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Analysis of four important decisions - January – March 2010.

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Let us begin our sojourn through this article on a humorous note. Once a king had a dream, in which he saw several ill omens. He described this dream to his astrologer, who was an expert dream interpreter. Hearing the description of the dream from the king, the wise astrologer turned his head gravely from one side to another and pronounced his analysis of the royal dream as follows - "O king! This dream foretells several ill ominous signs for you. You shall have the agony of seeing each of your dear ones dying one after another before your eyes." The enraged king drew his sword from its sheath and cut of the neck of this astrologer with one stroke.

Still not finding himself at ease, the king decided to seek a second opinion from another astrologer. This astrologer had known about the fate of his predecessor and pronounced his opinion as follows: - "O king! This dream augurs well for you! You shall have the good fortune of living the longest life in your clan!" The king, overwhelmed with happiness, removed his royal necklace from his neck and presented it to this astrologer.

Such should be our analysis of tax decisions too. A dissent should be tactfully stated and never invite the ire of the authorities pronouncing the decisions.

1. Concealment penalty u\s 271 [1][c] :-

Over a period of time, the law on this concealment penalty has been canonized by Courts in to several set principles. **Firstly,** this penalty is not automatic and therefore, merely because additions have been made in the assessment, it does not follow that the assessee should necessarily be treated as concealed his income qua these additions. **Secondly,** rejection of a bona fide claim should not entail penalty. This is more particularly so when the claim is based on a possible legal stand. **Thirdly,** if two interpretations are possible in penalty proceedings, a view favorable to the assessee should be adopted. **Fourthly,** whereas a false claim should invite penalty, a claim which merely remains unproved by the assessee but not disproved by the department should not be equated with a false claim. **Lastly,** the golden rule is that penalty is discretionary and should be levied only as an exercise of the last resort i.e. in ulterior cases, where the assessee has acted in open defiance of the law. But, where the default committed by the assessee is merely venial or technical and not in contempt of the law, the assessing authority must desist from levying penalty.

Apart from the above, it can be added that a subject can be visited with a penalty only if a default described in the language of the penalty provisions has been committed. This is because the mandate to levy penalty can be derived only from the language in the penalty provisions and not from implying something outside it. For example, the Supreme Court in CIT vs. Atul Mohan Bindal [2009] 317 ITR 1 {SC} observed as follows – *"It goes without saying that for applicability of section 271 [1] [c], conditions stated therein must exist."*

The decision, which I propose to discuss with the readers is that of the Supreme Court in the case of CIT vs. Reliance Petroproducts Pvt. Ltd. as reported in [2010] 322 ITR 158

{SC}. Here, in the assessment of the assessee, some claim for interest paid had been disallowed as the same pertained to exempt income under the provisions of section 14A of the Income Tax Act. The issue before the Supreme Court was whether there could be penalty leviable u\s 271 [1] [c] for concealment of income in respect of this disallowance.

Here, the Supreme Court proceeded on the language in the provisions of section 271 [1] [c] that penalty can be levied only if the assessee has either 'concealed particulars of its income' or 'furnished inaccurate particulars of its income'. The word 'particulars' means 'details' of the claim made. If the 'details' furnished are found to be not concealed or furnished inaccurately, then the penalty cannot be levied. In order to expose an assessee to penalty, unless the case is strictly covered by the provision, the penalty provision cannot be invoked.

From the record of the case before it, the Supreme Court observed there was no finding that the assessee had indulged either in either concealing particulars or furnishing inaccurate particulars of its income and held that penalty u\s 271 [1][c] was not leviable.

One would have expected the issue of penalty to be tested on predictable lines i.e. whether the claim for deduction of the interest as expenditure was bona fide or not. This is more particularly so because Explanation no. 1 to section 271 [1] [c] deems a disallowance of an expenditure as 'deemed concealment of particulars of income' unless the assessee shows that the explanation given by him for making the claim for the expenditure was bona fide. But, the decision seems to have proceeded on the language in the main provision, without percolating to the Explanation appended below it. These comments should not be understood as casting any apprehension on the merits of the assessee's case, as the assessee had vocally canvassed before the lower authorities that the disallowance had been made by the Assessing Officer despite differing views in respect of the claim and that therefore, penalty ought not to be levied merely because of a difference in opinions regarding its allowability.

Readers are urged to carefully study this decision.

2. Replication of master copy of software on CDs– whether manufacturing or processing?

The decision of the Supreme Court in the case of CIT vs. Oracle Software India Ltd. as reported in [2010] 320 ITR 546 {SC} presents an interesting study for its complexity.

