CASE STUDIES - SET 2 (5 Case Studies)

FINAL LEVEL - DT: EXAM IN YEAR 2021 & 2022

For Admission / Inquiry - Whatsapp at 8527230445 (11am to 6pm)

6. CASE STUDY - VERY IMPORTANT

Flash Inc, a company incorporated in Japan, was engaged in manufacture, trade and supply equipment and services for GSM Cellular Radio Telephones Systems. It supplied hardware and software to various entities in India. Software licensed by assessee embodied the process which is required to control and manage the specific set of activities involved in the business use of its customers, and also made available to its customers, who used it to carry out their business activities. The Assessing Officer contented that the consideration for supply of software embedded in hardware is 'royalty' under section 9(1)(vi)

Examine the correctness of the action of the Assessing Officer assuming that the software that was loaded on the hardware and embedded in the system does not have any independent existence.

Solution:

The issue under consideration in this case is *whether consideration for supply of software embedded in hardware would tantamount to 'royalty' for attracting deemed accrual of income under section 9(1)(vi).*

As per section 9(1)(vi), income by way of royalty payable by a person who is a non-resident would be deemed to accrue or arise in India, where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

For this purpose, 'royalty' includes transfer of all or any right for use or right to use a computer software irrespective of the medium through which such right is transferred.

The facts of the case are similar to the facts in ***CIT v. Alcatel Lucent Canada (2015) 372 ITR 476, wherein the above issue came up before the Delhi High Court****. The Court observed that the software supply is an integral part of GSM mobile telephone system and is used by the cellular operators for providing cellular services to its customers.* ***Where payment is made for hardware in which the software is embedded and the software does not have independent functional existence, no amount could be attributed as 'royalty' for software in terms of section 9(1)(vi).***

In this case, since the software that was loaded on the hardware and embedded in the system does not have any independent existence, there could not be any independent use of such software.

Therefore, the rationale of the Delhi High Court ruling can be applied to the case on hand. Accordingly, the action of the Assessing Officer in treating the consideration for supply of software embedded in hardware as royalty under section 9(1)(vi) ***is not correct.***

7. CASE STUDY - VERY IMPORTANT

Ms. RSRZ and Co. Ltd., sold one of its factory building for ₹ 14 lakhs on 19-4-2020. The building was acquired on 1-4-2010 and the assessee was using it for manufacturing activity and accordingly, depreciation was also being claimed. After sale of the building, the assessee reinvested the amount of capital gain in long-term specified assets under section 54EC and claimed exemption thereunder. The AO rejected the claim for exemption by the assessee and regarded that since the asset sold was depreciable asset, provisions of section 50 will be applicable and accordingly the assessee is not entitled to exemption under section 54EC. Discuss the validity of AO's claims.

Answer:

As per section 54EC, *where the capital gain arising from the transfer of a long-term capital asset, being land or building or both, is invested in the long-term specified asset, being the bonds issued by the National Highways Authority of India (NHAI) or the Rural Electrification Corporation Limited (RECL) or any other bond notified by the Central Government in this behalf, at any time within a period of six months after the date of such transfer,* ***the amount of such capital gain shall not be charged to tax, to the extent of ₹ 50 lakhs.***

Section 50 is a special provision for computation of capital gains in the case of depreciable asset, and has limited application in the context of computation of capital gains to the extent that the provisions of sections 48 and 49 would apply with the modifications stated thereunder. ***It does not deal with exemption which is provided in a totally different provision i.e., section 54EC.***

Section 54EC does not make any distinction between depreciable and non-depreciable asset *for the purpose of re-investment of capital gains in long term specified assets for availing the exemption thereunder. Further,* ***section 54EC specifically provides that when the capital gain arising on the transfer a long-term capital asset, being land or building or both****, is invested or deposited in bonds issued by NHAI or RECL, the assessee shall not be subject to capital gains to that extent [i.e., lower of capital gains or ₹ 50 lakhs].* ***Therefore, the exemption under section 54EC cannot be denied to the assessee on account of the fiction created in section 50.***

