‘Exemption or Deduction’ under tax holiday Sections – Controversial CBDT Circular : 16-09-2013

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THE Central Board of Direct Taxes has come out with a highly controversial Circular No. 07/DV /2013, bringing its own views. TIOL has already carried some articles on this very important development. This piece tries to understand issues from a different perspective.

The concept involving providing tax holiday to new industrial undertakings has always a subject matter of study, under the Income Tax law, for several decades now. I remember sections such as 80U, 80I, 80H, 80HH, 80-IA, etc., which have all existed in Income tax Act, 1961, at various points of time, in history. In the late 80s, we used to have Section 80HH, which provided tax holiday for 10 years for profits arising from industrial undertakings set up in specified backward areas. It is common knowledge that, hugely successful industrial towns such as Hosur (located near Bangalore) developed largely due to tax holiday. This is equally applicable for new plants being set up in states like Uttarakhand and Union territory like Pondicherry.

Of course, the concept of tax holiday for new industrial undertakings/units got a big fillip when the then FM, YashwantSinha, extended the tax holiday under Sections 10A and 10B and made the tax holiday as an open ended scheme for all new units to be set up. Thanks partly to the tax holiday we saw a lot of new investments flowing into the IT sector from MNCs, with tens of thousands of Indian subsidiaries getting set up. There can be little doubt that the tax holiday scheme played a vital role in the development of the export oriented IT industry, if the all-around development in a multi culture city like Bangalore is any example.

The IT industry was hugely disappointed when the Government went back on its promise of zero tax on 100% EOUs/STP units, when it brought these units under the MAT scheme with effect from FY2007-28, effectively undermining the scheme. The final blow came when the tax holiday was completely withdrawn from the Income tax Act from April 1, 2011 and despite repeated requests and representations from the Industry for a re-introduction of the tax holiday, the Government has not obliged.

As a student of income tax, one always understood the tax holiday benefit as ‘an exemption’ rather than, as a ‘deduction’. Under the ‘exemption’ route, only the profit of the new industrial undertaking /unit is considered for exemption, to the exclusion of the profits or losses of the other units/activities of the assessee. Thus, if an assessee had a profit of Rs. 100 lakhs from an eligible industrial undertaking and a loss of Rs. 40 lakhs for his other activities not connected to the new industrial undertaking, he was entitled to the tax exemption on the income of Rs. 100 lakhs while being allowed to carry forward the loss of Rs. 40 lakhs. Under the ‘deduction’ route,

for the same set of circumstances, the assessee would have been entitled to exemption from income tax on the net income of Rs. 60 lakhs (Rs. 100 lakhs under the tax holiday minus Rs. 40 lakhs from the non-tax holiday scheme). Of course, depending on the facts of the individual cases, the tax holiday provisions could apply favourably or unfavourably to the assessee, both in respect of the exemption of income as well as, in respect of carry forward and set off, of losses. However, it is an undisputable fact that the tax holiday provisions if interpreted as an 'exemption' would work out favourably to the assessees in, perhaps, 8 out of 10 cases and this perhaps, is the reason for the Board to come out with this controversial Circular.

The Courts and the ITAT Benches have taken contradictory stands on this vexatious issue. The High Court of Karnataka in CIT v Yokogawa India Ltd, (2011-TIOL-711-HC-KAR-IT) took t he view that the tax holiday provision is an 'exemption' provision and had held that the brought forward loss and unabsorbed depreciation of the non-eligible units need not be adjusted against the profit made in the eligible unit, for purposes of computation of the tax holiday exemption under Section 10A. The Delhi High Court, in Commissioner of Income Tax v. TEI Technologies Ltd (2012-TIOL-691-HC-DEL-IT) has concurred with the view taken by the Karnataka High Court and has categorically held that, Section 10A provides for exemption of income from eligible industrial undertakings in contra distinction to a deduction. Interestingly, the Bombay High Court, in THE COMMISSIONER OF INCOME TAX-10 Vs BLACK & VEATCH CONSULTING PVT LTD (2012-TIOL-318-HC-MUM-IT), has reaffirmed its own view in an earlier case, viz. Hindustan Lever Ltd v. DCIT (2010-TIOL-239-HC-MUM-IT) that, Section 10A provides for a deduction to the assessee, of the income of the eligible undertaking under Section 10A. It is interesting to note that the Bombay High Court did not refer to the contrary decision rendered by the Karnataka High Court. More interestingly, both the Karnataka High Court and the Delhi High Court did refer to the decision of the Bombay High Court in the Hindustan Lever case, which had been delivered on April 1, 2010.

