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"Anticipated losses" – Mother of all Controversies

by
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In this article, the author describes the practice of provisioning for anticipated losses as the 'Mother of all controversies'. An exception is made to the 'Matching Principle' which is one of the fundamental concepts of accrual basis of accounting. Notwithstanding that such accounting practice is followed customarily, is mandated by Accounting Standards and has judicial approval, the Revenue Authorities continue to hold the view that it deprives them of the taxes legitimately due. In the past, legislative amendments have been made to further the cause of the Revenue. Recently, the Taxation Authorities have, instead of making legislative amendments, resorted to novel method of issuing Tax Accounting Standards meant for computation of taxable income and not for maintenance of books of account. The author opines that such Standards cannot be issued under section 145(2) of the Act.

Introduction

1. "Matching Principle" is one of the fundamental concepts of accrual basis of accounting that offsets revenue against expenses on the basis of their cause-and-effect relationship. It states that, in measuring net income for an accounting period, the costs incurred in that period should be matched against the revenue generated in the same period. To this matching principle, an exception is made by providing for anticipated losses. This exception to the rule is justified on the grounds of prudence and is practised since long with the express approval of the judiciary. But Taxation Authorities feel that such accounting treatments make it possible for an assessee to avoid the payment of correct taxes. So, a controversy arises between the taxpayers and the tax authorities.

The earliest instance of controversy over recognition of anticipated losses is found in the matter of valuation of unsold stocks of a trader. Stocks are valued at cost or market rate, whichever is lower. In case of construction contracts spread over a number of years, foreseeable losses are considered while valuing the work-in-progress. In case of foreign exchange transactions where liabilities are settled in instalments spread over a number of years, the losses anticipated to arise due to fluctuation in the rate of foreign exchange are being accounted for in books. Liabilities for bonus, gratuity, leave encashment, etc., which are due for settlement under various statutory enactments are contingent upon certain conditions in future. But, provisions are considered necessary for such known liabilities. Provisions are also made for warranties and claims that may arise in future, due to contractual obligations. All these issues have resulted into controversies.

The list of controversial issues cited above is not exhaustive one. But the underlying reason behind all the controversies is provisioning for anticipated losses. This controversy persists since a very long time in spite of customary practice, judicial pronouncements and the accounting standards and so, there is no hesitation in describing it as the "Mother of all controversies".

Hereinafter, the historical perspective, role of provisioning for anticipated losses in giving rise to various controversies, accounting practices/standards, measures taken by the Revenue to resolve the various controversies are discussed in details.

Valuation of unsold stocks

2. As long back as 85 years and almost coinciding with the enactment of the Indian Income-tax Act, 1922, a Court was called upon to rule upon the question of valuation of closing stock of a trader at cost or market rate, whichever was lower.

It was observed by one of the learned Judges in *Whimster & Co.* v. *Commissioners of Inland Revenue* [1926] 12 Tax Cas. 813, 837 as follows:–

> "Under this law (Revenue law) the profits are the profits realised in the course of the year. What seems an exception is recognised where a trader purchased and still holds goods or stocks which have fallen in value. No loss has been realised. Loss may not occur. Nevertheless, at the close of the year he is permitted to treat these goods or stocks as of their market value".

Prior to this, it was pointed out in paragraph 8 of the Report of the Committee on Financial Risks attaching to the holding of Trading Stocks, 1919, as follows:

> "As the entry for stock which appears in a trading account is merely intended to cancel the charge for the goods purchased which have not been sold, it should necessarily represent the cost of the goods. If it is more or less than the cost, then the effect is to state the profit on the goods which actually have been sold at the incorrect figure. .... From this rigid doctrine one exception is very generally recognised on prudential grounds and is now fully sanctioned by custom, *viz.*, the adoption of market value at the date of making up accounts, if that value is less than cost. It is of course an anticipation of the loss that may be made on those goods in the following year, and may even have the effect, if prices rise again, of attributing to the following year's results a greater amount of profit than the difference between the actual sale price and the actual cost price of the goods in question."

The aforesaid report is extracted in paragraph 281 of the Report of the Committee on the Taxation of Trading Profits presented to the British

Parliament in April 1951 and quoted by the Supreme Court in the case of *Chainrup Sampatram* v. *CIT* [1953] 24 ITR 481. On October 9, 1953, in *Chainrup Sampatram* (*supra*), the Hon'ble Supreme Court explained the purpose of the valuation of unsold stock as follows:

"The true purpose of crediting the value of unsold stock is to balance the cost of those goods entered on the other side of the account at the time of their purchase, so that the cancelling out of the entries relating to the same stock from both sides of the account would leave only the transactions on which there have been actual sales in the course of the year showing the profit or loss actually realised on the year's trading. As pointed out in paragraph 8 of the Report of the Committee on Financial Risks attaching to the holding of Trading Stocks, 1919, "As the entry for stock which appears in a trading account is merely intended to cancel the charge for the goods purchased which have not been sold, it should necessarily represent the cost of the goods. If it is more or less than the cost, then the effect is to state the profit on the goods which actually have been sold at the incorrect figure .... From this rigid doctrine one exception is very generally recognised on prudential grounds and is now fully sanctioned by custom, *viz.*, the adoption of market value at the date of making up accounts, if that value is less than cost. It is of course an anticipation of the loss that may be made on those goods in the following year, and may even have the effect, if prices rise again, of attributing to the following year's results a greater amount of profit than the difference between the actual sale price and the actual cost price of the goods in question" (extracted in paragraph 281 of the Report of the Committee on the Taxation of Trading Profits presented to British Parliament in April 1951). While anticipated loss is thus taken into account, anticipated profit in the shape of appreciated value of the closing stock is not brought into the account, as no prudent trader would care to show increased profit before its actual realisation. This is the theory underlying the rule that the closing stock is to be valued at cost or market price, whichever is the lower, and it is now generally accepted as an established rule of commercial practice and accountancy. As profits for income-tax purposes are to be computed in conformity with the ordinary principles of commercial accounting, unless of course, such principles have been superseded or modified by legislative enactments unrealised profits in the shape of appreciated value of goods remaining unsold at the end of an accounting year and carried over to the following year's account in a business that is continuing are not brought into the charge as a matter of practice, though, as already stated, loss due to a fall in price below cost is allowed even if such loss has not been actually realised."

The Madras High Court also had an occasion as early as 1925 to rule upon this controversy in the case of *CIT* v. *Chengalvaraya Chetti* [1925] ILR 48 Mad. 836. In this case, an illustration of the rule in its practical working has been given.

The statement of the concept of 'accrual' as explained by the Supreme Court in *E.D. Sasoon & Co. Ltd.* v. *CIT* [1954] 26 ITR 27, has held good till date. Therefore, it follows that while computing business income chargeable to tax under section 28, the Mercantile System of Accounting has to be followed and provision for anticipated losses and foreseeable liabilities will have to be taken into account. Section 145 also acknowledges the need to follow accounting standards. These may be prescribed by the Central Government. The accounting standards prescribed by the ICAI are also required to be followed by the assessees. This has received recognition in several decisions of the High Courts and the Supreme Court. [Para 11]

Thus, the practice of provisioning for anticipated losses as a prudent measure was accepted, both by custom and the judicial pronouncements on the subject, even before the Accounting Standards entered the field of accountancy.

Accounting standards adopt time-honoured practice

3. It would be evident from the following noting that Accounting Standards have adopted the practice evolved over a time.

The Institute of Chartered Accountants of India, recognising the need for setting high quality of Accounting Standards in the country, established Accounting Standards Board in 1977. This Board issued Accounting Standard (AS) 1, Disclosure of Accounting Policies in 1979. The issues considered by the Board in the selection of the Accounting Policies can be found in paragraphs 16 and 17 thereof which are reproduced as under:

> "16. The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise at the balance sheet date and of the profit or loss for the period ended on that date.
>
> 17. For this purpose, the major considerations governing the selection and application of accounting policies are:–
>
> a. *rudence* – In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.
>
> b. *Substance over form*

c. *Materiality*

The Accounting Standards Board of the ICAI in June 1981 issued - Accounting Standard (AS) 2, Valuation of Inventories which was revised in 1999. Para 20 of this Standard prescribes as follows:

> "The practice of writing down inventories below cost to net realisable value is consistent with the view that assets should not be carried in excess of the amounts expected to be realised from their sale or use."

