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Contents

INCOME TAX

DOMESTIC TAXATION

GENERAL

CLARIFICATION REGARDING DEDUCTION UNDER SECTION 10B

The Central Board of Direct Taxes (CBDT) has instructed income-tax officials to allow export-oriented units (EOUs) approved by development commissioners to claim tax exemption, ending the uncertainty over tax benefits to EOUs.

It has been decided that an approval granted by the development commissioner in the case of an export-oriented unit set up in an export processing zone will be considered valid, once such an approval is ratified by the board of approvals (BoA) for EOU scheme.

INCOME-TAX (FIFTH AMENDMENT) RULES, 2009 - AMENDMENT IN RULE 67

Vide notification no 24/2009; CBDT has amended Rule 67 by notifying the Income-tax (Fifth Amendment) Rules, 2009. CBDT has amended sub rule (2) of Rule 67.

Sub rule two prescribes the manner of investments referred in sub rule (1) of Rule 67. It describes the investment pattern and maximum percentage amount to be invested in government securities/ other securities/units of mutual fund, debt securities/ term deposits/ rupee bonds, money market instruments and shares of the companies/ equity linked schemes of mutual funds.

Following amendments are also provided vide said notification:

1. any moneys received on the maturity of investments made prior to the 1st day of April, 2009, reduced by obligatory outgoings, shall be invested in accordance with the manner of investment specified in this sub-rule
2. the investment pattern specified in this sub-rule may be achieved by the end of the previous year; so however that at no time during the year investment in any category should exceed by more than ten per cent of the limit prescribed

3. irrespective of the proportion of investments stated, exposure of a trust to any individual mutual fund, which has been set up as a dedicated fund for investment in Government securities, shall not exceed five per cent of its total portfolio at any point of time
4. the turnover ratio, being the value of securities traded in the year divided by the average value of the portfolio at beginning of the year and the end of the year, should not exceed two.

INCOME-TAX (SIXTH AMENDMENT) RULES, 2009 – AMENDMENT IN RULE 37 BA AND INSERTION OF RULE 37 I

Vide notification no 28/2009; CBDT has amended Rule 37BA (Credit for tax deducted at source for the purposes of section 199) and inserted Rule 37I (Credit for tax collected a source for the purposes of sub-section (4) of section 206C).

It has been notified that credit for tax deducted at source and paid to the Central Government shall be given to the person to whom payment has been made or credit has been given (hereinafter referred to as deductee) on the basis of information relating to deduction of tax furnished by the deductor to the income-tax authority or the person authorised by such authority. For claiming credit of tax by other person, it has provided that if the income on which tax has been deducted at source is assessable in the hands of a person other than the deductee, credit for such amount of tax deducted at source shall be given to the other person in certain specified cases under this rule. Sub rule (4) provides that credit for tax deducted at source and paid to the account of the Central Government shall be granted on the basis of the information relating to deduction of tax furnished by the deductor to the income-tax authority or the person authorized by such authority and on the basis of the information in the return of income in respect of the claim for the credit.

Rule 37I also provides for credit for tax collected a source for the purposes of sub-section (4) of section 206C.

CASE LAWS

1. CIT vs. Inder V. Nankani (Bombay High Court)

VDIS's declared diamonds not liable to tax

The assessee under VDIS made a declaration which included assets in the form of diamonds. The assessee sold the diamonds and received consideration for the

same by cheque which was duly encashed and shown in the books of accounts. The Assessing Officer sought to add the said amount in his income on the ground that the assessee was unable to prove that he was actually in possession and ownership of the diamonds and as such, income received was undisclosed income.

During the course of appellate proceeding, the CIT (A) called for a report of the material which was in the possession of the Assessing Officer to arrive at a conclusion and CIT (A) also directed to submit a report whether an opportunity had been given to the assessee to cross examine the witness based on whose statement addition was sought to be done. The Assessing Officer failed to comply with the said directions. In these circumstances, CIT (A) proceeded to pass the order and which was subsequently affirmed by the ITAT. The tribunal in the instant case has held that the assessee had disclosed the diamonds in his possession at the time of VDIS declaration which was accepted. Once the consideration received from the purchaser which has not been doubted, the fact that there is doubt about the
second sale, cannot result in making addition, in the hands of the assessee.