Here, the assessee, a 100% subsidiary of Oracle Corporation, USA, imported master media of the software from Oracle Corporation, duplicated it on blank discs, packed and sold it in the market. The only right that the assessee had was to duplicate the software and it had no right to vary, amend or make value addition to the software embedded in the master media. The duplication was done by the assessee using sophisticated equipment, which enabled the imaging of the software on the master media on to the blank CDs.

The assessee had made a claim before the revenue authorities that this duplicating process constituted 'manufacturing or processing', the profits of which are entitled to deduction u\s 80-IA [Assessment Years 1995-96 and 1996-97]. It canvassed its claim on the basis that the blank CD was the input and the recorded CD as the output was a different product from the blank CD, which made the process of recording a 'manufacture'.

The Supreme Court has upheld this claim of the assessee. It observed that the Court has to move along with the times when there was technology advancement as in computer science. In each case, when an issue of this nature arose for determination, the Department has to study the actual process undertaken by the assessee. If an operation / process rendered a commodity fit for use for which it would otherwise not be fit, the operation / process fell within the meaning of the word ‘manufacture’. Applying this test, the Apex Court observed that the assessee had undertaken an operation which rendered the blank CD fit for use for which it would otherwise not be fit. The blank CD was an input. By duplicating process undertaken by the assessee, the recordable media which is unfit for any specific use got converted into the programme which is embedded in the master media and thus the blank CD got converted into recorded CD by an intricate process. The duplicating process changed the basic character of a blank CD dedicating it to a specific use. Without such processing, blank CDs would be unfit for their intended purpose. Therefore, processing of blank CDs dedicating them to specific use constituted ‘manufacture’ in terms of section 80-IA [12][b] read with section 33B of the Act. The marketed copies of the CDs were goods and the process in which they became goods was covered by ‘manufacture or processing of goods’. On the above reasoning, the Supreme Court has upheld the assessee’s claim for deduction u\s 80-IA.

Readers may examine my proposition whether the assessee’s claim for manufacture could have been presented to the Court in a different manner. The ‘goods’ sold by the assessee were not the CDs, but the software replicated on the CDs from the master media. This thinking would be in keeping with the general understanding in software licensing agreements that the subject matter of commerce is always the software and not the CD on which the software is recorded.

The CD is generally understood as the storage device of the software though this perception may not be hundred percent correct. This is because functionally an item of software cannot ‘physically’ exist without the media which stores it and the only reason that a software ‘exists’ is because of its association with this media.. Sans this media, the software has no independent existence. If seen from this angle, one can come to a consensus that the CD is not merely the ‘packaging’ or ‘container’ of the software, but an entity which lends to the software its very functional ‘existence’. It is therefore an input which contributes in the making of the recorded software fit for use in the market.

Yet the CD is not the only input which goes in the making of the replicated software. What then is the other input? The software on the master media? The original software on the master media cannot be treated as the input of the software replicated on the CD for sale. The original software remains in tact on the master media even after the replicating process is completed and it cannot therefore be said that it is that input which after conversion in to an output has passed in to the hands of the buyer of the CD. What then is the ‘software input’ that has gone in to making of the ‘software output’?

In this world, nothing is created out of nothing and everything is created out of something or the other! This ‘something or the other’ in the instant case is the ‘exploitable potential’ of the software on the master media. The ‘exploitable potential’ is the capacity of the software on the master media to be ‘copied’ or ‘self multiply’ just as an atom has the capacity to divide to multiple atoms when it is exploded and even after the explosion, the original atom remains an atom. This ‘exploitable potential’ has the legal characteristics of a

property – in terms of exploitation as a resource for a commercial gain [say replicating copies of it for sale] and also transferability for a price. It is the conversion of this 'exploitable potential' of the software on the master media in to 'replicated copies' on CDs that constitutes 'manufacture'.

In short, the Readers are urged to examine the Oracle decision minutely and ascertain whether the issue of 'manufacture' ought to have been tested vis-à-vis the CDs or vis-à-vis the software.

3, Scope of re-assessment proceedings u\s 147 –whether subject matter confined only to reasons recorded for issue of notice u\s 148?

The provisions of section 147 states that where an Assessing Officer has reason to believe that any income chargeable to tax for any assessment year has escaped assessment, then he may assesses or reassessment such income and *also any other income which comes to his notice subsequently in the course of the proceedings under this section.*{emphasis supplied in italics}.

The scope of the Assessing Officer to assess escaped income is not unfettered and has been bridled by courts in tax decisions. Without referring to the plethora of the same, the commonly known principles emanating from these decisions are summarized.