Various Accounting Standards prescribed under IND AS & IFRS are no exception and contain provisions similar to Accounting Standards issued by the ICAI.

CBDT accepts provisioning for known liabilities and losses on grounds of prudence

4. In exercise of the powers conferred by sub-section (2) of section 145 of the Income-tax Act, 1961 (43 of 1961), the Central Government notified accounting standards *vide* Notification No. 9949 [F. No. 132/7/95-TPL] dated 25-1-1996 to be followed by all assessees following mercantile system of accounting, namely:

> "4. Accounting policies adopted by an assessee should be such so as to represent a true and fair view of the state of affairs of the business, profession or vocation in the financial statements prepared and presented on the basis of such accounting policies. For this purpose, the major considerations governing the selection and application of accounting policies are following, namely .
>
> (i) *Prudence* – Provisions should be made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information;
>
> (ii) *Substance over form*
>
> (iii) *Materiality*

Thus, there is no difference between Accounting Standard (AS) 1 issued by ICAI and the Accounting Standard notified by CBDT on the issue that Provisions should be made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. But the Taxation Authorities are not willing to concede the ground and controversies persist as illustrated herein below.

5. Controversies

5.1 ***Controversy relating to provision for foreseeable losses in construction contracts*** – The accounting practice of valuing unsold stocks at cost or net realisable value (market value) which is lower is widely accepted now. But when the same theory of prudence was applied to other anticipated losses in case of investments forming part of closing stock-in-trade, work-in-progress under construction contracts, fluctuations in foreign exchange transactions and other matters, litigations surfaced and persist till date.

In 1983, the Accounting Standards Board of the ICAI issued Accounting Standard (AS) 7, Accounting for Construction Contracts. Para 19 of the Standard stipulates as follows:

> "19. A foreseeable loss on the entire contract should be provided for in the financial statements irrespective of the amount of work done and the method of accounting followed."

When the assessees started adopting the accounting practice envisaged in the above Accounting Standard (AS) 7, the tax authorities rejected the same. Following few cases are stated as examples.

In a case before The ITAT Mumbai Bench 'A' in *Mazagon Dock Ltd.* v. *Jt. CIT* [2009] 29 SOT 356 decided on February 18, 2009, the issue was whether as far as change in method of valuation of work-in-progress was concerned, in view of mandatory requirements of AS-7, it was a *bona fide* change, particularly in view of qualification made in this regard by statutory auditors as well as by the Comptroller & Auditor General of India. It was held as follows:

"The question that came up for consideration was as to whether the anticipated loss on the valuation of fixed price contract, in view of the mandatory requirements of the AS-7, was to be allowed in the year in which the contract had been entered into or it was to be spread over a period of contract, as was done by the assessee in earlier years. As far as the change in the method of valuation of work-in-progress was concerned, it could not be disputed that in view of mandatory requirements of the AS-7, it was a *bona fide* change in the method of valuation of work-in-progress, particularly in view of the qualification made in this regard by statutory auditors as well as by the Comptroller & Auditor General of India. Therefore, the observation of the Commissioner (Appeals) that the assessee had booked bogus loss was not correct. As far as the basis of estimation was concerned, the same was done on technical estimation basis and, therefore, merely because there were some variations in the figures furnished by the assessee at different stages, it could not be said that the estimated loss was not allowable. It was not disputed that the department in earlier years had allowed the loss on estimated basis having regard to the expenditure actually incurred in various years. Therefore, in principle, it was not disputed that the estimated loss under the present circumstances was an allowable deduction. However, merely because the change in method of accounting was *bona fide*, it could not lead to the inference that the income was also deducible properly under the Act. This aspect is very evident from the first proviso to section 145 as it stood prior to the

> amendment by the Finance Act, 1995 with effect from 1-4-1997. It could not be disputed that from the method adopted by the assessee, the assessee's income could not be deduced properly in the year in which the loss had been anticipated. As a matter of fact this aspect was not disputed by the Assessing Officer also. He had been swayed more by the revenue loss than by the correct principle to be applied. The matching principle of accounting was not of much significance in the present context because if the loss had been properly estimated in the year in which the contract had been entered into, then it had to be allowed in that very year and could not be spread over the period of contract. The matching principle is of relevance where income and expenditure, both are to be considered together. However, in the instant case, the effect of valuation of WIP would automatically affect the profits of subsequent years accordingly. Therefore, there was no reason for not accepting in principle the assessee's claim as being allowable."

On May 26, 2009, the ITAT Mumbai Bench 'J' in the case of *Jacobs Engineering India (P.) Ltd.* v. *Asstt. CIT* [2011] 14 taxmann.com 186, held as follows:

> "Having regard to the above legal and factual discussions, and following the decision of the ITAT in the case of *Mazagon Dock Ltd.* (*supra*) and *Metal Box Co. of India Ltd.* (*supra*) and decision of the Hon'ble Delhi High Court in the case of *Woodward Governor India (P.) Ltd.* (*supra*) the contention of the assessee regarding allowability of foreseeable loss is accepted in principle. However, the issue is restored to the file of Assessing Officer, for the purpose of quantification and calculation of the said loss in terms of Accounting Standard - 7, as the same has not been done."

It is clear from above that the underlying reasons of controversy are the provisioning for anticipated losses. As the taxation authorities are not yet comfortable with the requirement of provisioning for anticipated losses, the CBDT has issued exposure draft of "Tax Accounting Standards on Construction Contracts" laying down rules for computation of taxable income.

5.2 *Controversy regarding anticipated losses in transactions involving foreign exchange* - The issue before the Delhi High Court in the case of *CIT* v. *Woodward Governor India (P.) Ltd.* [2007] 162 Taxman 60, was whether in cases where foreign currency is held on revenue account, increase in liability on account of fluctuation in rate of foreign exchange prevailing on last day of financial year is not notional or contingent and, therefore, can be allowed as a deduction in terms of section 37(1)? The Court ruled in favour of the assessee.

Similarly, the issue before the Supreme Court in the case of *Oil & Natural Gas Corpn. Ltd.* v. *CIT* [2010] 189 Taxman 292, was whether when assessee maintained its accounts on mercantile system of accounting, there was no finding by the Assessing Officer on correctness or completeness of account and assessee had complied with Accounting Standards laid down by the Central Government, 'loss' suffered by the assessee on account of fluctuation in rate of foreign exchange as on date of balance sheet could be allowed as an expenditure under section 37(1), notwithstanding fact that liability had not been actually discharged in year in which fluctuation in rate of foreign exchange had occurred? The Court ruled in favour of the assessee.

In *CIT* v. *International Creative Foods (P.) Ltd.* [2011] 9 taxmann.com 191 (Ker.), the Assessing Officer disallowed the assessee's claim for deduction of exchange rate fluctuation on outstanding loan on ground that loan remained outstanding and exchange rate fluctuation was not actual liability but was only a provision which could not be allowed. On appeal, first appellate authority as well as the Tribunal allowed the assessee's claim by following Accounting Standard (AS) II issued by the Institute of Chartered Accountants of India. The issue before the Kerala High Court was whether since there was nothing to indicate in orders of any of the authorities below as to when the assessee availed loan and whether the assessee was claiming deduction for every year whenever exchange rate fluctuation was adverse to it, matter required reconsideration and if it was found that the assessee-company had followed uniform practice of debiting and crediting profit and loss account with variation in exchange rate fluctuation, then deduction should be allowed in the assessment year in question also if exchange rate fluctuation had caused increase in rupee liability of loan account. The Court ruled in favour of the assessee.