On behalf of the assessee, the learned counsel submitted that there was no material before the Assessing Officer to show that the consideration received was not part of the sale transaction.

Decision of Bombay High Court:

The Bombay High Court dismissed the appeal of department and held that considering the findings of facts in the case, this is not a fit case where question of law would arise.

2. CIT vs. Auric Investment and Securities Ltd (Delhi High Court)

Penalty not attracted on account of disallowance of loss on the ground of speculative business

The assessee had filed its return on October 31, 2001 declaring a loss of Rs 23,05,096. The assessee in its return of income has claimed an amount of Rs 22,15,837 in its profit and loss account on account of share trading loss and treated the same as normal business expense. The return was selected for scrutiny and assessment order was passed by assessing a loss of Rs 85,259 as a business loss. AO found that the loss under question claimed by assessee was speculative in nature which could be allowed to be adjusted against speculative income only. Therefore, the AO initiated penalty proceedings under section 271

(1) (c). He held that since the assessee has furnished inaccurate particulars of income to the extent of making a wrong claim of share trading loss against normal income and hence he was liable to penalty.
The assessee filed an appeal before CIT (A). CIT (A) deleted the penalty. Revenue challenged the order of CIT (A) before the Tribunal. The Tribunal has also dismissed the appeal of revenue.
Revenue then filed an appeal before the Delhi court stating that in the present case there is not only concealment of income but the assessee also furnished inaccurate particulars which would attract penalty under section 271 (1) (c).

Decision of Delhi High Court:

The Delhi High Court passed the order dismissing the appeal of Revenue and held that the assessee has filed a loss return and was assessed as such, there is no question of any penalty being levied on the assessee.

3. Prasad Agents vs. ITO (Bombay High Court)

Explanation to section 73 applies to valuation losses as well

The assessee, being a non-banking financial company, had filed its return by claiming loss of Rs 6,00,877 in share trading as normal loss. The assessing officer had directed that this loss in share trading was a speculation loss having regard to the provisions of Explanation to Section 73 of the Income Tax Act, 1961.

The assessee preferred an Appeal before CIT (A). CIT (A) observed that the business of the appellant consisted of trading and investment in shares, debentures, bonds, mutual funds and other securities pursuant to its Memorandum of Association. CIT (A) held that the assessing officer was not justified to treat the loss in shares as speculative loss and accordingly the disallowance on that count was deleted.

Aggrieved by the order, Revenue preferred an appeal before Tribunal. The Tribunal placed reliance on the decision in the case of High Power Motors Pvt. Ltd Co. and on the judgment of the Supreme Court in Chainrup Sampathram.(1951-(IT2)-GJX-0066) The Supreme Court held in the case of Chainrup Sampathram that loss or profit on account of valuation of closing stock has to be treated as speculative loss and allowable as revenue loss or revenue receipt as the nature of these profits are similar to the nature of business in trading of shares. Hence, the Tribunal set aside the order of CIT (A) and allowed the appeal of Revenue.

The question rose before the Bombay High Court was whether the Explanation to s. 73 (which deems the loss from trading in shares by a company to be a speculation loss) can be confined only to cases where there is manipulation in shares of group companies and whether the loss arising on valuation of closing stock of shares is also covered.

Decision of Bombay High Court:

The Bombay High Court passed the order dismissing the appeal of Assessee and held that though the Circular of the CBDT supports the interpretation that the object of the Explanation to section 73 is to curb manipulation of group companies' shares, the scope of the Explanation extends to all companies carrying on business in shares. It also held that though the Explanation refers to purchase and sale of shares and not to losses suffered on account of valuation, it applies to valuation losses as well as there is no difference between trading losses and losses on account of valuation.

