 'enduring'.

The Supreme Court laid down a very important principle in Travancore Sugars & Chemicals Ltd. v. CIT* that an annual payment based on a percentage of the turnover and unrelated to any fixed sum, would be on revenue account even if it is for acquiring a capital asset. In order to appreciate this principle, the relevant facts were, that the promoters of the assessee-company which was floated to take over the assets of certain undertakings, run by the Government of Travancore, entered into an agreement with the Government, whereby the assets of a Sugar Manufacturing concern, a distillery and a tincture factory were agreed to be sold by the government to the assessee-company. The consideration for the sale of the assets of the Sugar manufacturing concern was Rs 3.25 lakhs, the consideration for the sale of the distillery was agreed to be arrived at as a result of joint valuation by engineers to be appointed by the parties and that for the sale of the assets of the tincture factory was the book value. The government agreed to recognise the transfer of the licence for the distillery to the assessee, and to secure the continuance of the licence for a period of 5 years after the termination of the existing licence, and also to purchase the pharmaceutical products manufactured by the assessee in the tincture factory to meet its

39. contd. other benefits...

40. Ibid, 492

41. The judgments in Hylam Ltd. v. CIT(1978) 87 ITR 310 (AP) Supra fn. 26; Fenner Woodroffe & Co. Ltd. v. CIT(1976) 102 ITR 665 (Mad), Supra fn., 29; or in Mysore Kirloskar Ltd. v. CIT (1968) 67 ITR 23 (Mys) are too glaring to ignore.

42. (1966) 62 ITR 566 (SC)
Apart from the cash consideration, the government were entitled to 20% of the annual net profits subject to a maximum of Rs 40,000 after providing for depreciation and remuneration of the secretaries and treasurers. In January, 1947, instead of 20%, government's entitlement was reduced to 10% of the annual net profits. In the assessment year 1958-59, the government became entitled to Rs 42,480 on the basis of 10% of the annual net profits. The question for consideration was, whether the said payment was deductible on revenue account by the assessee-company.

The Supreme Court was impressed, in particular, with the following two considerations:

1. The payment of the commission was related to the annual profits which could flow from the trading activities of the assessee and the payment had no relation to the capital value of the assets; and,

2. The annual payment of 20% was not related to or tied up, in any way, to any fixed sum agreed between the parties as part of the purchase price of the three undertakings.

The Supreme Court pointed out:

"...It is not easy to distinguish whether an agreement is for the payment of price stipulated in instalments or for making annual payments in the nature of income. The court has to look not only into the documents but also at the surrounding circumstances so as to arrive at a decision as to what was the real nature of the transaction from the commercial point of view...The name which the parties may give to the transaction, which is the source of the receipt and the characterization of the receipt by them are of little consequence. The court has to ascertain the true nature and character of the transaction from the convenants of the agreement tested in the light of surrounding circumstances."

43. The government was also entitled to nominate a director on the Board of Directors of the assessee-company, but he did not have voting power or the right to interfere with the normal management and the books of the assessee-company were open to inspection by the authorised government officers.

44. Ibid, 570-571
While laying down the aforementioned principle, the Supreme Court further observed:

"The mere fact that the capital sum is payable by instalments spread over a certain length of time will not convert the nature of that payment from the capital expenditure into a revenue expenditure, but the payment of instalments in such a case would always have some relationship to the actual price fixed for the sale of the particular undertaking. As we have already mentioned, there is no specific sum fixed in the present case as an additional amount of price payable in addition to the cash consideration and payable by instalments or by any particular method".

It is interesting to note that a second round of litigation took place - CIT Kerala v. Transvancore Sugars & Chemicals Ltd., and the principle of 'overriding title', a fortiori, was applied in favour of assessee-company by the Supreme Court. Jagannohan Reddy, J., delivering the judgment of the Supreme Court held:

"Where by the obligation income is diverted before it reaches the assessee, it is deductible. But where the income is required to be applied to discharge an obligation after such income reaches the assessee it is merely a case of application of income to satisfy an obligation of payment and is therefore not deductible. Whether as revenue expenditure or as an overriding charge of the profit making apparatus or as laid out and expended wholly and exclusively for purposes of trade, the answer must be in the affirmative and against the revenue".