*Thus, in the present case, the action of the Assessing Officer disallowing the claim for exemption under section 54EC on the reasoning that capital gain on transfer of depreciable asset (building) is a short-term capital gain in respect of which the provisions of section 50 apply, even if held for more than 24 months****, is not valid.***

Note – *The facts of the case are similar to the facts in* ***CIT v. V.S. Dempo Company Ltd*** *(2016) 387 ITR 354, wherein the above issue came up before the Apex Court.* ***The above answer is based on the rationale of the Supreme Court in the said case.***

8. CASE STUDY

Alpha Ltd. is engaged in commercial production of mineral oil. It claimed deduction under section 80-IB in respect of profits and gains derived by it from such business, including transport subsidy, interest subsidy and power subsidy received from the Government.

The Assessing Officer disallowed the deduction in respect of these three subsidies contending that such subsidies were not "derived" from the business of commercial production of mineral oil but belonged to the category of ancillary profits and hence do not qualify for deduction under section 80-IB.

Discuss the correctness of the action of the Assessing Officer.

Solution:

As per section 80-IB(1) read with section 80-IB(9), where the gross total income of an assessee includes any profits and gains derived from, inter alia, the business of commercial production of mineral oil, deduction ***will be allowed at 100% of such profits for a period of seven consecutive assessment years.***

The issue under consideration in this case is whether transport subsidy, interest subsidy and power subsidy received from the Government can be treated as profits derived from business or undertaking to qualify for deduction under section 80-IB.

This issue came up before the Supreme Court in CIT v. Meghalaya Steels Ltd. (2016) 383 ITR 217, *wherein it was observed that an important test to determine whether the profits and gains are derived from business or an undertaking is that* ***there should be a direct nexus between such profits and gains and the undertaking or business. Such nexus should not be only incidental****.*

The profits and gains referred to in section 80-IB has reference to net profit, which can be calculated by deducting from the sale price of an article, all elements of cost which go into manufacturing or selling it. Thus, the profits arrived at after deducting manufacturing costs and selling costs reimbursed to the assessee by the Government, is the profits and gains derived from the business of the assessee.

The Supreme Court observed that section 28(iiib) specifically states that income from cash assistance, by whatever name called, received or receivable by any person against exports under any scheme of the Government of India, will be income chargeable to income-tax under the head "Profits and gains of business or profession".

The Apex Court further observed that if cash assistance received or receivable against exports schemes are being included as income under the head "Profits and gains of business or profession", subsidies which go to reimbursement of cost in the production of goods of a particular business would also have to be included under the head "Profits and gains of business or profession", and not under the head "Income from other sources".

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Accordingly, the Supreme Court held that transport subsidy, interest subsidy and power subsidy from Government ***were revenue receipts which were reimbursed to the assessee for elements of cost relating to manufacture or sale of their products****.*

Therefore, there is a direct nexus between profits and gains of the undertaking or business, and reimbursement of such subsidies. The subsidies were only in order to reimburse, wholly or partially, costs actually incurred by the assessee in the manufacturing and selling of its products.

Applying the rationale of the Supreme Court ruling in the above case, ***the action of the Assessing Officer*** *in not allowing deduction under section 80-IB in respect of transport subsidy, interest subsidy and power subsidy received by Alpha Ltd. from the Government,* ***is not correct.***

9. CASE STUDY - VERY IMPORTANT

Sigma Ltd., incorporated on 1.4.2019, is a technology enabled eligible start-up engaged in innovation of processes. The company filed its return of income for A.Y.2021-22 after claiming deduction of ₹ 18 lakhs under section 80-IAC. The return was selected for scrutiny. In the assessment, a sum of ₹ 7 lakhs, being 30% of ₹ 21 lakhs, towards payment of fees for professional services was disallowed for non-deduction of tax at source by invoking section 40(a)(ia). The Assessing Officer, however, limited the deduction under section 80-IAC to the original amount claimed by Sigma Ltd.

Sigma Ltd. contended that it was eligible for a higher deduction of ₹ 25 lakhs under section 80-IAC consequent to disallowance under section 40(a)(ia). Examine the correctness of contention of Sigma Ltd.

