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An e-newsletter from **Lakshmikumaran & Sridharan**, India

June 2021 / Issue–81

Contents

Article
Cess: An allowable expenditure under the Income-tax Act? 2

Notifications & Circulars......... 6

Ratio Decidendi........................ 8

June
2021

Article

Cess: An allowable expenditure under the Income-tax Act?

By **Shashank Sharma and Snehal Ranjan Shukla**

Introduction

It is a settled principle statutorily that the income tax paid by a taxpayer on its income is not allowed as a deductible expenditure under the provisions of the Income-Tax Act, 1961 ('**Act**'). The term 'income-tax' has not been defined under the provisions of the Act, however, the term 'tax' has been defined to mean income-tax chargeable under the provisions of the Act. Section 4 of the Act creates a charge of tax on the total income of the previous year of a person. It is important to note that Section 4 of the Act though creates a charge of income-tax, such tax is charged at the rate or rates provided by the Finance Act. However, the question that looms is what are the kinds of levies which are included in the income-tax so charged. Whether the income-tax is simply the basic income-tax charged or does it include in its ambit the surcharge and cess also, which are charged in addition to the basic income-tax. In either scenario, can a deduction of the cess be claimed under the Act. The issue has been prone to litigation in the past and the debate has been revived again by the judgements of the High Court of Bombay[1] and the High Court of Rajasthan[2] wherein the issue has been decided in favour of the taxpayers by allowing the deduction of the cess paid.

This article attempts to discuss this issue in detail through the provisions of the Act and various judicial pronouncements.

Charge of income-tax

As has been highlighted in the preceding paragraph, Section 4 of the Act is the charging section which provides that income tax shall be charged on the total income of the previous year **at rates** prescribed in the Finance Act for that year. Section 2(1) of the Finance Act, 2021, provides that income tax shall be charged at the rates specified in Part I of the First Schedule and such tax shall be increased by a surcharge. Section 2(11) of the Finance Act, 2021, further provides that the amount of income tax as increased by the surcharge shall be further increased by an additional surcharge, which shall be called the Health and Education Cess on Income Tax ('**Cess**').

Therefore, on a harmonious reading of Section 4 of the Act with Section 2 of the Finance Act, 2021, it is apparent that income tax is levied in pursuance of Section 4 of the Act at the rates prescribed in Section 2 of the Finance Act and shall further be increased by an additional surcharge to be known as the 'Cess'. Thus, it can be interpreted that the levy of cess in effect is tax levied on the income as contemplated under Section 4 of the Act though specified separately, thus the same is nothing but income tax.

[1] *Sesa Goa Ltd.* v. *JCIT* [[2020] 117 taxmann.com 96 (Bombay)].
[2] *Chambal Fertilisers & Chemicals Ltd.* v. *JCIT* [[2019] 107 taxmann.com 484 (Rajasthan)].

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What is Cess?

The term 'cess' has not been defined in the Act, neither in the Finance Act nor in the Constitution. However, an inclusive definition of the term 'taxation' has been provided[3] in the Constitution to include the imposition of any tax or impost, whether general or local or special.

Accordingly, the term has been understood to mean as a tax levied and collected for an earmarked/specified purpose and is calculated as a levy in addition to the basic tax. The same is evident from a reading of the Finance Act as well wherein cess is levied and collected for the purpose of being spent on the health and education and the same is calculated as a percentage of tax.

Therefore, surcharge as levied is in addition to the basic income tax and is part of the income tax itself. This inference can be supported by Article 271 of the Constitution of India which provides the Parliament the power to increase duties or taxes by a surcharge. The said Article implies that the levy of taxes under Article 265 of the Constitution can be **increased** by a surcharge. This could be interpreted to mean that the Parliament is only increasing the basic amount of duties or taxes, *inter alia*, by levying taxes of the same kind though with a different nomenclature and having a specific and identifiable purpose as opposed to the basic taxes and duties.

Legislative history and scope of Section 40(a)(ii)

Section 40(a)(ii) has been on the statute book since the year 1961. It is similar to Section 10(4) of the erstwhile Income-tax Act, 1922. The only difference between the erstwhile and the existing provision being that in the erstwhile section the word 'cess' found a specific mention alongside words rate and tax, whereas, in the present section i.e. 40(a)(ii), 'cess' has not been included.

