Analysis of four important decisions – July to September 2013

By CA Anant. N Pai

(1) Business Income :- [Section 28 (1)] – *Security deposit collected in sales invoice towards possible levy of sales tax on packing charges is not trading receipt.*

Dalmia Cement {Bharat} ltd. vs. CIT [2013] 36 taxmann.com 358 (Delhi)

In the case before the Delhi High Court, the assessee had collected refundable security deposits from its trade customers towards possible levy of sales tax on packing charges. At the time of collection, levy of sales tax on packing charges was a pending dispute before Courts. The security deposit was collected by the assessee in the invoice with a specific citation therein that the amount collected would be paid to Government, if the issue of levy of sales tax was upheld in Supreme Court and otherwise returned to the payer, if the levy was not sustained.

In the assessment, the Assessing Officer treated the security deposit as the trading receipt of the assessee and taxed it relying on the decision of the Supreme Court in the case of Chowringhee Sales Bureau (P) Ltd vs. CIT (1979) 87 ITR (SC) . In the case of Chowringhee Sales Bureau, the assessee had collected in its invoices amounts as 'sales tax' and not paid the same to the Government on the ground that the levy was in dispute before the Courts. The Supreme Court had held that the amount collected as 'sales tax' (even if the levy was in dispute) is a trading receipt and taxable in hands of the assessee. The assessee was held entitled to deduction of sales tax as expenditure in the year in which it would be paid.

To my mind, the decision of the Supreme Court is understandable because once an amount is collected as 'sales tax', it forms a part of the price charged to the customer and it is therefore taxable as trading receipt. This should be more particularly so because under sales tax laws, sales tax is payable by the seller irrespective of whether he has collected the same from the buyer. In these circumstances, Courts have ruled that the charge of sales tax is on the seller as an assessee and that he is not a mere collection agent.

But, where the amount is collected in the invoice as a 'deposit' with a clear understanding with the customer that the same would be paid to the government if the levy of sales tax is upheld and otherwise returned to the customer, if the levy was not upheld, the amount collected is not 'sales tax'. This is the finding of the Constitution Bench of the Supreme Court in the case of State of Mysore vs. Mysore Spg. and Mfg. Co. Ltd (1960) 11 STC 734 {SC}.

In short, where the very levy of sales tax is in dispute before Court, then if the trader chooses to collect the disputed amount as 'sales tax ' in his invoice, the same will become taxable as a trading receipt based on the decision of the Supreme Court in Chowringhee Sales Bureau. On the other hand, if the amount is collected as a deposit, the same will not be so taxed based on the Apex Court decision in the case of Mysore Spg. & Mfg. Co. Ltd.

Noting these fine lines of distinction, the Delhi High Court in the case of Dalmia Cement has held that the security deposits collected by the assessee in its invoices are not trading receipts.

This should also be understandable from the point of view that the monetary property in the security deposit, at no point of time, vests in the assessee because the amount is either payable to the government, or refundable. The amount is thus held only in fiduciary capacity..

Further, since the amount is not collected as 'sales tax', it cannot form part of the price charged to the customer.

The decision of the Delhi High Court should therefore strike us as well laid down. To tax assessees, it should sound as a warning that the mode in which they package their transactions to the Revenue can affect their tax fortunes.

(2) **Business Income: - [Section 41 (1)] –** *Remission or Cessation of liability – Where assessee's returns, claiming interest deduction, were treated as non-est, then waiver of such interest cannot be taxed subsequently as remission of liability.*

CIT vs. Rayala Corporation (P) Ltd. [2013] 36 taxmann.com 285 (Mad).

Courts have held that the provisions of section 41 (1) create two deeming fictions. Firstly, a remission or cessation of a liability allowed as a deduction in the past assessment would be taxable as business income. Secondly, the benefit received by assessee on remission or cessation would be taxed in the year in which the remission or cessation takes place. According to Courts, but for these deeming fictions, the benefit received on remission or cessation could not have been taxed otherwise at all.