The following passage from this judgment has become classic on many aspects of fiscal legislation.

45. Ibid, 571
46. (1973) 89 ITR 1(SC). Because on the first occasion the Supreme Court allowed the appeal in favour of the assessee and remanded the case for being reheard and dealt with in accordance with the directions given in that judgment. After the matter went back, a Division Bench of the Kerala High Court, Raghavan, J., (as he then was) and Issac, J., heard the matter but as there was a difference of opinion between the learned judges, the case was placed before Mathew J (as he then was) who agreed with the judgment of Raghavan, J., this was an appeal against that judgment by certificate.
47. Ibid, Headnote
"In considering the nature of the expenditure incurred in the discharge of an obligation under a contract or a statute or a decree or some similar binding covenant, one must avoid being caught in the maze of judicial decisions rendered on different facts and which always present distinguishing features for a comparison with the facts and circumstances of the case in hand. Nor would it be conducive for clarity or for reaching a logical result if we were to concentrate on the facts of the decided cases with a view to match the colour of that case with that of the case which requires determination. The surer way of arriving at a just conclusion would be to first ascertain by reference to the document under which the obligation for incurring the expenditure is created and thereafter to apply the principle enshrined in the decisions of those facts. Judicial statements on the facts of a particular case can never assist courts in the construction of an agreement or a statute which was not considered in those judgments or to ascertain what the intention of the legislature was. What we must look at is the contract or the statute or the decree, in relation to its terms, the obligation imposed and the purpose for which the transaction was entered into."

In CIT v. Belpahar Refractories Ltd., the Didier Works AG., a German company, was one of the collaborators of the assessee-company. The authorised capital of the assessee-company, a public limited company was Rs 5 crores. The German company had agreed to take shares of not less than Rs 70 lakhs to be contributed thus:

a) Rs 30 lakhs by providing an equivalent proportion of the purchase prices of machinery and equivalent required for the plants;

b) the remaining Rs 40 lakhs by instalments equivalent to the amounts payable to the German Company under any of the following heads:

i) engineering fee payable under clause 3 of the agreement;

ii) percentage of net profits as set out in clause 8 of the agreement; and

iii) any dividends payable on the share-holding of the German Company until the full equivalent of the said Rs 40 lakhs shall have been appropriated.

Clause 8 of a separate agreement provided that by way of remuneration for the rights and technical information and services
given and provided or agreed or covenanted to be given and provided under this agreement, the German company shall be paid in rupees the remuneration @ 6½% of the yearly net profits for a period of 8 years. In terms of this remuneration clause, the German company was paid certain amounts in the assessment years 1962-63 to 1966-67.

The Tribunal allowed the claim holding that though the said payments had ultimately brought into existence a capital asset, yet the expenditure was revenue in character in view of the rule indicated in Travancore Sugars & Chemicals Ltd. v. CIT. 49

Curiously enough, the Orissa High Court disallowed the claim, while distinguishing the Travancore Sugars & Chemicals, 50

"...The court was impressed by the fact that this was not a case of payment of a part of the consideration money by spreading it over a number of years, and the payments lost connection with the capital asset. But, in the present case, as already found, a capital asset had been acquired and the amounts in dispute were payments for it. The link between the payments and the acquisition of asset was direct".

It is submitted that whenever a payment is based on a percentage of yearly net profits, and that too, for a limited period, as in Belpahar Refractories, it necessarily has no relation to the capital asset or its value. It cannot be estimated at the time of agreement, as to what the profits would be over a period of years. Neither the capital value of the 'emerging' assets can be found out. The Orissa High Court incorrectly distinguished the Travancore Sugars & Chemicals for that reason.

Moreover, it is an established principle of fiscal law that if it constitutes capital expenditure, depreciation and other relatable allowances would be allowed by virtue of the extended definition of 'plant' enumerated in section 43(3) of the Income Tax Act, 1961. The writer is of this opinion that expenditure incurred in making the payment to foreign collaborators could have been...

49. (1966) 62 ITR 566 (SC)
50. Ibid, Headnote
allowed as revenue expenditure by virtue of a specific statutory
definition of 'foreign collaboration' which would be in conformity
with both the decisions of the Supreme Court in Travancore Sugars
& Chemicals Limited, as under:

Section 2-definitions:
"Revenue Expenditure' includes -

a) An annual payment based on a percentage of the turnover
or net profits, and unrelated to any fixed sum, even if it is for
acquiring a capital asset.

b) An annual payment diverted by virtue of an overriding
charge of the profit-making apparatus, before it reaches the
assessee."