4. CIT v. B Suresh (Supreme Court)

Income from overseas rights to exploit feature film is eligible for tax holiday as sale of goods/merchandise

Section 80HHC provides that an Indian resident company or a person resident in India engaged in the business of export out of India of any goods or merchandise is eligible for a deduction to the extent of profits derived from the export of such goods or merchandise. Such profits are to be computed as per the formula prescribed in the section.

Facts of the case

The assessee transferred certain feature film rights for exploitation outside India and earned income in convertible foreign exchange. He accordingly claimed deduction for the same under section 80HHC of the ITA.

The Tax Authorities took the view that he was not entitled to such deduction on the ground that the export of movies/films was not of any 'merchandise' or 'goods' as envisaged under section 80HHC and that it was merely export of certain 'rights' as such in the film. The Tax Authorities also took the view that there was no 'sale' involved in the transaction; it was merely a 'lease' but not a 'sale' as understood in common parlance.

The arguments of the Tax Authorities were that:

- The assessee was not engaged in the export of goods and merchandise;
- The films recorded on beta-cam tapes did not qualify either as 'goods' or 'merchandise';
- Beta-cam tape (cassette) was only a medium of transfer; but there was no 'sale' of the film in beta -cam format and that the assessee had only transferred the right to use for a limited period of 5 years and since the title remained with him, such transaction would not qualify for tax deduction under section 80HHC;
- The films transferred on beta -cam tapes were given on lease with a right to telecast given to Star TV under a lease agreement for a period of 5 years; but there was no element of 'sale' so as to attract section 80HHC; and
- Movies are neither 'goods nor 'merchandise'.

The assessee appealed to the Commissioner (Appeals) who accepted his claim and allowed the benefit of deduction under section 80HHC. The Income Tax Appellate Tribunal (Tribunal) as well as the High Court also confirmed this view. The Tax Authorities finally approached the Supreme Court of India by way of a 'Special leave petition' which was granted by the Court.

Decision of Supreme Court

The issue before the Supreme Court was whether foreign exchange earned by the assessee by transferring the right of exploitation of the films outside India by way of lease was eligible for deduction under section 80HHC?

The Supreme Court held that:

- The assessee was eligible for deduction under section 80HHC in respect of earning of foreign exchange from transfer of feature film rights outside India for exploitation;
- The Court observed that two key questions that arise for its consideration are: (i) whether foreign exchange earned from transfer of feature film rights for exploitation outside India, in the form of lease, is entitled to the benefit of section 80HHC deduction; and (ii) whether such 'rights' are goods/merchandise so as to qualify for this deduction;

- The Court observed that the basic requirement of section 80HHC is earning in foreign exchange and retention of profits for export business. Profits are embedded in the 'income' earned. Earning of income depends on sale of goods and services. With rapid technological advancement, the difference between goods and services is getting blurred with globalization and cross-border transactions and one needs to reinvent concepts such as goods, merchandise and articles. The assessee had bought rights of various decoders and had recorded movies on beta-cam tapes which were transferred as telecasting rights to Star TV for 5 years. Such rights of exploitation of films can be treated as articles of trade and commerce and as merchandise; and

- On the question whether transfer of such rights by way of lease would attract section 80HHC, the Court observed that in Rule 9A and Rule 9B of the Income Tax Rules, 1962 (IT Rules) the word 'lease' is included in the meaning of the word 'sale'. 'Sale' of the rights of exhibition of feature films would include the 'lease' of such rights. Rule 9B (6) of the IT Rules, provided that 'sale' of the rights of exhibition of a feature film would include 'lease' of such rights. Accordingly, the Court rejected the appeal of the Tax Authorities and concluded that the assessee was entitled to deduction under section 80HHC in respect of earning of foreign exchange from lease of overseas rights of exploitation of feature films.