However, Section 40(a)(ii) of the Income-tax Bill, 1961, as introduced in the Parliament had the word 'cess' alongside the words rate and tax. However, the Select Committee of the Parliament, decided to omit the word 'cess' from the aforesaid clause of the Income-tax Bill, 1961. The effect of the omission of the word 'cess' is that only any rate or tax levied on the profits or gains of any business or profession are to be deducted in computing the income chargeable under the head 'profits and gains of business or profession'.

The fact that the term 'cess' was subsequently deleted appears in CBDT's Circular No. 91/58/66-ITJ(19), dated 18.05.1967 ('**Circular**'). In this Circular, the CBDT said that disallowing a cess paid by an assessee on the ground that there is no material change in the provisions of Section 10(4) of the erstwhile Income-tax Act, 1922 and Section 40(a)(ii) of the Act is not correct. It states that the word 'cess' had been explicitly deleted by the Select Committee and effect of such omission would be that *'only taxes paid are to be disallowed in the assessments for the years 1962-63 onwards'*.

As per Section 40 of the Act, one of the expenditures which cannot be claimed as deduction is any sum paid on account of any rate or tax which is levied on the profits or gains of any business or profession.

[3] Article 366(28) of the Constitution of India, 1950.

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Therefore, to invoke disallowance under Section 40(a)(ii) of the Act, there are twin conditions which are required to be satisfied. The *first* condition being that the expense so incurred is in the nature of any rate or tax and the *second* condition being that such rate or tax is levied on the profits or gains of business or profession. Until and unless both the conditions are satisfied, disallowance under Section 40(a)(ii) of the Act cannot be made.

Whether cess is tax levied on profits?

We have already discussed that Section 4 of the Act is the charging section and the applicable rate of tax is provided under the Finance Act. We have also seen that as per Section 2 of the Finance Act, 2021, there is no separate mechanism for calculating the amount of surcharge, but it is levied at a percentage on the final tax amount payable. Further, Section 2(11) of the Finance Act, 2021 provides that the amount of income tax as increased by the surcharge shall be further increased by an additional surcharge. In this case of additional surcharge, even though the nomenclature is different, the underlying nature of the levy is surcharge only. The legislature itself calls the levy as additional surcharge though naming it as a Cess.

Considering the position that 'cess' is in the nature of tax, it can be interpreted, on a combined reading of Section 4 and Section 40(a)(ii) of the Act with Section 2 of the Finance Act, that even though the word 'cess' has not been mentioned in Section 40(a)(ii) of the Act, however, the same has a direct relation to the profit or gains of business or profession, and therefore has the potential to attract disallowance under this section.

To further elaborate on this point reference can be made to the judgment of the Supreme Court[4] where while deciding the issue that whether or not the words 'Income-tax' in Section 2(2)(a) & (b) of the Finance Act, 1964 include surcharge and additional surcharge, traced the history of the concept of surcharge in taxation laws. It was observed that special surcharge has been levied by the State prior to the year 1970 'in addition to the income tax' owing to their powers under the Government of India Act, 1935, to do so. Similarly, post 1970, surcharge has been levied by the Parliament in addition to the income tax, in exercise of its powers under Article 271 of the Constitution, by way of section 2 read with first schedule to the Finance Act. The Court thus having regard to the legislative history held that surcharge and additional surcharge being charged in addition to income tax in exercise of constitutional powers are nothing but tax on income.

To further augment the point, reference can be made to the judgment of the High Court of Rajasthan[5] wherein, in the context of excise duty, it held that at the time of collection, education cess takes the character of the parent levy itself and accordingly, the education cess is excise duty.

Basis above, it can be said that the levy of Cess in addition to income tax is the charge of income tax itself at an increased rate. Such charge of Cess is on the profits or gains of business or profession. Absent such profits or gains there would be no charge of Cess also.

[4] *CIT* v. *K Srinivasan* [(1972) 83 ITR 346].
[5] *Banswara Syntex Ltd.* v. *Union of India and Ors.* [(2007) SCCOnline (Raj) 365].

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Cess is not tax: The controversy

Contrary to the position examined hereinabove, the Hon'ble High Court of Rajasthan as well as the Hon'ble High Court of Bombay have decided that for the purposes of Section 40(a)(ii) of the Act disallowance of deduction claimed for payment of cess cannot be made.

The question before the High Court of Rajasthan was whether or not education cess is a disallowable expenditure under Section 40(a)(ii) of the Act. The Court, without giving a finding of its own held that cess is not tax.

The Court placed reliance on the dictum of the Supreme Court judgement (though it does not mention which specific judgment), wherein the Supreme Court is supposed to have held that cess is not in the nature of tax.