From a perusal of all the three cases cited above and also from many other cases on this issue, the controversy related to provision for anticipated losses is clear.

To nullify the impact of the above judgments, the provisions of section 43A of the Income-tax Act, 1961 were amended.

5.3 *Controversy relating to provision for dimunition in value of investments* - Para 31 of the Accounting Standard (AS) 13, Accounting for Investments, stipulates as under:

> "31. Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on overall (or global) basis."

The recognition of lower of cost and fair value amounts to provisioning for anticipated losses. This accounting treatment is frowned upon by the taxation authorities. So, *vide* the Finance (No. 2) Act, 2009 these sections were amended *inter alia* to provide that any provision for diminution in the value of assets shall not be allowed while computing book profit under section 115JA and 115JB. These amendments have been made with retrospective effect from the date and the period during which respective section was/is in force.

5.4 *Controversy relating to provision for warranty claims* – In *Rotork Controls India (P.) Ltd.* v. *CIT* [2009] 180 Taxman 422 (SC), the assessee-company was manufacturing and selling valve actuators in large numbers. At the time of sale it provided a standard warranty, whereby in the event of any actuator or part thereof becoming defective within 12 months from the date of commissioning or 18 months from the date of dispatch, whichever was earlier, it undertook to rectify or replace the defective part free of charge. For the relevant assessment years, the assessee made a provision for warranty on account of warranty claims likely to arise on the sales effected by it and to cover up that expenditure. Since the provision exceeded the actual expenditure, it reversed the excess amount and claimed deduction in respect of the net provision under section 37(1). The Assessing Officer declined deduction holding that the liability was merely a contingent liability.

The issue before the Supreme Court was whether for a provision to qualify for recognition, there must be a present obligation arising from the past events, settlement of which is expected to result in an outflow of resources and in respect of which a reliable estimate of amount of obligation is possible. The Court ruled in favour of the assessee holding that if historical trend indicates that in the past large number of sophisticated goods were being manufactured and defects existed in some of the items manufactured and sold, then provision made for warranty in respect of such sophisticated goods would be entitled to deduction from gross receipts under section 37(1), provided data is systematically maintained by the assessee.

In this case also, the underlying reason behind the controversy can be traced to provision for anticipated losses.

5.5 *Controversy relating to provision for gratuity* – Gratuity is payable under the Payment of Gratuity Act. When the assessees provided for this liability in their books of account, the taxation authorities objected to it being contingent in nature.

In the case of *Metal Box Co. of India Ltd.* v. *Their Workmen* [1969] 73 ITR 53 (SC), the Supreme Court had an occasion to resolve the controversy. The Supreme Court held as follows:

> "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 consideration. An estimated liability under a scheme of gratuity, if properly ascertainable and its present value discounted, is deductible from the gross receipts while preparing the profit and loss account. This is recognised in trade circles and there is nothing in the Bonus Act which prohibits such a practice. Such a provision provides for a known liability of which the amount can

> be determined with substantial accuracy. It cannot be termed as a "reserve". Therefore, the estimated liability for the year on account of a scheme of gratuity should be allowed to be deducted from the gross profits. The allowance is not restricted to the actual payment of gratuity during the year."

The taxation authorities were not willing to concede the ground easily. The Finance Act, 1975 inserted the provisions of section 40A(7) with retrospective effect from April 1, 1973. It provided that no deduction is to be allowed, in the computation of the profits and gains of business or profession, in respect of any provision made for payment of gratuity to the employees on retirement or on termination of employment. However, this provision was subject to some exceptions. It did not apply to any provision made for the purpose of payment of a sum by way of contribution towards an approved gratuity fund that has become payable during the year, or for the purpose of meeting actual liability that has arisen during the year.

Even a provision made for contribution to a recognised provident fund was subjected to stricter conditions. The Finance Act, 1983 inserted section 43B with effect from April 1, 1984 providing that such provision would be allowed in the year when actual payment is made.

On December 4, 1989, the High Court of Calcutta in the case of *CIT* v. *Metal Box India Ltd.* [1992] 63 Taxman 160 held that claim for liability towards gratuity calculated on basis of actuarial valuation is allowable.

In 1995, the ICAI issued Accounting Standard (AS) 15, Accounting for Retirement Benefits in the Financial Statements of Enterprises.

Thus, the underlying reasons for the persisting controversy are traceable to provisioning for anticipated losses.

5.6 ***Controversy relating to provision for leave encashment*** – In *Bharat Earth Movers* v. *CIT* [2000] 112 Taxman 61 (SC), the issue was, if a business liability has definitely arisen in an accounting year, whether deduction should be allowed, although liability may have to be quantified and discharged at a future date but what should be definite is incurring of liability? The Supreme Court held 'Yes'. Provision was made by the assessee-company for meeting liability towards leave encashment proportionate to entitlement earned by the employees of company subject to ceiling on accumulation, as applicable on the relevant date. Whether assessee would be entitled to deduction of such provision out of gross receipts for accounting year during which provision was made for liability inasmuch as liability was not a contingent liability? Again, the supreme Court held 'Yes'.

As the taxation authorities were not willing to concede, they amended section 43B of the Income-tax Act, 1961. The Finance Act, 2001 inserted clause (*f*) with effect from April 1, 2002 providing that any sum payable by the assessee as an employer in lieu of any leave at the credit of his employee shall be allowed in that previous year in which such sum is actually paid.

This amendment has been struck down by the Calcutta High Court in the case of *Exide Industries Ltd.* v. *Union of India* [2007] 164 Taxman 9, being arbitrary, unconscionable and *de hors* the Apex Court's decision in the case of *Bharat Earth Movers* (*supra*).

Against the judgment in *Exide Industries Ltd.'s* case *(supra),* the I-T Department filed a special leave petition in the Supreme Court which stayed the judgment.

Beginning of new innings of controversies

6. From the above write-up, it is clear that the taxation authorities have always been reluctant to accept the provisioning for anticipated losses. It is immaterial for them whether the Accounting Standards permit such accounting treatment and/or whether such Standards are issued under the authority of the ICAI or the Ministry of Corporate Affairs or by international bodies. In the event of adverse judicial pronouncements, they have frequently resorted to legislative changes.

Recently (*i.e.,* on October 17, 2011), in exercise of powers conferred under section 145 of the Income-tax Act, the CBDT has issued two Tax Accounting Standards - one relating to construction contracts and another relating to the Governmental Grants. It proposes to issue more such Standards. These Standards are meant to apply for computation of income chargeable under certain heads and not for the purpose of maintenance of books of account. The Tax Accounting Standard on construction contracts does not stipulate that expected losses should be recognised as an expense immediately. In this way, this Standard makes a provision which is contrary to that of Accounting Standard (AS) 7 issued by the ICAI.

By notifying Tax Accounting Standards (TAS) for the purpose of computation of income and not for maintenance of books of account, the CBDT has made paradigm shift in the way the income of an assessee would be computed in future.

Tax accounting standards unlikely to achieve purpose for which they are being issued

7. Section 145 of the Income-tax Act, 1961 is a part of Chapter XIV - Procedure for assessment. It reads as under:

> "145. *Method of accounting.* —(1) Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.
>
> (2) The Central Government may notify in the Official Gazette from time-to-time accounting standards to be followed by any class of assessees or in respect of any class of income.

> (3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where the method of accounting provided in sub-section (1) or accounting standards as notified under sub-section (2), have not been regularly followed by the assessee, the Assessing Officer may make an assessment in the manner provided in section 144."

From a reading of the above provisions, it may be noted that sub-section (2) of the above section authorises the Central Government to notify Accounting Standards to be followed by any class of assessees or in respect of any class of income. This sub-section does not expressly specify the purpose for which such accounting standards can be notified. So, the question, whether a Standard can be notified by virtue of these powers for maintenance of accounts or for computation of taxable income or for both would have to be decided, keeping in view the scheme of the Act. If the heading of the section is taken as the guiding factor, then a notification under this section would necessarily have to be one prescribing maintenance of accounts and not for computation of taxable income.