In the case before the Madras High Court, the returns of income, in which the assessee had claimed deduction for interest expenditure, were treated as 'non est' by the income tax department. The interest was not paid by the assessee in these years, but was claimed as expenditure in the accounts on accrual basis. In subsequent year, the assessee's bankers waived some part of the unpaid interest amount.

The issue for consideration before the High Court was whether the benefit of remission of interest liability can be taxed in the hands of the assessee u\s 41 (1) in the year of remission.

This was more particularly so because there were no income tax assessments for the years in which the interest remitted was claimed as expenditure as the returns were treated as 'non est' by the income tax department and not processed. It is pertinent that the language used in the provisions of section 41 (1) contemplates that a deduction for a liability must have been availed by the assessee in an "assessment."

The High Court ruled that that the expression ' assessment' in section 41 (1) suggest a determination of income by the Assessing Officer, A self assessment made by the assessee for paying tax u\s 140-A is not' assessment'. In holding so, the High Court relied on the findings of the Supreme Court Tirunevili Motor Bus Services (P) Ltd. vs. CIT (1970) 78 ITR 55 (SC) a decision rendered in context of section 10 (2A) of Income Tax 1922, which section corresponds with the present section 41 (1) of 1961 Act. Here, the Apex Court had observed there that " *the question whether the allowance has been granted or deduction allowed in respect of trading liability has to be decided by referring to the **order** relating to assessment 1950-51).*

In short, according to the Madras High Court, the word 'assessment' in section 41 (1) contemplates a passing of an order by the Assessing Officer determining the income of the assessee. The provisions of section 41 (1) prescribe a pre-condition that a deduction for expenditure must have been obtained by an assessee in an 'assessment. The provisions of section 41 (1) are deeming provisions and can operate only within the scope created by the deeming and not more. In absence of such assessment, the deeming provisions of section 41 (1) do not come in to play . In the instant case before the High Court, there was no 'assessment' because the returns filed by assessee were treated as 'non-est". The remission received by the assessee has therefore held as not taxable u\s 41 (1) because the deeming provisions failed to operate in absence of an assessment.

According to me, the decision of the High Court is well considered on the law of the deeming fictions. . The benefit of this decision can today be availed by assessees who have not filed their returns and no assessment process has been initiated by the Department thereafter to pursue an assessment.

(3) Capital Gains :- Section 45 - *Interest received by assessee for delay in completion of the process of buy-back of shares under open offer to be deemed as capital gain and not interest income.*

Genesis Indian Investment Co. Ltd. vs. CIT [2013] 36 taxmann.com 300 (Mumbai-Trib).

The assessee (Genesis), in this case, was resident in Mauritius. Its capital gains were therefore not taxable under the DTAA. British Petroleum {BP}, as part of its global takeover of Castrol group companies, approached SEBI to make a public offer to buy shares of Castrol India. The price fixed by SEBI was not acceptable to BP and it disputed the same before the Securities Appellate Tribunal, which upheld the SEBI order. BP preferred an appeal to the High Court. In the meantime, SEBI passed an order directing BP to pay interest @ 15 % p.a. for delaying the offer. The High Court also dismissed BP's appeal on the price dispute. BP appealed to the Securities Appellate Tribunal against the levy of interest by SEBI, which appeal was dismissed. In further appeal, the High Court also upheld the levy of interest.

In these circumstances, BP made the public offer to acquire the Castrol shares at the SEBI price plus the awarded interest of 15 %. In response to this offer, the assessee Genesis sold some of its Castrol shares to BP on these terms. In income tax assessment proceedings, it contended that the interest received by it was chargeable as Capital Gains and not as interest income. This claim was turned down by the Assessing Officer and Commissioner (Appeals).