It is submitted, that such a provision in section 2 itself
would dispense with much of the prolific litigation, mostly related
to foreign collaborations. Perhaps it would not be much to say
that it would act as a fillip towards encouragement of foreign
collaborations.

111. EXPENDITURE EXCLUSIVELY FOR THE PROMOTION OF BUSINESS

It is one of those significant areas which is ridden with a
plethora of case law, thus speaks of the enormity of this provision
of law.

Considering the concept of 'commercial expediency', the court
of Appeal held in British Sugar Manufacturers Ltd v. Harris.

Travancore Sugars & Chemicals Ltd v. CIT, Kerala (1966) 62
ITR 566 (SC); CIT, Kerala v. Travancore Sugars & Chemicals
Ltd (1973) 88 ITR 1 (SC)

(1938) 2 KB, 220. In the instant case, the company was
carrying on business as manufacturers of beet Sugar, had
agreed to pay to two companies, also its shareholders, 20%
of its net profits in consideration of technical and
financial knowledge and experience and disposal of the
company's products.

The question for consideration before the court of
Appeal was, whether the payment out of the profits was an
'expenditure' or 'division of profits'. Reversing the
decision of Finlay, J., the court of Appeal held it as
deduction as being wholly or exclusively laid out or
expended for the purposes of the trade.

Sir Wilfred Greene, M.R., of the Court of Appeal held (Ibid,
233-34).

"Now bearing all those things in mind, the question
arises: On which side of the line does the case fall? I
quite accept the proposition that there is a line between
a contract for payment of a share of profits simpliciter
and a payment of remuneration which is deductible in truth
"The test of commercial expediency cannot be reduced in the shape of ritualistic formula, nor can it be put in the water-tight compartment so as to be confined in a strait-jacket. The test merely means that the court will place itself in the position of a businessman and find out whether the expenses incurred could be said to have been laid out for the purpose of the business or the transaction was merely a subterfuge for the purpose of sharing or dividing the profits ascertained in particular manner.

Cardozo states in his novel work "The Nature of the Judicial Process" that even a single significant detail may alter the entire aspect. One should avoid the temptation to decide cases by matching the colour of one case against the colour of another.

Perhaps, the dictum of Jagannmohan Reddy, J., in CIT.Kerala v. Travancore Sugars & Chemicals Ltd., is equally pertinent to quote:

"...Judicial statements on the facts of a particular case can never assist courts in the construction of an agreement or a statute which was not considered in those judgments or to ascertain what the intention of the legislature was...".

Admittedly, Section 37 of the 1961 Act enumerates the word 'General' in its marginal heading. Often this vexed question has arisen, as to what is the nature and scope of the 'generalization' of such business deductions; more so, when the intention of the legislature could be relied upon by the courts deriving support from a precedent. Allen states, while emphasising the necessity for a jurisdiction supplementary to law, as under:

"Law and justice exist for the regulation of actual rights and duties; and the incompleteness of the generalization, which is certain to make itself felt at some point or other, may produce results which are antithetic to the very purpose of the generalization".

52 contd., before the profits divisible are ascertained, and that line in some cases may be very difficult to draw".

In the same case, Romer L.J. observed: "In such cases the real question is: Is the payment that has to made by the trader under contract which is in question, in truth, a mere division of profits with another party; or is it in truth payment to the other party the amount of which is ascertained by reference to the profits?*

54. (1973) 88 ITR 1(SC)
One such instance of 'generalization' could be seen in the Supreme Court's decision in CIT v. Gemini Cashew Sales Corporation. This case related to the liability of an employer to pay compensation to the employees under section 25 FFF read with section 25F of the Industrial Disputes Act, 1947, consequent upon transferring the undertaking to others. The Supreme Court held the liability, applying the principle of basis of accrual of liability, to be not one arising in the course of the employer's business, because the liability did not arise during the period the employer carried on the business. The payments did not constitute business expenditure, because the expenditure incurred at the time of or for the purpose of closing down a business could not be considered as expenditure incurred 'for the purpose of the business'.