Apart from above, sub-section (3) lays down the consequences of not following the same. Sub-section (3) is attracted under any of the following three circumstances:

(a) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee; or

(b) Where the method of accounting provided in sub-section (1) has not been regularly followed by the assessee; or

(c) Where accounting standards as notified under sub-section (2), have not been regularly followed by the assessee.

Not conceding, but assuming that an assessee maintains his accounts in accordance with the mandatory Accounting Standards issued by the ICAI and other authorised bodies but does not compute his taxable income in accordance with the Tax Accounting Standards. The Assessing Officer is satisfied about the correctness or completeness of his accounts. In this example, let us assume that an assessee fulfils the first two conditions envisaged in sub-section (3) of section 145 but does not satisfy the third condition. The three conditions are not cumulative. So, can it be argued that the third condition will have an overriding effect over the other two conditions and for non-compliance with the same, the consequences stipulated in sub-section (3) would follow. It is doubtful that the provisions of sub-section (3) would be attracted in such a situation.

It would be too early to say that notifications issued under section 145 of the Income-tax Act would receive judicial approval or not. But the following observations are equally noteworthy:

- irstly, inasmuch as the earlier Accounting Standard notified under section 145(2) of the Act under Notification No. 9949 -

F.N. 132/7/95-TPL, dated 25-1-1996 recognises 'Prudence' as a measure consideration governing the selection and application of accounting policies and TAS does away with this aspect, the two Standards are contradictory to each other - although both the Standards are notified by the same authority, *i.e.*, the CBDT.

- Secondly, the following observations in the judgment of the Gauhati High Court in the case of *MKB (Asia) (P.) Ltd.* v. *CIT* [2008] 167 Taxman 256 , deserve attention. [The Standard was adopted by the assessee on the advice of the author before it became mandatory]. In this case the Court held:

  "The accounting system as contemplated in AS-7 is an approved system of accounting by the Institute of Chartered Accountants of India. As such, the authenticity of the said accounting system was not under challenge. The assessee was maintaining its accounts following the said system and the accounts were duly audited by a qualified chartered accountant. Maintenance of the accounts as well as the valuation of work-in-progress would not prejudice either side. Admittedly, the particular works contract was not completed and it came under the category of work-in-progress. There was also no dispute that the ultimate liability of the assessee as regards tax will be dependant upon the total (fixed) amount received by the assessee against the particular works contract. [Para 12]

  The income-tax authority has no option/jurisdiction to meddle in the matter either by directing the assessee to maintain its accounts in a particular manner or adopt a different method for valuing the work-in-progress. An assessee has the option/liberty to adopt any recognized method of accounting for its business and the income should be computed in accordance with such regularly maintained accounting system. [Para 13]

  Thus, the Tribunal was not right in not accepting the valuation of closing work-in-progress in accordance with Accounting Standard-7."

- Thirdly, one must take note of the strictures passed by the Calcutta High Court in the case of *Exide Industries Ltd.* (*supra*), while striking down the provisions of section 43B(*f*) of the Income-tax Act as being arbitrary, unconscionable and *de hors* Apex Court's decision in the case of *Bharat Earth Movers* (*supra*), as follows:

  "Such enactment is not consistent with the original provision being section 43B, which was originally inserted to plug in evasion of statutory liability. The Apex Court considered the situation in *Bharat Earth Movers* v. *CIT* [2000] 245 ITR 428/ 112 Taxman 61 when clause (*f*) was not there. The Apex Court, considering all aspects, rejected the contention of the revenue

> and granted appropriate deduction to the concerned assessee. The Legislature, to get rid of the decision of the Apex Court, brought about the amendment which would otherwise nullify the Judge-made law. The Apex Court's decisions are Judge-made law and are applicable to all under the Constitution. The Legislature was entitled to bring such amendment; it was within its power to bring such amendment. However, it must disclose reasons which would be consistent with the provisions of the Constitution and the laws of the land and not for the sole object of nullifying the Apex Court's decision." [Para 13]

Conclusion

8. As long as the taxation authorities hold the view that provision for anticipated losses and accounting deprives them of the taxes legitimately due, they would reject the accounting practices, notwithstanding the fact that such practices are *bona fide* , justified or are adopted by a taxpayer under a mandatory Accounting Standard issued by the designated Accounting Standards Boards or under the provisions of other enactments, *e.g.* , the Companies Act, 1956, etc. It has been demonstrated herein above that in the event of judicial approval of the accounting practice of providing for anticipated losses under various circumstances, the Legislature has invariably resorted to legislative amendments to achieve its aim. The latest measures to issue Tax Accounting Standards meant for computation of taxable income are prone to give rise to new controversies. In *MKB (Asia) (P.) Ltd.'s* case (*supra*), the Court had ruled that "The income-tax authority has no option/jurisdiction to meddle in the matter either by directing the assessee to maintain its accounts in a particular manner or to adopt a different method for valuing the work- in-progress". In *Exide Industries Ltd.'s* case (*supra*), the Court was concerned with a legislative enactment passed by the Parliament and had no hesitation in striking off the same being arbitrary, unconscionable and *de hors* a judge-made law. As the Tax Accounting Standards are notified under the provisions of section 145(2) of the Act, the same cannot be equated with a legislative enactment passed by the Parliament and it remains to be seen if they meet judicial approval.

Germany

Berlin Waves through "City Tax"

Berlin's state parliament has waved through plans to introduce a so-called "city tax" on overnight stays in the German capital, from January 1, 2014.

Berlin intends to impose a 5 percent tax on the cost of overnight accommodation for all private stays, irrespective of whether or not the stay is in a hotel, youth hostel, or indeed on a campsite.

The charge will be imposed on a per night basis, up to a maximum period of 21 nights. Professionals staying overnight in the capital on a business trip will be exempt from the tax, however. The levy is expected to generate annual revenues of approximately EUR25m (USD34.4m).

Defending the measure earlier this year, Berlin's Finance Senator Ulrich Nußbaum underscored that the city of Berlin currently attracts millions of tourists every year from all over the world, emphasizing that tourism is growing rapidly. The overnight tax is designed to ensure that tourists visiting the city provide a small contribution to maintaining and improving Berlin's attractiveness, Nußbaum argued, making clear that the measure will benefit both those living in Berlin and visitors to the city.

Furthermore, Nußbaum pointed out that many other tourist destinations, both at home and abroad, levy similar fees, including notably Paris, Rome, and Barcelona. Experience in other cities shows that a moderate tax does not deter visitors, Nußbaum insisted. Finally, Nußbaum pledged to keep administration costs as low as possible, to avoid increasing the burden on businesses.

Firmly opposed to the plans, Hotel and Restaurant Association Dehoga Berlin has already announced its intention to submit a legal appeal challenging the city tax. Hotels and other accommodation providers in Berlin will be responsible for collecting the tax. More details will be provided shortly. – *Courtesy tax-news.com*

United Kingdom

UK Relief for Employee Ownership Structures Welcomed

The Chartered Institute of Taxation (CIOT) has welcomed the UK Government's decision to provide capital gains tax (CGT) relief to owners of limited liability companies who transfer a controlling interest in a trading company to an employee-owned structure.

The Government has also announced proposals to allow employee-owned companies the ability to pay up to GBP3,600 (USD5,900) per annum free of income tax to employees. The measures, announced on December 10, 2013, will, if approved, be included in the next Finance Bill.

John Barnett, Chairman of the CIOT Capital Gains Tax sub-committee, said: "We are pleased with the Government's commitment to supporting and encouraging employee ownership. The proposals also include a generous income tax exemption in respect of a bonus or similar payment to employees from the business and we welcome the commitment to keep the operation of the exemption as simple as possible. However, it should be noted that National Insurance Contributions (NICs) will be payable on the bonus payments: this is a change from the original proposal. Also, it is not clear to us why indirectly employee-owned businesses are to be favoured with this exemption and not, for example, directly owned employee businesses."