For a student of lawit would seem that the view that Section 10A provides for an 'exemption' and not a 'deduction' gets reinforced by the decisions of the two High Courts of Karnataka and Delhi, as they have also considered the decision of the Bombay High Court in the Hindustan Lever case that had taken a different view.

Be that as it may…. even as the assessees are awaiting the final word on this contentious matter from the Apex Court, the Board has come out with this highly controversial Circular07/DV/2013 dated July 16, 2013which many believe, is driven purely by considerations related to tax collections.

This development leads to several disturbing issues that could arise, some of which are discussed below…

Firstly… the Circular states that, the provisions of Sections 10A/10AA/10B/10BA are 'being interpreted differently by the Officers of the Department as well as by different High Courts" and proceeds to clarify the stand of the Revenue. In a set up like what we have in India, the appellate and quasi-appellate authorities are duty bound to follow the decisions of their respective High Courts under whose respective jurisdiction they fall, when there are conflicting decisions from non-jurisdictional High Courts in respect of central laws that are applicable throughout the country. Given this, while assessees located in Karnataka and Delhi are entitled to the benefit of the favourable decisions rendered by their respective High Courts, the assessees located in Maharashtra could be at a disadvantage given the Bombay High Court's decisions referred to above. The matter will have to wait for the decision of the Supreme Court. But, pending this, can the Board legally ask its officers to follow the 'deduction' route prescribed by the Bombay High Court, including its officers located in Karnataka and Delhi? The answer is a clear 'No'. Taking this discussion forward…. the Circular makes it clear that, the clarifications issued are to set right 'the confusion arising out of different interpretations of the High Courts'. Since when has the CBDT assumed the powers of the Supreme Court, Sir? And, how can the Board, which can only exercise executive powers, take upon itself, the powers to set right the decisions of the High Courts?

Secondly…. the proper and logical route for the Government would be to go on appeal to the Supreme Court, whenever it feels aggrieved by a HC decision and ask for a stay of the operation of that particular decision/s. Or, as it is very fond of doing, the Government could also amend the law, annulling the decisions of the Courts, even perhaps, on a retrospective basis. As the relevant Sections, viz. 10A and 10B have already been deleted from the Income tax Act with effect from 1-4-2011, the Government was, perhaps, left with no choice but to come out with an executive order aimed clearly at overcoming the impact arising out of the decisions of the two High Courts. This is a rather unfortunate development involving not the Legislature, but an executive order trying to scuttle the decisions of the High Courts, in an important tax matter. This Circular, in my view, is unsustainable in law and greatly undermines the principle of judicial discipline which is one of the cardinal principles laid down in our Constitution.

Thirdly….as has been repeatedly held by the Supreme Court in several cases, this Circular is not binding on the assessees for sure, though, and a lot of practical problems in terms of assessments, re-opening of concluded assessments, etc. could arise. In G.M. Mittal Stainless Steel (P) Ltd. [2002-TIOL-220-SC-IT], the Supreme Court had held unequivocally that the decision of the jurisdictional High Court is binding on the Revenue Authorities within the state and that, Revenue Authorities cannot refuse to follow the jurisdictional High Court's decision on the ground that the decision of some other High Court was pending disposal before the Supreme Court. Post this Circular, after all, no assessing officer even located in Karnataka or Delhi, can dare take the view that, the assessee is entitled to the tax holiday computation under

Section 10A/10B under the 'exemption' route, given this circular. This could lead to a situation of the jurisdictional High Court's decision not being implemented in the respective States, leading to a bizarre situation.

Fourthly…… at a time when foreign investors are just pulling out their investments from the country mainly due to uncertain tax laws, what kind of a message is this Circular conveying to them? It is anybody's guess as to how the international investors would look at our super-efficient Board coming out with a clarification on a tax matter which has been existing for the past 13 years and after the relevant Sections have been deleted two years back. This circular is a very poor reflection on the country's tax administration and would further discourage foreign investors, who are already feeling harassed due to the manner in which the Income tax Department is interpreting the transfer pricing related provisions.

And lastly…. If this is the manner in which the Government wants to respond to High Court decisions not to its liking, I have a simple suggestion. Why not abolish the provisions in the Income tax Act providing for appeals to CIT (Appeals), ITAT, the High Court and the Supreme Court?

(The views expressed are strictly personal.)