Solution:

The issue under consideration in this case is whether the increase in gross total income on account of disallowance of expenditure under section 40(a)(ia) can be considered for the purpose of deduction under section 80-IAC.

The ***Bombay High Court, in CIT v. Sunil Vishwam bharnath Tiwari*** *(2016) 388 ITR 630, observed that if, on account of non-deduction of tax at source by a company, expenses have been disallowed under section 40(a)(ia) which goes to increase the income chargeable under the head 'Profits and gains of business or profession',* ***such enhanced income becomes eligible for deduction, as profit-linked deduction under Chapter VI-A is with reference to an assessee's gross total income.***

The High Court held that the company is entitled to claim profit-linked deduction under Chapter VI-A in respect of the enhanced gross total income as a consequence of disallowance of expenditure under section 40(a)(ia).

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Further, the CBDT has, in its Circular No.37/2016 dated 2.11.2016**, mentioned that the courts have generally held that if the expenditure disallowed is related to the business activity against which the Chapter VI-A deduction has been claimed, **the deduction needs to be allowed on the enhanced profits.

***Thus, the settled position** is that the disallowances made under, inter alia, section 40(a)(ia), relating to the business activity against which the Chapter VI-A deduction has been claimed, result in enhancement of the profits of the eligible business, and that deduction under Chapter VI-A is admissible on the profits so enhanced by the disallowance.*

*Accordingly, **applying the rationale of the Bombay High Court ruling and the CBDT Circular** in this regard to the facts of this case, Sigma Ltd. would be entitled to claim deduction under section 80-IAC in respect of the enhanced profits of ₹ 25 lakhs, consequent to disallowance under section 40(a)(ia).*

The contention of Sigma Ltd. is, therefore, correct.

10. CASE STUDY - VERY IMPORTANT

XYZ Ltd. is a company engaged in the manufacture of paints. The company incurred preliminary expenses of ₹ 42 lakhs. The cost of the project was ₹ 400 lakhs and the capital employed in the business of the company was ₹ 700 lakhs. For the purpose of claiming deduction under section 35D, the company restricted the said expenditure to ₹ 35 lakhs, i.e., 5% of ₹ 700 lakhs, being the capital employed in the business of the company. For this purpose, the company treated share premium of ₹ 100 lakhs as part of the capital employed.

For the A.Y. 2021-22, it claimed deduction of ₹ 7 lakhs, being 1/5th of ₹ 35 lakhs, under section 35D. The Assessing Officer disallowed ₹ 1 lakh, being the portion relating to share premium (1/5th of 5% of ₹ 100 lakhs), contending that the same was not part of capital employed.

Whether "premium" on subscribed share capital is "capital employed in the business of the company" under section 35D to be eligible for a deduction? Examine the correctness of contention of the Assessing Officer, with the aid of a case law.

Solution:

The issue under consideration is whether "premium" on subscribed share capital can be treated "capital employed in the business of the company" under section 35D to be eligible for increased deduction

This issue came up before the ***Supreme Court in Berger Paints India Ltd*** *v. CIT [2017] 393 ITR 113. The Supreme Court observed that the share premium collected by the assessee on its subscribed issued* ***share capital could not be part*** *of "capital employed in the business of the company" for the purpose of section 35D(3)(b).*

If it were the intention of the legislature to treat share premium as being "capital employed in the business of the company", it would have been explicitly mentioned. Moreover, Form MGT- 7 read with Section 92 of the Companies Act, 2013 dealing with capital structure of the company provides the break-up of "issued share capital" and "subscribed share capital" ***which does not include share premium at the time of subscription.***

Hence, in the absence of the reference in section 35D, share premium is not a part of the capital employed. ***Also, section 52 of the Companies Act, 2013 requires a company to transfer the premium amount to be kept in a separate account called "securities premium account".***

Accordingly, the amount qualifying for deduction under section 35D would be ₹ 30 lakhs, being 5% of ₹ 600 lakhs [i.e., ₹ 700 lakhs (-) share premium of ₹ 100 lakhs].

The deduction under section 35D for A.Y. 2021-22 would be ₹ 6 lakhs, being 1/5th of ₹ 30 lakhs. ***The contention of the Assessing Officer is, therefore, correct.***

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