The High Court of Bombay was faced with the identical question that whether education cess is an allowable deduction under Section 40(a)(ii) of the Act and whether the expression 'any rate or tax levied' under Section 40(a)(ii) includes cess.

The High Court observed that nothing can be read in or implied into a taxing statue. The Court further held that since the word 'cess' is not present in the text of the provision, it cannot be said that it being in the nature of tax is also not deductible. The Court held that such an argument, if accepted, would amount to reading something into the text of the provision which is otherwise absent. Accordingly, the Court decided the issue in favour of the taxpayer and also held that if the legislature would have intended to tax the Cess, it would have kept the reference to it in the provision and would not have deleted it from the bill.

However, the Court did not refer any of the judgements of the Hon'ble Supreme Court wherein it is held that Cess is a special kind of tax which takes its identity from the principal levy. Thus, the observation of the Hon'ble High Court that cess is not a tax, appears to be in direct conflict with the principles laid down by the Hon'ble Supreme Court[6].

Both the High Courts have relied upon the CBDT Circular. The Circular can also be read to mean that it is not every kind of cess that is excluded from the purview of Section 40(a)(ii) of the Act. What the Circular seeks to propound is that only those levies which are in the nature of taxes, having a direct relation to the profits or gains of business or profession, are to be disallowed and not every Cess.

Conclusion

It appears that while passing the judgments that cess is not a tax, both the High Courts, appear to have not been apprised of the judgment of the Supreme Court as well as the other High Courts. Accordingly, there is a strong possibility of the Supreme Court not agreeing with the view taken by the High Court of Rajasthan and Bombay. The issue is still open for litigation unless either the Supreme Court or the legislature brings in the much needed clarification on the matter.

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[6] *Supra* Note 5.

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Notifications & Circulars

Cash payments to hospitals for treatment of Covid-19 relaxed

The CBDT *vide* Notification dated 7 May 2021 (amended on 10 May 2021) has provided relaxation in the applicability of Section 269ST of the Income-Tax Act, 1961 to hospitals, dispensaries, nursing homes, Covid care centres and other similar medical facilities which are providing treatment to patients suffering from Covid. As per the Notification all the aforementioned medical facilities providing Covid treatment can receive cash payments of amount INR 2 lakh or more. For availing the relaxation, hospital or other such medical facilities would have to obtain the PAN or AADHAR of the patient and the payer along with the relationship between the payer and the patient. This relaxation is provided for all the payments made between 1 April 2021 to 31 May 2021.

Time limits for certain compliances extended to provide relief in view of Covid pandemic

In view of Covid-19 pandemic in India, CBDT *vide* Circular dated 20 May 2021 extended the due-dates for certain compliances. A summary of extended dates of compliance is available in L&S Direct Tax Update No. 22 of 2021. The Update is available here

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Slump sale – New Rule introduced for computation of fair market value of capital assets

Capital gains in case of a slump sale is computed by reducing the net worth of the undertaking from the full value consideration received from the sale. *Vide* the Finance Act 2021, Section 50B(2) has been substituted to provide for a definition of 'full value consideration' of slump sale. It states that the full value consideration received in a slump sale would be the fair market value of the capital assets as on the date of transfer of capital assets. It may be noted that this amendment is applicable from assessment year 2021-22 and hence, any slump sale transaction done during financial year 2020-21 (from April 1, 2020) would be affected.

For calculating the fair market value of capital assets, Section 50B(2)(ii) of the Income-tax Act, 1961, provide that the same shall be done in the manner prescribed. Now, CBDT *via* Notification dated 24 May 2021 has notified Rule 11UAE to prescribe the manner of computation of the fair market value of the capital assets as referred in said section.

As per this new rule, the fair market value of the capital assets transferred by way of slump sale shall be higher of the following:

i. Fair market value of capital asset transferred by way of slump sale (FMV1); or

ii. Consideration received or accruing as a result of transfer by way of slump sale (FMV2).

The two FMVs shall be determined as per the formula prescribed in the new rule. The fair market value of the capital assets, i.e. either FMV1 or FMV2 shall be computed on the date of slump sale and while doing so the date of valuation of various properties under Rule 11UA shall be the date of slump sale.

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Appeals to CIT(A) – Limitation period clarified

The Supreme Court *vide* its Order dated 27 April 2021 in Suo Motto Writ Petition (Civil) No. 3 of 2020 had directed that the period of limitation under any general or special law in respect of all judicial or quasi-judicial proceedings shall stand extended till further orders. Further, the CBDT *vide* its Circular No. 8 of 2021 had extended the period for filing appeal before the CIT(A) till 31 May 2021.