While it is true that reassessment proceedings u\s 147 are meant for the benefit of the Revenue and not the assessee, it is also necessary that the same are not exercised arbitrarily. Firstly, a notice u\s 148 cannot be issued only if the Assessing Officer has reasons to believe that income has escaped assessment. These reasons should be genuine and not a pretence or a garb to re-open the assessment on basis of suspicion. Reason to believe is not the same thing as reason to suspect or doubt. Forming of this belief is the sine quo non for assuming jurisdiction to initiate proceedings u\s 147 and non existence of such reasons will render the entire assessment u\s 147 void ab initio even if escaped income has been subsequently discovered in the course of assessment. While a court in entitled to test the validity o the proceedings for existence of these reasons, it will not be inclined to interfere if the reasons exist but are not adequate or sufficient. Reassessment proceedings u\s 147 are not meant to disturb issues which have reached finalities in the initial assessment. Neither can these proceedings be used for conducting roving inquiries. An issue which has been subjected to scrutiny and adjudicated in the original assessment cannot be reopened on the basis of a mere change in opinion of the Assessing Officer. It would be a different matter if the assessee had failed to disclose fully and truly all material facts required for assessment and the issue had been decided in favour of the assessee in the original assessment. But where there is no such failure and the issue has been decided in favour of the assessment, the same cannot be reopened only because the Assessing Officer has changed his opinion after the original assessment was completed.

Coming back to the provisions of section 147, a perusal of these suggests that two types of escaped incomes can be brought to tax.

The first category is the escaped income in respect of which the Assessing Officer had formed belief of its escapement before issuing notice u\s 148. The category of income can be identified from the reasons recorded by the Assessing Officer for issuing notice u/s 148.The second category of escaped income which can be taxed u\s 147 is the income which comes to the notice of the Assessing Officer in the course of the assessment proceedings u\s 147. The difference between the first category and the second one is that the existence of the escapement of second category of income was not in the mind of the Assessing Officer when recording his reasons for the issue of notice u\s 148, but was discovered by the Assessing Officer in the course of the assessment proceedings.

With the above discussion in the back of my mind, the decision I wish to discuss with my readers is the decision of the Delhi Tribunal in the case of ACIT vs. Hyundai Heavy Industries Co. Ltd as reported in 35 SOT 316 for Assessment Years 1995-96 and 1996-97. The assessee, in this case, was Korean Company which had filed its returns for these years and was assessed by the Assessing Officer at a higher figure of income than the one returned. Subsequently, the Assessing Officer discovered that these assessments had been completed without interest u\s 244A received by the assessee and he issued a notice u\s 148 citing this reason. Original assessment had been completed at the income tax rate applicable to domestic companies [i.e. not at the higher rate applicable to foreign companies]. It is also pertinent that the past assessment had also been completed at rate applicable to domestic companies based on certain mutual agreement procedures between the Governments of India and Korea who were treaty parties to a Double Taxation Avoidance Agreement between them. In the reassessments u/s 147 for Assessment Years 1995-96 and 1996-97, the higher rate of tax as applicable to foreign companies was applied apparently relying on certain decisions of the Authority for Advance Ruling.

In its decision, the Delhi Tribunal has held that only that escapement of income which was the be subject matter of the reasons recorded for issue of a notice u\s 148 can be the subject matter of an assessment u/s 147 and none other. Since in the instant case, the reasons recorded for issue of notice u\s 148 were for non inclusion of interest income u\s 244A and not for levy of lesser rate of tax, it was not permissible for the Assessing Officer to apply the higher rate of tax applicable to foreign companies. In coming to this conclusion, the Assessing Officer has relied on the decisions of the Punjab & Haryana High Court in the cases of Vipin Khanna vs. CIT [2002] 255 ITR 220 {Punj. & Har.}and Amrinder Singh Dhiman vs. ITO [2004] 269 ITR 378 {Punj. & Har.}.

This finding of the Tribunal that only incomes, the escapement of which have been noted by the Assessing Officer in the reasons recorded for issue of notice u\s 148 can be the subject matter of an assessment u\s 147 requires careful appraisal by the readers. This proposition may be examined by the readers in light of the language used in the provisions of section 147 to the effect that escaped income which comes subsequently to the notice of the Assessing Officer in the course of proceedings u\s 147 can be also be subjected to tax in proceedings u\s 147. The Punjab and Haryana High Court decisions cited above as relied by the Assessing Officer may also be examined by the readers. In both these decisions, the Assessing Officer had in the reassessment proceedings sought by a notice several details