The Supreme Court of India held that income from overseas rights to exploit feature film is eligible for tax exemption as sale of goods/merchandise under section 80HHC of the Income-tax Act, 1961 (ITA).

International Taxation

CASE LAWS

1. DIT v. Sheraton International Inc, USA (Delhi High Court)

Fees earned by Sheraton USA from Indian Hotels/Clients are business profits and not taxable and not Royalty or Fee for Technical Services

Facts of the case

The assessee, Sheraton International Inc (Sheraton) is a foreign company incorporated in USA engaged in the business of providing service to hotels across the world. It entered into one agreement with ITC Ltd, an Indian company for providing services to three of its hotels in India. The scope of services envisaged in the agreement was publicity, advertisement and sales including reservation services. The tenure of the agreement was fixed at 10 years. In consideration of the services to be rendered by Sheraton, ITC Ltd was to pay a fee at the rate of 3% of the room sales.

For the period prior to India-USA Tax Treaty coming into existence, the fee received by Sheraton was taxed in India as 'Business income' on which withholding tax was deducted under section 195 of the ITA at the rate of 10%. After the India-USA Tax Treaty came into force, Sheraton reviewed its stand on taxability in India and claimed that the fee received by it was not taxable in India as it did not have any PE in India. Initially, the Tax Authorities in India accepted this stand and permitted remittance of fee to Sheraton without any withholding tax in India.

However, subsequently the Tax Authorities changed its view and held that the fee received by Sheraton was indeed taxable in India and accordingly, treated ITC Hotels Ltd as an agent of Sheraton for recovery of the taxes.

The view of the Tax Authorities was that Sheraton was 'making available' to ITC Ltd its technical and consultancy services; provision of training to its employees; use of its trademark; technical know-how, documentation and manuals, etc. Accordingly, they held that fees earned by Sheraton were 'Fees for Included Services' (FIS) falling under Article 12(4)(b) of the India-USA Tax Treaty. They also held that Sheraton had a 'business connection' with India and accordingly, fee received was deemed to accrue, or arise in India and therefore,

taxable in India under section 9 of the ITA. They estimated the income at INR 300 million and held that it was taxable in India as FIS at the rate of 15%.

On appeal, the Commissioner (Appeals) classified the services rendered by Sheraton into four different categories. He treated the usage of Sheraton's trademark, trade name, etc. and payments made towards reservation services and services for maintaining high international standards as 'Royalty' income taxable in India under Article 12(3) (a) of the India-USA Tax Treaty. Since services in the nature of publicity, marketing, promotion activities etc were rendered outside India, he held them to be commercial income (business profits) not taxable in India in the absence of Sheraton's PE in India. Accordingly, he held that 75% (3 out of 4 services taxable in India) of the total payment made to Sheraton was taxable in India.

On second appeal, the Tribunal held that the fees received were business profits not taxable in India in the absence of a PE in India. The Tax Authorities then appealed to the High Court for adjudication and ruling.

Decision of Delhi High Court

The key issue before the Court was whether the Tribunal was right in law in taking the view that fee earned by Sheraton from Indian hotels/clients for the services rendered under the agreement were in the nature of 'Business profits' falling under Article 7 of the India-USA Tax Treaty?

The High Court held that:

- Fees earned by Sheraton were not FIS;

- The main purpose of the agreement between Sheraton and ITC was to promote the business, keeping in mind their mutual interests through worldwide publicity, marketing and advertisement. All other services rendered by Sheraton were incidental and ancillary to this main object under the agreement;

- Article 12(4)(b) of the India-USA Tax Treaty would have no applicability in such a case. The Court referred to the Memorandum of Understanding (MoU) forming part of the India-USA Tax Treaty and the examples set out therein. Article 12(4)(b) applied to those services which related to areas where a technology was made available; whereas in this case, Sheraton was providing its services to the hotel industry in relation to advertisement, publicity and sales promotion which were not in the nature of technical or consultancy service involving making available any technology, etc;