Accordingly, ambiguity was created as to whether in filing an appeal before the CIT(A) and calculating the period of limitation for the same the assessee should follow the CBDT Circular or the Supreme Court order.

Clarifying the position, the CBDT, *vide* Circular No. 10/2021 dated 25 May 2021, has said that when different relaxations are available to the taxpayer for a particular compliance, then the taxpayer is entitled to that relaxation which is more beneficial to him.

Applying the above-mentioned principle, it has been clarified that the period of limitation for filling of appeals before the CIT(A) under the Income Tax Act, 1961 shall stand extended till further orders are received from the Supreme Court in the abovementioned petition.

Withdrawal of application pending before Settlement Commission – Procedure prescribed

Vide Notification No. 05 of 2021 dated 24 May 2021, the CBDT has notified the procedure to upload Form No. 34BB to exercise the option of withdrawing an application pending before the Income Tax Settlement Commission.

An assessee who wishes to exercise the option of withdrawing the pending application will have to provide the details in the form available on the e-filling portal of the department by 15 June 2021. The Notification further provides that in case where there are more than one assessment years, the assessee will have to mention the first assessment year and the same will be applicable in the case of block assessment.

Based on the details submitted by an assessee, a letter shall be generated through the ITBA system to the e-filling account of the assessee. The assessee will then have to take a printout of the Form No. 34BB and upload the scanned signed copy of the form on the e-filling portal to proceed further.

Online submission of Form No. 34BB in the manner discussed above would be treated as intimation to the Assessing Officer about withdrawal of the application under Section 245M(1) of the Income Tax Act, 1961.

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Ratio Decidendi

Assessment order under National Faceless Assessment Scheme, without a hearing, when not correct

Observing that neither the submissions of the assessee were considered nor any opportunity of hearing, despite the same being specifically sought, was granted, the Delhi High Court has set aside the assessment order passed under the National Faceless Assessment Scheme. It was held that there was a breach of principles of natural justice. The assessment order was set aside with the liberty to the Income Tax Department to pass a fresh assessment order after considering the submissions of the assessee and after granting an opportunity of personal hearing.

The Assessee in this case, as part of the assessment proceedings under Section 143(3) of the Income-tax Act, 1961, was issued a show cause notice along with a draft assessment order dated 1 March 2021. The show cause notice required the assessee to submit its response by 8 March 2021 on the draft assessment order that why addition under Section 68 should not be made. The assessee on 8 March 2021 requested for an adjournment of a week to furnish its reply. As no response was received in reply to the adjournment request, the assessee out of abundant caution filed its reply to the show cause notice along with a request for grant of personal hearing on 12 March 2021. However, the assessment order was passed as per the draft assessment order on 13 March 2021 without taking into account and considering the submissions of the assessee as well as without providing a hearing.

The assessee had contended that the detailed reply filed by it explaining why addition under Section 68 on account of unexplained and unsecured loans would be incorrect in light of the evidence furnished to establish the genuineness of the transactions, was not considered. [*DJ Surfactants* v. *National E*-Assessment Centre – Order dated 2 June 2021 in W.P.(C) 4814/2021, Delhi High Court]

Carry forward of short-term capital loss, exempt under India-Singapore DTAA, allowed as Section 74 more beneficial to assessee

In an appeal filed before the ITAT Mumbai, the assessee was a Singapore-based company registered with SEBI as a sub-accountant of Goldman Sachs & Company. For AY 2012-13 the assessee incurred short-term capital loss of INR 20.59 cr. and sought to carry it forward in light of the more beneficial provisions of the Income Tax Act, 1961 over the India-Singapore DTAA. The Assessing Officer and DRP denied the claim of carry forward of short-term capital loss on the basis that capital gains earned by the assessee were exempt from tax under the India-Singapore DTAA.

The ITAT however noted that the Assessee had opted to be governed by Section 74 of the Income Tax Act, 1961 which allows carry forward of short-term capital loss for eight assessment years. The ITAT observed that where the losses have not been offset in a subsequent year under assessment, it is not open to the Assessing Officer to deny the carry forward of losses so determined and quantified in a prior year.