"While these changes are designed to encourage employee ownership of companies, the continuing attack on employee benefit trusts generally, and the disguised employment proposals which will affect partnerships bringing employees in as partners, sends mixed messages to employers who want to grow their business through greater employee involvement," Barnett pointed out, concluding that: "While anything which improves employee-ownership is to be welcomed, the CIOT does have some concerns that these measures only address half the story as they would have benefited from a more wide-ranging and better thought-out approach to the whole area of employee engagement." – *Courtesy tax-news.com*

United States

CBPP: US 'Tax Extenders' Extension should be Funded

With pressure growing on the United States Congress to agree to the annual renewal of the group of federal tax provisions requiring frequent annual renewal (the "tax extenders"), the Center on Budget and Policy Priorities (CBPP) has advised that, given current fiscal deficits, policymakers should make a firm commitment to provide funding for any extension of these provisions.

There are said to be some 64 tax provisions expiring on December 31 this year, some of more significance than others. However, the CBPP confirms that "paying for those tax extenders that Congress continues would have a significant impact on long-term deficits."

For businesses, the tax extenders available until end-2013 include increased expensing under Section 179 (full deduction on cost of qualifying equipment), the 50 percent bonus depreciation; the work opportunity tax credit; and the credit for research and development expenses. For individuals, they include mortgage tax relief, the deduction for state and local sales taxes, education tax deductions, and tax-free distributions from individual retirement accounts for charitable purposes.

US public debt amounts to 75 percent of gross domestic product (GDP) in 2013 and, assuming the tax extenders are continued but not paid for, the CBPP projects that it will climb under current policies to 99 percent of GDP in 2040. If policymakers were to offset the roughly USD50bn annual cost of continuing the tax extenders, it forecasts that the debt-to-GDP ratio would rise about 8 percent less, reaching 91 percent in 2040 and eliminating about one-third of the projected rise in the debt ratio by 2040 under current policies.

In addition, the CBPP feels that having to pay for the extension of any tax extenders would also improve tax policy decision-making. "Imposing the same type of fiscal discipline on the extenders that we impose on other budgetary measures would apply needed scrutiny," it says. "In addition, the need to pay for continuing those extenders that withstand scrutiny should provide a vehicle to pare some highly inefficient tax subsidies."

It is advised that "Congress should adhere to this 'pay-for' norm on tax extenders, whether it extends them in a stand-alone bill or as part of broader tax reform."

"While the primary reason to require offsets for the tax extenders is fiscal responsibility, such a move also should improve tax policy by subjecting these provisions to needed (and, in some cases, long overdue) scrutiny," the CBPP concludes. "Policymakers may decide that some extenders are not worth maintaining. And a commitment to paying for the extenders would nudge policymakers to address some weaknesses in the tax code as they searched for other revenues to offset the extenders." – *Courtesy tax-news.com*

FBR transfers 17 officers

The Federal Board of Revenue (FBR) has transferred 17 officers of the Inland Revenue Service (BS-18-20) with immediate effect.

According to the notification issued here, Jehanzeb Mahmood (Inland Revenue Service/BS-20) has been transferred and posted as Commissioner Inland Revenue (Zone-I) Regional Tax Office, Peshawar. Ghazanfar Hussain (Inland Revenue Service/BS-20) has been transferred and posted as Commissioner Inland Revenue (WHT) Regional Tax Office, Sialkot .He will also hold additional charge of the post of CIR (Zone-I), RTO, Sialkot. Muhammad Akram (Inland Revenue Service/BS-20) has been transferred and posted as Commissioner Inland Revenue (WHT) Regional Tax Office, Sargodha. He will also hold additional charge of the post of CIR (Zone-II), RTO, Sargodha. Sarfraz Ahmad (Inland Revenue Service/BS-20) has been transferred and posted as Commissioner Inland Revenue (WHT) Regional Tax Office, Islamabad. He will also hold additional charge of the post of CIR (Zone-II), RTO Islamabad. According to the notification, Shad Muhammad (Inland Revenue Service/BS-20) has been transferred and posted as Commissioner Inland Revenue (WHT) Regional Tax Office, Peshawar. Abdul Malik (Inland Revenue Service/BS-20) has been transferred and posted as Commissioner Inland Revenue (WHT) Regional Tax Office, Bahawalpur. He will also hold additional charge of the post of CIR (zone-I), RTO, Bahawalpur.

The notification further stated that Dr. Ahmad Shahab (Inland Revenue Service/BS-19) has been transferred and posted as Commissioner Inland Revenue (WHT) (OPS) Regional Tax Office, Gujranwala.

He will also hold additional charge of the post of CIR/OPS (zone-II), RTO, Gujranwala. Asif Haider Orakzai (Inland Revenue Service/BS-19) has been transferred as Commissioner Inland Revenue (WHT) (OPS) Regional Tax. – *Courtesy The Nation*

Repayment-cum-drawback: ghee exporters are entitled to file claims: FBR

The Federal Board of Revenue has ruled that the registered persons are entitled to claim composite repayment-cum-drawback of sales tax and Federal Excise Duty (FED) against exports of vegetable ghee and cooking oil under SRO.993(I)/2006. In this regard, the FBR on Thursday issued instructions to the Chief

Commissioners of the Large Taxpayer Units (LTUs) and Regional Tax Offices (RTOs) for compliance.

According to the FBR, field formations would process the claims of repayment-cum-drawback against exports in accordance with the provisions of SRO.993(I)12006 through manually generated refund payment orders (RPOs) and to guide the refund claimants about the correct procedure.

The FBR stated with reference to the letter received from M/s Bilour Industries (Pvt) Limited that registered persons are entitled to claim composite repayment-cum-drawback of sales tax and federal excise duty (FED) against exports of vegetable ghee and cooking oil in terms of SRO 993(1)/2006 dated September 21, 2006 wherein specified rates have been prescribed. As such, it is different from export-related sales tax refund claims, where the full amount of input tax is refunded.

The FBR further said that such composite repayment-cum-drawback is subject to the conditions and procedure prescribed in the aforesaid notification. The amount of FED paid on edible oil is required to be claimed for Sales Tax-cum-Federal Excise Return wherefrom it will be automatically transferred to Row No 31 of the return, and shown as “Federal Excise Duty (FED) Drawback”. As per para 3A of the aforesaid notification, refund of sales tax on electricity, gas and packing materials shall however, be paid on the basis of actual quantities consumed.

Apparently, exporters were previously mentioning their imports of edible oil only on the return, which caused the FED to be treated as input tax in Row No 3 of the return. Due to linking of returns with customs data in July 2013, this is no longer possible in case of manufacturers and exporters of vegetable ghee and cooking oil, FBR maintained.

The FBR further directed the field formations that the concerned LTUs/RTOs are therefore advised to process the claims of repayment-cum-drawback against exports in accordance with the provisions of SRO 993(1) 12006, dated 21-09-2006 through manually generated RPOs and to guide the refund claimants about the correct procedure. For previous tax periods, wherein returns have already been filed by the registered persons without claiming repayment-cum-drawback, the claims may also be processed manually, keeping in view all the legal requirements to ensure proper calculation and admissibility of the claim, FBR added.

Earlier, Bilour Industries Pvt Ltd had informed the FBR that the unit is registered as manufacturing-cum-Importer/Exporter and engaged in the production of vegetable ghee. At import stage on edible oil, the unit is paying FED @ 16% (in Sales Tax mode) along with Rs 1/Kg under SRO 24(1)/2006. However, when the unit load Import GDs of the Sales Tax Return the Input Tax is not reflected at serial No 03 of Sales Tax & Federal Excise Return from Tax Period June, 2013. In this respect the unit had approached the FBR and submitted sales tax and federal excise returns according to official's guidance.