The Mumbai Tribunal has upheld the claim of the assessee that the interest received was chargeable as Capital Gains and not as interest income. The reasoning given was that in the initial stages, when the offer price was in dispute with SEBI, the assessee was not in the picture and that therefore, there was no contract in existence with assessee by offerer . The assessee's contract with the offerer BP came in to existence only subsequently after the interest was awarded by SEBI and upheld.

The interest received was compensation for delay in executing the offer process and not compensation for delay in tendering the offer price. The interest paid was thus not in nature of 'interest' as understood in the sense of compensation for delay in payment of money. The same was held to be chargeable under head 'capital gains'.

According to me, the Tribunal has rightly decided the issue. After all, so far as assessee was concerned, it got as consideration for parting with its shares, the SEBI price plus interest and not interest was for delay in payment of price due to him. The interest was nothing but consideration paid to it for sale of shares. The fact that the payment was styled as interest should not make a difference to its taxation. What is decisive for taxation is the true character of the receipt and not the nomenclature applied to it.

(4) Business income vs. Capital gains – *Sections 28 / 45 (3)/50-C – Development rights held by assessee as stock-in-trade – Development rights transferred to joint venture – Whether transfer of capital asset or stock-in-trade ?*

ACIT vs. Ali Akbar Jafari (ITA no. 1256/PN/2010 and 1257/PN/ 2010

In this case, the assessee had introduced development rights in a land of 60,631 square metres held by him as stock-in-trade as his capital in Joint Venture / Association of Persons at value of Rs. 25,00,000. The Assessing Officer held that the transaction is that of introduction of capital asset and adopted transfer consideration at Rs. 5,67,00,000 being stamp duty value invoking section 50-C.

The Pune Tribunal noted that the assessee had shown the development rights as stock-in-trade in his accounts and also wealth tax returns before it was introduced as capital in the joint venture. The income tax department has also accepted this position in income tax and wealth tax assessments. It has therefore held that the transaction is a transfer of stock-in-trade and not capital asset and that therefore, section 50-C cannot be invoked.

Readers may compare this Pune Tribunal decision with the decision of the Delhi Special Bench in the case of DLF Universal Ltd vs. DCIT [2010] 123 ITD 1 (Del) (SB) . Here, the Special Bench in a majority view (one Member dissenting } had held that transfer of land held as stock in trade as capital by partner in firm would amount to transfer of capital asset to the firm and not transfer stock in trade. The majority view noted that section. 45 (3) applies when a capital asset is introduced into a firm as capital contribution. According to the Special Bench, this provision also applies also when stock-in-trade is introduced into a firm because the transaction is on the capital account and stock-in-trade does not retain its character as stock-in-trade at the point of time of introduction. This is also shown by the fact that the assessee revalued the stock-in-trade to its market value prior to the introduction into the firm. Consequently, the gains on such transfer were held as taxable u/s 45(3).

The Delhi Special Bench decision was not referred in the Pune Tribunal decision. However, on comparing the two, a thought struck me.

Whether an item of property is stock-in-trade or capital asset has to be tested on the basis of commercial reality of the situation. Under general law, a partnership and joint venture are not legal entities distinct from the individuals who constitute it. It only happens that the income tax statute designates them as separate entities like individual, firm or association of persons for purpose of taxation. When partner or member introduces his individual trade item of stock –in trade as capital in the firm or joint venture, there is no change in the mode of doing business qua the property. What is changed is merely the number of owners qua the property. The property, which was held at one time in business by only person as sole proprietor, is continued to be held in business by more than one person again either in partnership or in joint venture. In short, the individual handling of the property is merely converted in to collective handling. The change brought about in the situation is in the number of owners handling the property and not in the character of the property. If this view is acceptable, it would mean that the item of property should continue to remain 'stock-in-trade even after introduction as capital by the partner or member.

The decision of the Pune Tribunal in the case of Ali Akbar Jafari can thus be supported on these lines too. The readers may examine this proposition and see whether the decision of the Delhi Special Bench in case of DLF Universal Ltd requires reconsideration on basis of these lines of thinking.