- Referring to the MoU, the Court further observed that the examples and illustrations as set out in the MoU did not relate to or cover 'hotel industry' as such. One of such areas as indicated in the MoU is communication through satellite or otherwise. The Court rejected the argument of the Tax Authorities that the interface between the reservation system of Sheraton and that of the Indian hotels/clients was covered in this category of illustration in the MoU;

- The Court observed that it was an area which was specified in the MoU for ascertaining the services relating thereto being of technical and consultancy nature making technology available whereas the services rendered by Sheraton were in the field of hotel industries. Such services being advertisement, publicity and sales promotion activities, they can not be viewed as technical or consultancy services making available any technology, etc. as envisaged in Article 12(4)(b). Secondly, the interface between the computerized reservation system of Sheraton and the computerized reservation system of the Indian hotels/clients was provided to facilitate the reservation of hotel rooms by the customers globally as an integral part of the integrated business arrangement. This interface was neither separable nor independent of the main integrated job undertaken by Sheraton of rendering services in relation to marketing, publicity and sales promotion. Such services cannot be regarded as technical and consultancy services that make available any technology to the Indian hotels/clients in the field of communication through satellite or otherwise. No communication through satellite was involved in the interface between the computerized reservation system of the assessee and that of the Indian hotels/clients; and

- The Court observed that what was transferred to the Indian company through the service contract was 'commercial information'. The mere fact that technical skills were required by the performer of the services in order to perform the commercial information, services does not make the service a technical service within the meaning of Article 12(4) (b) of the India-USA Tax Treaty. Accordingly, the Court concluded that the main service rendered by Sheraton to its client-hotels was advertisement, publicity and sales promotion, keeping in mind their mutual interest, and, in that context, the use of trademark, trade name or the stylized 'S' or other enumerated services under the agreement were incidental to the main service. Such payments were neither 'Royalty' under section 9(1) (vi) of the ITA nor Fee for Technical Services (FTS) under Section 9(1) (vii) of the ITA or FIS under Article 12. They were 'Business profits' covered in Article 7 of the India-USA Tax Treaty, not taxable in India in

the absence of a PE in India. Accordingly, the Court rejected the appeal of the Tax Authorities and confirmed the decision of the Tribunal.

The Delhi High Court held that fees earned by foreign company from Indian Hotels/Clients for services rendered were in the nature of 'Business profits' falling under Article 7 of the India-USA Tax Treaty and not taxable in India in the absence of a PE in India.

ACCOUNTS & AUDIT

Revised Standards on Auditing (SA) 530 (Revised) "Audit Sampling" and (SA) 540 (Revised) "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

Recently the Institute of Chartered Accountants of India (ICAI) has come out with revised Standards on Auditing (SA) 530 (Revised) "Audit Sampling" and (SA) 560 (Revised) "Subsequent Events"

Revised Standard on Auditing (SA) 530 (Revised) "Audit Sampling"

This Standard on Auditing (SA) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.

This SA complements SA 500 (Revised), which deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. SA 500 (Revised) provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

Revised Standard on Auditing (SA) 540 (Revised) "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Effective Date

These SAs are effective for audits of financial statements for periods beginning on or after April 1, 2009.

Standards on Internal Audit (SIA) 12 "Internal Control Evaluation" and (SIA) 13 "Enterprise Risk Management"

Recently the Institute of Chartered Accountants of India (ICAI) has come out with Standards on Internal Audit (SIA) 12, "Internal Control Evaluation" and Standards on Internal Audit (SIA) 13, "Enterprise Risk Management".

Standards on Internal Audit (SIA) 12 "Internal Control Evaluation"

The purpose of this Standard on Internal Audit is to establish standards and provide guidance on the procedures to be followed by the internal auditor in evaluating the system of internal control in an entity and for communicating weaknesses therein to those charged with governance.

Nature, Purpose and Types of Internal Controls

Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met. "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated.