unconnected with the reasons recorded for issue of notice u\s148 from which it was clear that the Assessing Officer was merely embarking on a roving inquiries even after the original assessment had reached a finality. The notices seeking details had been challenged in writ petitions by the assessees in both these cases before the High Court, which notices was struck down on the ground by the High Court on the grounds that the details sought in the same were unconnected with the reasons recorded for issue for notices u\s 148. This was quite rightfully too because once an assessment has reached a finality, it was not permissible to reopen issues which have reached finality thereon merely on suspicion. But, these decisions cannot be taken as authorities for make an absolute proposition that only incomes whose escapement has been noted in the reasons for issue of notice u\s 148 can be the subject matter of assessment u\s 147, when the language in these very provisions permit bringing to tax also escaped incomes which come subsequently to the notice of the Assessing Officer in the course of the re-assessment proceedings. Of course this escaped income must be discovered by the Assessing Officer on his own without roving inquiries conducted on issues reached finality in the original assessment. The comments of the author must not be understood as casting an apprehensions on the merits of the assessee's case before the Delhi Tribunal because the assessee's representative had carefully canvassed to the Tribunal that the application of higher rate of tax in the reassessments was merely on account of change in opinion by the Assessing Officer more particularly because the lower rate had been consciously applied both in the original assessments and in past assessment based on a mutual agreement procedure between the Governments of India and Korea.

4 Search related assessments u/s 153A:-

The present search related assessment procedures u\s 153A are an enigma which only time can unravel. One would have thought that after the end of the block assessment regime, search related assessments would involve lesser courtroom wrangles at least on jurisdictional aspects. But, this does not appear to be so in face of several unanswered questions touching these provisions. As on date, the much needed clarity on the law therein is slowly emerging from some Tribunal decisions.

The provisions of section 153A prescribes that once a search has been initiated u/s 132, the Assessing Officer shall issue a notice on the assessee requiring him to file a return of income in respect of each of the six assessments years immediately preceding the assessment year relevant to the previous year in which the search was conducted. All pending assessment or reassessment proceedings pending on the date of initiation of the search shall abate.

The significance of abatement of pending proceedings is two fold. Firstly, it implies that proceedings which are not pending should be treated as concluded and reached finality. Secondly, issues arising in the abated proceedings are alive and can be taken up for adjudication in the assessment u\s 153A. In short, the proceedings u\s 153A takes over the responsibility of assessing the incomes of the years for which pending proceedings have abated.

The recent decision of the Delhi Tribunal vs. ACIT as reported in [2010] 1 ITR {Trib} 484 {Del} is interesting and attempts to resolve some of the grey areas in the provisions of section 153A. After considering various decisions cited before it, the Tribunal has agreed with the proposition that an assessment proceedings are set in to motion the moment a return is filed and such proceedings remains pending till finality is given to it by

the Assessing Officer. A processing of a return by the Assessing Officer u\s 143 [1] [a] is a disposal of the pending proceedings because there is no obligation on the Assessing Officer to compulsorily issue a notice u\s 143 [2] for a regular assessment. Therefore, if an intimation u\s 143 [1][a] is passed by an Assessing Officer before the date of initiation of a search u\s 132, then it should be treated that there are no pending assessment proceedings. An assessment that takes place u\s 153A is not expected to disturb proceedings which have become final on the date of the search. The assessment u\s 153A in such a case is not a de nova assessment and what can be assessed here is only the escaped income detected during the search. Additions can only be made in respect of evidence found in material seized at the time of the search and not relating to any other items. Accordingly, additions made in the assessments for agricultural incomes, gifts etc. were deleted in appeal by the Tribunal as these additions did not arise from any seized materials and also because such additions cannot be made in an assessment u\s 153A as there were no pending assessment proceedings on these issues as on the date of the search.

This decision is undoubtedly welcome. It should fire the minds of the readers in to a further probe as to whether the jurisdiction for commencing assessment proceedings u\s 153A arises in the hands of an Assessing Officer merely because a search has been initiated u\s 132 or only when search material suggesting escaped income has been found at the time of the search. If nothing is found at the time of the search to infer escapement of income, what assessment can an Assessing Officer after all make u\s 153A more particularly when there are no pending assessment proceedings? Would not the entire procedure u\s 153A be a futile and absurd process? Would it not be a better proposition to say that the jurisdiction to make an assessment u\s 153A is conferred only when there is material found at the time of the search and not merely because a search has been initiated? Further, if there is material found relating to some years only and not others, why make an assessment u\s 153A for all six assessment years? It is true that the word ‘shall’ in section 153A suggests that once a search is initiated, it is mandatory for the Assessing Officer to issue notice for each of the six assessment years. But, courts have held that if a literal interpretation of an enactment leads to absurd results, the courts should avoid such interpretation and leans to an interpretation which fulfills the purpose of the enactment. Courts have even found cases where the word ‘shall’ can be interpreted as ‘may’. If these interpretations are followed, it is possible to derive a proposition that the Assessing Officer is obliged to issue notice u\s 153A on an assessee only for such assessment years where search materials suggesting escapement of income has been found and not otherwise.

5. With these observations, I shall take leave of my readers.