To claim refund/drawback electronically the unit has written a letter on September 12, 2013 to Secretary (ST & FE-L&P), Federal Board of Revenue, Islamabad to modify the Risk Management System (RMS) accordingly or otherwise, enabling us to claim S. Tax Refund & Federal Excise Duty (FED) Drawback. It is requested that to do the needful at your earliest to avoid from strain as huge working capital has been stuck from the tax period June 2013 till date. – *Courtesy Business Recorder*

FBR steps vide Circular 15 against Prime Minister's vision: TBA

Tax Bar Associations on Thursday termed the measures taken by Federal Board of Revenue (FBR) through SRO 1040(I) and circular no 15 as against Prime Minister Nawaz Sharif's vision. Pakistan and Karachi Tax Bar Associations in their separate letters sent to chairman FBR, Tariq Bajwa, said that measures announced by PM Nawaz for broadening of tax base had not been reflected in FBR policy.

It said that after the issuance of circular no 15, no taxpayer could avail immunity and urged the board to take remedial measure to remove the flaws and make the scheme a 'success story'. There is a need to pay heed to some issues highlighted in the letters.

Letters stated said that taxpayers have been permitted to make lump sum addition (adhoc), which was presently prohibited as per S. No 9 of Part I (General) of Circular No 15.

Therefore, changes made in profit and loss account ,to enhance tax liability by 25 per cent, will not only not be supported by the books of accounts but also not be declared by the taxpayers in sales tax returns.

Resultantly, huge segment of the taxpayers will be excluded from availing this immunity scheme. Keeping this in view, it has been suggested that taxpayers be allowed to calculate lump sum addition tax and avail the benefit of the scheme.

Despite the announcement made by PM Nawaz the scheme currently grants immunity from tax audit only under sections 177 and 214C of the Income Tax Ordinance, 2001.

However, the commissioner has the authority to use sections 122(5) and 122 (5A) to amend assessment without a detailed audit and these powers are often misused to harass taxpayers.

In the absence of immunity from all sorts of assessment / amendments under the Income Tax, Sales Tax and Federal Excise Act, the scheme is unlikely to attract the large number of traders and small and medium size taxpayers.

Therefore, it has been suggested that immunity may be granted across the board under all fiscal laws to make this scheme workable. The cases should only be reopened where definite information is available with the department after the due approval of the board, the letters said.

As per clause 4 of Part I of Circular No 15, the time limit for filing of tax returns for Tax Year 2013 has been fixed as December, 15 2013.

On the other hand, there is no Performa, related to circular 15 available on FBR web portal to make taxpayers enable filing of income tax returns, electronically. It has also been requested that the board may extend the date of filing of returns for at least a month.

The letters said that who declared income below taxable limit (which was Rs 350,000/-) for Tax Year 2012 under clause 7 of Part I of circular 15 were not eligible to avail tax immunity.

In the past, similar immunities were granted under the Repealed Ordinance. In those immunities where the taxpayer declared income below the taxable limits in any previous year, was permitted to work out his enhanced tax liability based on the preceding available liability.

Therefore, the letters suggested that taxpayers may be allowed to adopt any preceding tax year's tax liability to avail benefit of immunity scheme.

It said that, there is no identification of the taxpayer in the Performa attached to the circular, creating confusion whether the taxpayers were required only to file such Performa.

It is requested to provide space for name and NTN in the Performa besides clarifying the last date of filing of tax returns for the companies.

Both Tax Bar Associations in their letters requested the authority to take appropriate measures in the light of issues raised by the associations and provide maximum relief to the taxpayers. – *Courtesy Business Recorder*

Restaurants' registration: tax survey launched in Islamabad

A tax survey has been launched in the federal capital to compulsorily register restaurants, hotels and guest houses with the sales tax department through special teams of tax officers physically inspecting all markets and posh locations in Islamabad. Sources told here on Thursday that the tax survey is expected to register dozens of un-registered restaurants, where sales tax has been charged from consumers, but never deposited with the Federal Board of Revenue (FBR).

Regional Tax Office (RTO) Islamabad would depute Inland Revenue officers in all such potential restaurants liable to be registered with the sales tax department. Special teams of the said RTO would inspect all un-registered restaurants and exercise powers of the Sales Tax Act 1990 for their compulsory registration. In case the restaurant is liable to be registered, the tax officials would immediately register it with the tax department.

According to the RTO Islamabad communication to the FBR, in view of the fact that there is no full time Commissioner Inland Revenue and Additional Commissioner Inland Revenue is posted at Zone-III, RTO Islamabad. Hence, for proper monitoring of restaurants the jurisdiction of restaurants, hotels and guest houses have been assigned to Commissioner Inland Revenue, Zone-II RTO Islamabad. Moreover, as desired by the FBR, the survey teams have been constituted to conduct survey of unregistered restaurants. They will be submitting the report during December, 2013 and accordingly meeting will be held with Chief Executive Officers (CEO), Pakistan Revenue Automation Limited (Pral) to decide the strategy for the electronic monitoring of restaurants. – *Courtesy Business Recorder*

S.R.O. 1049(I)/2013, Islamabad, the 10th December, 2013.– Whereas a difficulty has arisen in the treatment of "the Capital Redemption Reserve Fund" subsequent to the redemption of the preference shares in pursuance of the provisions of Section 85 of the Companies Ordinance, 1984 (XLVII of 1984). Now therefore, in exercise of the powers conferred on it, under the provision of Section 514 of the Companies Ordinance, 1984 read with clause (c) of section 43 of the Securities and Exchange Commission of Pakistan Act, 1997 (XLII of 1997), and the Finance Division Notification No. S.R.O. 698(I)/86, dated 2nd July, 1986, the Securities and Exchange Commission of Pakistan is pleased to direct that the provisions of section 85 'Redemption of preference shares' of the aforesaid Ordinance shall have effect in respect of the capital redemption reserve fund as:–

> *the capital redemption reserve fund created as per the provisions of Section 85 of the Companies Ordinance, 1984, after redemption of the preference shares, may be applied by the company in paying up un-issued shares of the company to be issued to members of the company as fully paid bonus shares.*

Date: 12th December, 2013

Mr. Muhammad Ishaq Dar,
Minister of Finance,
Government of Pakistan,
Q Block, Pakistan Secretariat

Respected Sir

IMMUNITY FROM TAX AUDIT UNDER SECTION 177 AND 214C UNDER CLAUSE 84 OF PART IV OF SECOND SCHEDULE TO THE ORDIANNCE AS PER SRO.NO.1040(I)/2013 DATED 05.12.2013 READ WITH CIRCULAR 15 OF 2013.

We are receiving various queries and proposals from all over the Country from the our affiliated Bar Association and subsequently we have attended the meeting of the office bearers and members of the Karachi Tax Bar Association (KTBA) which was held today at Bar Chambers, Regional Tax Office, Karachi, to further discuss the issues arising from the Circular No. 15 of 2013 issued on 10-12-2013.

There was a general consensus amongst the practicing tax fraternity that the measures announced by Mian Muhammad Nawz Sharif, Honourable Prime Minister of Pakistan to enhance the tax base of our beloved Country by taking into confidence the business community has not been truly reflected in the implementation measures introduced by the Federal Board of Revenue (FBR) through SRO 1040(I)/2013 dated 05-

12-2013 and its guidelines issued through Circular No. 15 of 2013 dated 10-12-2013.

In the above meeting the members of the Bar have strongly criticized the above Circular and were of the view that in the present prescribed form it will be next to impossible to avail the immunity by a large number of taxpayers and the same will not get the desired results as per the expectations of the Prime Minister.