The aforementioned Supreme Court's judgment has been followed in a recent judgment of the Calcutta High Court, Binani Printers (P) Ltd. v. cit. The material facts of Binani Printers were that the assessee-company, engaged in the business of printing and publication of a journal, was sustaining heavy losses in the printing establishment and decided to close down the entire printing establishment. Consequently, it issued a general notice to the employees: (i) that the printing establishment would be closed down and the services of all workers borne on the pay roll of the printing establishment would be terminated with effect from 1.7.1968; (ii) that they would all be paid their dues including notice pay and compensation in accordance with section 25 FFF read with section 25F of the Industrial Disputes Act, 1947; and (iii) that they should collect their dues on 1.7.68.

56. (1967) 65 ITR 643
57. The Supreme Court holding that the liability for paying retrenchment compensation was contingent during the existence of the business as it arose only after the closure of the business, observed as under: Ibid, 649

"Broadly stated, the present value on commercial valuation of money to become due in future, under a definite obligation, will be a permissible outgoing or deduction in computing the taxable profits of a trader, even if in certain conditions the obligation may cease to exist because of forfeiture of the right. Where, however, the obligation of the trader is purely contingent, no question of estimating its present value may arise, for to be a permissible outgoing or allowance, there must in the year of account be a present obligation capable of commercial valuation."

(1983) 13 Taxmann 215 (Cal)
Accordingly on 1.7.68, the assessee paid to the concerned employees certain amounts as retrenchment compensation and notice pay and claimed deduction of these amounts as business expenditure. In the relevant accounting year, the assessee carried on the other business viz. the publication business.

The Calcutta High Court held that the following decision arrived at by the Tribunal was correct:

"It is now settled law that 'for the purpose of business' means for 'the purpose of enabling the assessee to carry on business', vide the decision of the Supreme Court in Liquidators of Pursa Ltd. v. CIT. Retrenchment compensation and pay in lieu of notice were paid by the assessee under section 25 FFF of the Industrial Disputes Act, 1947, not for the purpose of carrying on the business but with a view of winding-up or close down the business. Such repayments cannot, therefore, be regarded as business expenditure...".

It is submitted that the Calcutta High Court's decision in Binani Printer's is an incorrect decision. At least on two points, it can be easily distinguished from Gemini Cashew Sales Corporation. First, the assessee continued with its another business of publication; second, the workmen who were borne on the pay rolls of the appellant till 30.6.68 and the business was not closed down on that date. Hence the payment of the amount due on 1st July, 1968 to the workmen were not contingent liabilities, and they were definitely in the nature of ascertained liabilities.

The writer is of this opinion that in such cases the constrained interpretation of the expression 'for the purpose of the business' as 'for the purpose of enabling the assessee to carry on business' has been responsible for much of the forensic Syndrome. Could it be more antithetic to the spirit of fiscal law, that workers are being paid their due, but the employer has to pay tax on such payments too?

59. Ibid, 217
60. (1954) 25 ITR 265
It is submitted that the expression "for the purposes of the business" may be substituted by the expression "for managing the business operations" in section 37(1) of the Income Tax Act, 1961.

Perhaps, it is appropriate at this stage to quote the recommendation of the Chokshi Committee on this enormity of law. The committee observed:

"We are of the view that the general provision in section 37(1) should have primacy in the scheme of computation of income from business or profession and should come immediately after sections 28 and 29. The other sections which specifically refer to certain items of expenditure do so either with a view to illustrating the categories of business expenditure or, alternatively to identify certain items of business expenditure in order to place restrictions upon the allowability of such expenditure. For example, in dealing with deduction for repairs, sections 30 and 31 refer to expenditure on current repairs; while dealing with interest, section 36(1)(iii) refers to monies borrowed for the purposes of the business; etc. It appears to us unnecessary to place restrictions of this nature on the allowance of business expenditure. In our view, the sole test for allowance of business expenditure should be that laid down in section 37(1), namely, whether the expenditure is laid out or expanded wholly and exclusively for the purposes of the business or profession not being capital expenditure or personal expenditure."

61. Direct Tax Laws Committee (Final Report) Sep 1978 Para 1-8,9, 51. This report is popularly known as Chokshi Report, after the name of its Chairman.