Standards on Internal Audit (SIA) 13 "Enterprise Risk Management"

The purpose of this Standard on Internal Audit is to establish standards and provide guidance on review of an entity's risk management system during an internal audit or such other review exercise with the objective of providing an assurance thereon, Ibis Standard applies where the internal auditor has been requested by the management to provide such an assurance on the effectiveness of its enterprise risk management system.

Enterprise risk management enables management to effectively deal with risk, associated uncertainty and enhancing the capacity to build value to the entity or enterprise and its stakeholders. Internal auditor may review each of these activities and focus on the processes used by management to report and monitor the risks identified.

Risk and Enterprise Risk Management

Risk is an event which can prevent, hinder, fail to further or otherwise obstruct the enterprise in achieving its objectives. A business risk is the threat that an event or action will adversely affect an enterprise's ability to maximize stakeholder value an to achieve its business objectives. Risk can cause financial disadvantage, or example, additional costs or loss of funds or assets. It can result in damage, loss of value and /or loss of an opportunity to enhance the enterprise operations or activities. Risk is the product of probability of occurrence of an event and the financial impact of such occurrence to an enterprise.

Risk may be broadly classified into strategic, Operational, Financial and Knowledge. Strategic Risks are associated with the primary long term purpose, objectives and direction of the business. Operational Risks are associated with the on going, day to day operations of the enterprise. Financial Risks are related specifically to the processes, techniques and instruments utilised to manage the finances of the enterprise, as well as those processes involved in sustaining effective financial relationships with customers and third parties. Knowledge Risks are associated with the management and protection of knowledge and information within the enterprise.

These Standards shall become mandatory from such date as may be notified by the Council in this regard.

Internal auditor cannot be tax auditor for the same company.

Come April 1, an internal auditor of an organization cannot take up tax audit of the same entity. The auditing profession regulator — the Institute of Chartered Accountants of India (ICAI) – has now decided to implement this norm in true spirit from this date. This decision will mainly impact those chartered accountancy firms that were being appointed as internal auditors and also performing tax audits for the same organization. It also covers those employees who had taken up the role of an internal auditor.

The stipulation that an internal auditor cannot be a tax auditor has been put in place to ensure there is quality of service and auditor independence is maintained.

Auditors may get powers to refuse to sign accounts.

Auditors may get powers to refuse signing a company's accounts if these are not found to be in order. A special group constituted by the Institute of Chartered Accountants of India (ICAI), the statutory body regulating the profession in India, is veering round to the view that the institute should push for statutory backing to such a move.

Company balance sheets could soon acquire a new look, with the government asking ICAI to suggest ways to strengthen reporting norms following Satyam Computer Services founder Ramalinga Raju's shock confession to long-term financial fraud. ICAI sources said the mandate from the government was to ensure that company managements did not use notes to accounts as a cover-up for misdemeanors.

The special group will finalize the recommendations over the next few weeks and submit its report to the ministry of corporate affairs (MCA).

Currently, auditors may only qualify accounts if managements are unwilling to accept the discrepancies they point out.

International Federation of Accountants (IFAC's) Publishes Quality Control Implementation Guide for Small and Medium Practices

To help further to Small and Medium Practices (SMPs) in the implementation of international standards, IFAC has published a Guide to Quality Control for Use by Small- and Medium-sized Practices. This non-authoritative implementation guide is intended to help SMPs understand and efficiently apply International Standard on Quality Control (ISQC) 1,Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services, as redrafted under the IAASB's Clarity Project* (http://web.ifac.org/clarity-center/index).

Developed by CGA-Canada for IFAC's Small and Medium Practices (SMP) Committee, the guide uses an integrated case study to illustrate how to implement the requirements of ISQC 1, and includes two sample firm policy manuals and key checklists and forms. It can be downloaded free-of-charge from IFAC's online bookstore at www.ifac.org/Store/. A Microsoft Word version is available to allow for translation and adaptation by institutes and small firms.

The guide will help SMPs provide high-quality services to their clients and contribute to improving audit quality.

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