Pakistan Tax Bar Association strongly recommends to your good self to take immediate remedial measure and prompt action to remove the lacunas and obstacles by taking the following amendments to make the scheme successful and to get the desired results as per the expectations which is the need of the day:

1. Allowing taxpayers to make lump sum addition (adhoc) which at present is prohibited as per S.No. 9 of Part I (General) of Circular No. 15. This is due to the fact that changes to the profit and loss account to effect the requirements to enhance tax liability by 25% will not be supported by the books of accounts maintained and/or revenue declared in sales tax returns by the taxpayers. Hence, a very large segment of the taxpayers will be excluded from availing this immunity scheme. Therefore, the Pakistan Tax Bar strongly recommends that the Taxpayers should be allowed to make lump sum addition to tax to avail the benefit of the scheme.
2. The Honourable Prime Minister in his speech announced immunity from Tax Audit. However, the scheme currently grants immunity from tax audit only U/s. 177 and U/s. 214C only whereas under the Income Tax Ordinance, 2001. However, the Commissioner has the authority to amend the assessment without a detail audit by using his powers U/s. 122(5) and U/s. 122(5A) of the Income Tax Ordinance, 2001. These powers are often being misused to harass the taxpayers unnecessarily.
3. In the absence of immunity from all sorts of assessment/ amendments under the Income Tax, Sales Tax and Federal Excise Act, the scheme is unlikely to attract the large number of traders and small and medium size taxpayers. We, therefore, suggest in this regard that immunity may be granted across the board under all fiscal laws to make this scheme workable. Cases should only be reopened where definite information is available with the Department after the due approval of the Board.
4. As per clause 4 of Part I of Circular No. 15, the time limit of filing of tax returns for Tax Year 2013 has been maintained at 15th December, 2013. This is inspite of the fact that the aforesaid Circular No. 15 was available on the website of FBR after office hours on 10th December, 2013. Further, as of now,

there is no Performa in respect of the said Circular No. 15 yet available on the web portal of FBR where return of income are to be filed online by the taxpayer.

Pakistan Tax Bar Association earnestly request the FBR for a prompt immediate appropriate action in this regard and we, therefore, strongly request you to first Extend the date of filing of Tax Returns by at leas ONE MONTH in order o take care of these issues.

5. Other Matters Requiring Attention:

   a. Under clause 7 of Part I of Circular No. 15, where a taxpayer has declared income below taxable limit (which was Rs. 350,000/-) for Tax Year 2012, the taxpayer is not qualified to avail immunity. In the past, similar immunities were granted under the Repealed Ordinance. In those immunities where the taxpayers declared income below the taxable limits in any previous year, he was permitted to work out his enhanced tax liability based on the preceding available liability, therefore, Pakistan Tax Bar Association recommends that a taxpayer may be allowed to adopt any preceding tax year's tax liability to avail benefit of this immunity scheme.

   b. In the Performa attached to the Circular, there is no mention of identification of the taxpayer which shall create confusion where the taxpayers is only required to file such Performa.

      Therefore, Pakistan Tax Bar Association further recommend, space for Name and National Tax Number should be provided for the convenience of the taxpayer and tax officials in the Performa.

   c. Clause4 of Circular 15 of 2013 causes confusion as to the last date of filing of tax returns for the Companies who otherwise as per law are required to file the return of income by December 31 (Companies having close of year between January 01 and June 30). This issue required clarification.

We are hopeful that your honour will keenly indulge into the mater and look into the recommendations, shortcomings/anomalies highlighted above which are to be taken care off on prompt basis in order to implement the Scheme in a proper way so the taxpayers can be benefited from this Immunity announced by the worthy Prime Minister of Pakistan.

Yours truly,

Munawwar Husain Shaikh
President

No.4(67)ITP/2013(Pt-I) Islamabad, the 12th December, 2013

INCOME TAX CIRCULAR NO. 16/2013

Subject: **Corrigendum to Circular No. 15 of 2013 dated 10.12.2013.**

The following correction is hereby made in Federal Board of Revenue's Circular No. 15 of 2013 dated 10 December, 2013 namely:–

I. *The word and figures appearing in the subject of the said Circular as "dated 05.12.2012" may be read as "dated 05.12.2013".*

II. Part-II of the circular is amended as under:

PART-II
(PROFORMA)

The Proforma as per SRO.1040(I)/2013 dated 05.12.2013 to be filed along with the Return is as under:–

FEDERAL BOARD OF REVENUE
GOVERNMENT OF PAKISTAN
REQUEST FOR SEEKDING IMMUNITY FROM AUDIT FOR TY-2013
(To be Filed along with the Return)

NTN ______________________ Person ☐ Company ☐ AOP ☐ Individual
Name ______________________
Address ______________________
City______________________ Tax Office______________________
Mobile #______________________ Phone #______________________
e-Mail ______________________

a) Where income was not exempt during tax year 2012

Sr.	Description	Amount
1.	Taxable Income declared for Tax Year 2012	
2.	Whether taxable income revised/amended (Y/N)?	
3.	If Yes, latest amended taxable income for Tax Year 2012	
4.	Tax Paid on Taxable Income	
5.	25% of 4	
6.	Minimum Tax Payable for Tax Year 2013 under SRO.1040/2013 (4+5)	
7.	Tax Paid for tax year 2013	
8.	CPR No.	
9.	Whether Eligible for Immunity from audit (FOR OFFICIAL USE ONLY)	

b) Where income was exempt during tax year 2012.

1.	Income declared for Tax Year 2012	Amount
2.	Whether income for Tax Year 2012 Exempt (Y/N)?	
3.	If answer to 2 is yes, tax payable if it was not exempt	
4.	25% of 3	

5.	Minimum Tax Payable for Tax Year 2013 under SRO.1040/2013 (3+4)	
6.	Tax Paid for Tax Year 2013	
7.	CPR No.	
8.	Whether Eligible for Immunity from audit (FOR OFFICIAL USE ONLY)	

Date

Signature Applicant

2013 TRI 2004 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
CHENNAI "C" BENCH, CHENNAI

Dr. O.K. Narayanan, Vice President and Challa Nagendra Prasad, Judicial Member

FACTS/HELD

Section 14A & Rule 8D: Onus is on AO to show how assessee's claim is incorrect. AO has to show direct nexus between expenditure & exempt income. Disallowance cannot be made on presumptions

1. In AY 2009-10 the AO made a disallowance of Rs 58 lakhs u/s 14A read with Rule 8D. The assessee claimed that the disallowance was not permissible on the grounds that (i) the AO had not recorded any satisfaction as to the correctness of the assessee's claim that it had not incurred expenditure of more than 2% of the dividend income earned, (ii) it had not made any fresh investment during the year and the dividend was received from an unlisted company out of an investment made in an earlier year & (iii) the AO had not pointed out any direct nexus between the interest expenditure incurred and the exempt income earned during the year. The CIT(A) accepted the claim & restricted the disallowance to Rs 50,000 On appeal by the department to the Tribunal HELD dismissing the appeal:

    (i) A disallowance u/s 14A read with Rule 8D cannot be made without recording satisfaction as to how the assessee's calculation of s. 14A disallowance is incorrect. It is a prerequisite that before invoking Rule 8D, the AO must record his satisfaction on how the assessee's calculation is incorrect. The AO cannot apply Rule 8D without pointing out any inaccuracy in the method of apportionment or allocation of expenses. Further, the onus is on the AO to show that expenditure has been incurred by the assessee for earning tax-free income. Without discharging the onus, the AO is not entitled to make an ad hoc disallowance. A clear finding of incurring of expenditure is necessary. No disallowance can be made on the basis of presumptions, (ii) the mere fact that some interest expenses were incurred cannot be the reason for disallowance unless the nexus between the expense and the exempt income is established, (iii) the assessee did not make any fresh investment during the year which could generate exempt income in forthcoming years, (iii) the exempt income earned during the year comprised of dividend received from an investment made in an earlier year, (iv) the interest expenditure of the year is not directly related to the earning of exempt income & (v) the AO has not pointed out any direct nexus between the interest expenditure incurred and the exempt income earned during the year (Hero Cycles Ltd 323 ITR 518 P&H) & Godrej and Boyce 328 ITR 81 (Bom) followed)

Appeal dismissed.

ITA No. 305/Mds/2013 (Assessment Year: 2009-10).

Heard on: 7th November, 2013.

Decided on: 7th November, 2013.

Present at hearing: T.N. Betgeri, JCIT, for Appellant. Saroj Kumar Parida, Advocate, for Respondent.

JUDGMENT

Per Challa Nagendra Prasad:– (Judicial Member)

This appeal is filed by the Revenue against the order of the Commissioner of Income Tax (Appeals)-III, Chennai dated 20.11.2012 for the assessment year 2009-10. The only grievance of the Revenue in this appeal is that the Commissioner of Income Tax (Appeals) erred in restricting the disallowance under section 14A of the Act to Rs. 50,000/- as against disallowance of Rs. 58,64,016/- made by the Assessing Officer.

2. The Assessing Officer while completing the assessments disallowed Rs. 58,64,016/- invoking the provisions of section 14A read with Rule 8D. The assessee filed an appeal before the Commissioner of Income Tax (Appeals) contending that the Assessing Officer has not recorded any satisfaction as to the correctness of the assessee's claim that it had not incurred expenditure more than 2% of the dividend income earned. The appellant contended that it had not made any fresh investment during the year and the dividend was received from unlisted company out of the investment in shares of the company made in the year 2003-04. The interest expenditure incurred by the assessee during the assessment year does not relate to earning of exempt income. The Assessing Officer has not pointed out any direct nexus between the interest expenditure incurred and the exempt income earned during the year. Therefore, there is no justification in disallowing Rs. 58,64,016/-

under section 14A read with Rule 8D. The Commissioner of Income Tax (Appeals) considering the submissions of the assessee restricted the disallowance to Rs. 50,000/- under section 14A of the Act against which the Revenue is in appeal before us.

3. The Departmental Representative supports the order of the Assessing Officer .

4. The counsel for the assessee supports the order of the Commissioner of Income Tax (Appeals) and also places reliance on the decision of the co-ordinate Bench of this Tribunal in the case of Shiva Distilleries in ITA No.2125/Mds/2012 dated 26.8.2013 in support of his contention that in the absence of any satisfaction recorded by the Assessing Officer in regard to the correctness of the claim of the assessee that it had not incurred any expenditure, no disallowance under section 14A of the Act can be made.

5. Heard both sides. Perused the orders of the lower authorities and the order of this Tribunal relied on by the counsel for the assessee. The Commissioner of Income Tax (Appeals) after considering the submissions of the assessee elaborately discussed the circumstances under which the provisions of section 14A read with Rule 8D especially the interest income cannot be subjected to disallowance observing as under:–

> *"4.2 I have carefully considered the facts of the case and the submissions of the Id. AR. I have also gone through the decisions relied on by the AO and the AR. The AO has applied rule 8D for the above disallowance because funds for the appellant came in a common kitty and the appellant could not clearly show the utilization of the funds. The appellant has strongly contested the disallowance made by the AO. From the details of investments filed, it is found that the value of total investments as on 31.3.2008 was Rs. 12,81,09,1102/- and as on 31.3.2009 it was Rs. 4,93,16,401/-, the decrease in the value of investments was due to loss in partnership firm. The details of exempt income filed by the appellant reveal that dividend income was received from the investments made in M/sVaigai Chemical Industries Ltd., this investment was made in the year 2003-04, there was no fresh investment in the relevant assessment year in this company from which dividend was. received. Appellant has given break-up of interest expenditure of Rs. 1,13,15,453/-, from the details reproduced in para 4.1.3 (supra), it is noted that no part of interest expenditure can be attributed to any borrowing which was utilised for making investments which could generate exempt income. From the above discussion, the following points emerge:*
>
> *1. The appellant did .not make any fresh investment during the year which could generate exempt income in forthcoming years.*

> *2. The exempt income of Rs.3,33,320/- earned by the appellant during the year comprised of dividend received from an unlisted company M/s. Vaigai Chemical Industries Ltd, investment in the shares 'of this company was made in the year 2003-04.*
>
> *3. The appellant incurred interest expenditure of Rs. 1,13,15,453/- during the year under five major heads, none of which is directly related to earning of exempt income.*
>
> *4. The AO has not pointed out any direct nexus between the interest expenditure incurred and the exempt income earned during the year.*

4.3. It is pertinent to mention here the decision of the Mumbai Tribunal in the case of M/s. Krishna Land Developers Pvt. Ltd A.Y. 2008-09 wherein the Assessing Officer made a disallowance of Rs. 31 lakhs under section 14A of the Act by applying Rule 8D without recording any satisfaction as to how the assessee's calculation of section 14A disallowance was incorrect. The ITAT held that it is a prerequisite that before invoking Rule 8D, the must record his satisfaction on how the assessee's calculation is incorrect. The AO cannot apply Rule 8D without pointing out any inaccuracy in the method' of apportionment or allocation of expenses. Further, the onus is on the AO to show that expenditure has been incurred by the assessee for earning tax-free income. Without discharging the onus, the AO is not entitled to make an ad hoc disallowance. ·A clear finding of incurring of expenditure is necessary. No disallowance can be made on the basis of presumptions.

Further, the Punjab & Haryana High Court in the case of CIT vs Hero Cycles Ltd (2010) (323 ITR 518) has held that for the purpose of disallowance under section 14A of the Act, expenses must have been incurred for the purpose of earning exempt income. The mere fact that some interest expenses were incurred cannot be the reason for disallowance unless the nexus between the expense and the exempt income is established.

> *"It is held in the case of Godrej and Boyce Mfg Co. Ltd vs. DC IT (194 Taxman 203) High Court of Bombay) "Sub-section (2) of section 14A does not enable the AO to apply the method prescribed by rule 8D without determining in the first instance the correctness of the claim of the assessee, having regard to the accounts of the assessee. Sub-section (2) of section 14A mandates that it is only when, having regard to the accounts of the assessee, the Assessing Officer is not satisfied with the correctness of the claim of the assessee in respect of expenditure incurred in relation to income which does not form part of the*

total income under the Act, that he can proceed to make a determination under the Rules. The satisfaction envisaged by sub-section (2) of section 14A is an objective satisfaction that has to be arrived at by the Assessing Officer having regard to the accounts of the assessee. The safeguard introduced by subsection (2) of section 14A for a fair and reasonable exercise of power by the Assessing Officer, conditioned as it is by the requirement of an objective satisfaction, must, therefore, be scrupulously observed. An objective satisfaction contemplates a notice to the assessee, an opportunity to the assessee to place on record all the relevant facts including his accounts and recording of reasons by the Assessing Officer in the event he comes to the conclusion that he is not satisfied with the claim of the assessee."

From the above discussion, it transpires that the objective satisfaction of the AO as to the correctness of the assessee's claim was not recorded in the instant case. However, even if Rule 8D cannot be applied, the AO is obliged to ascertain the expenditure which had been incurred to earn the tax-free income. He must adopt a reasonable basis consistent with the relevant facts and circumstances of the case. The appellant's dividend income during the year is Rs. 3,33,320/- and appellant estimated an expenditure of 2% of dividend income as related to exempt income and disallowed an amount of Rs.6,666/- in the computation of total income. The expenditure estimated by the appellant appears to be highly inadequate. Appellant has to incur various direct and indirect expenses in as much as the efforts of the employees go in tracking the mutual fund and other investments, purchase and sale of mutual funds and other assets, deposit of the dividend warrants, portfolio management etc. Considering the facts and circumstances of the case and judicial precedents discussed in preceding paras, a sum of Rs. 50,000/- is considered as reasonable expenditure to earn the exempt income. Accordingly, the disallowance is restricted to Rs.50,000/-. This ground is partly ***allowed.****"*

6. On a careful reading of the order of the Commissioner of Income Tax (Appeals), we do not find any valid reason to interfere with the findings of the Commissioner of Income Tax (Appeals). The grounds raised by the Revenue are rejected.

7. In the result, the appeal of the Revenue is dismissed.

Order pronounced in the open court at the time of hearing on Thursday, the 7^{th} day of November, 2013 at Chennai.

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