The ITAT, in the light of Section 90(2), held that if domestic law provisions, i.e. Section 74, are

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more beneficial, then same shall prevail over DTAA and thus, capital losses incurred from capital market transactions shall be construed as income accruing or arising from transactions undertaken in India falling within Section 5 and eligible to be carried forward to subsequent years. The ITAT directed the Assessing Officer to allow carry forward of the short-term capital losses to the subsequent years. [*Goldman Sachs India Investments (Singapore) PTE Limited* v. *DCIT (IT)* – Order dated 9 April 2021 in ITA No. 6619/Mum/2016, ITAT Mumbai]

Adjustment of refund against outstanding demand, over and above the amount necessary to grant stay, not correct

The Bombay High Court has directed the revenue department to refund to the assessee the amount adjusted over and above the amount necessary for granting a stay on the disputed demand. The Court observed that the revenue must call for restraint from recovering amount over and above the amount required for stay, as per instructions, circulars and guidelines issued by CBDT, from time to time.

Assessee's return of income for the AY 2013-14 was selected for scrutiny assessment and the assessment culminated in a tax demand, against which the assessee preferred an appeal before CIT(A) and also filed an application seeking stay of the tax demand. The revenue department adjusted assessee's outstanding demand with the refund pertaining to AY 2014-15 to 2016-17 and granted stay on the balance amount with the direction that it reserves the right to adjust the refund for subsequent year if any against the demand for AY 2013-14. Further, the refund arising for the AY 2018-19 and 2019-20 was also adjusted against a portion of the balance tax demand for AY 2013-14.

The High Court held that exercise of power to have set off / adjustment of refund is regulated by legislative provisions and instructions and the revenue departments reliance on the Centralised Processing of Return of Income Scheme, 2011, justifying the adjustment would be incongruous inasmuch as it would mean that all refunds arising are liable to be adjusted against the tax demands irrespective of orders thereon by the authorities and / or subsisting instructions and provisions applicable.

The assessee had submitted before the High Court that having regard to the office memorandum dated 31 July 2017, modified from time to time, the right of the revenue department to adjust the refund is restricted only to the extent of 20% of the demand amount. The High Court directed the Revenue to refund amount recovered from assessee over and above the amount pending in appeal, along with interest. It also directed that refund of amount as per instructions / guidelines will not be adjusted towards the tax demand for assessment year 2013-14 till the disposal of appeal. [*Vrinda Sharad Bal* v. *ITO* – Order dated 25 March 2021 in W.P.(L) No. 7231 of 2020, Bombay High Court]

Expenses incurred between setting up and commencement of business deductible

The Delhi High Court has held that the expenses incurred by an assessee post the setting up and before the commencement of the business is an allowable expenditure. Observing that there is a difference between 'setting up' and 'commencement of business' the High Court held that when the expression 'setting up of business' is used, it, merely means that the assessee concerned is ready to commence business and not that it has actually commenced its business.

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The assessee was incorporated on 24 November 2010 and thereafter applied to IRDA for obtaining broker's license under the Insurance Brokers Regulation 2002. In the meanwhile, the assessee entered into an agreement with another company whereby the employees of latter were sent to assessee on deputation. The assessee also entered into various lease agreements to open offices at various locations. The broker's license was issued on 2 February 2012.

In its return for the assessment year 2012-13, the assessee claimed certain business expenses. The return of income of the assessee was selected for scrutiny assessment and while passing the assessment order the Assessing Officer concluded that since the license was issued in 2012, the assessee' s business could not have been said to set up prior to that and therefore the business expenditure was disallowed and capitalized as pre-operative expenses. Appeals before the CIT(A) and ITAT were not helpful.

The High Court noted that the IRDA took more than a year to grant the license to the assessee, whereas the assessee was all primed up to commence the business. It held that the assessee having acquired the necessary wherewithal and physical infrastructure for carrying on its business - it was only waiting for the approval of its application for commencement. It held that in the time period between the entity's readiness to do business and when business was actually conducted some expenses were incurred towards keeping the business primed up and such expenses cannot be capitalized. [*Maruti Insurance Broking Pvt. Ltd.* v. *DCIT* – Order dated 12 April 2021 in ITA No. 17/2021, Delhi High Court]

Foreign exchange fluctuation gains arising on receipt of repayment of personal loan not taxable as capital receipt

Assessee, a resident individual had extended a personal interest free loan (not in the course of business of the assessee) of USD 2,00,000 to his cousin residing in Singapore under the Liberalized Remittance Scheme (LRS) of the Reserve Bank of India in the year 2010. As per the then exchange rate, the amount of loan amounted to INR 90,30,758. In the year 2012, the borrower paid this money back to the assessee and as per the prevailing exchange rate, the amount which was credited to the assessee was INR 1,12,35,326. Therefore, the assessee was in the receipt of INR 22 lakh more than what he had given in loan.

The Assessing Officer was of the view that the surplus amount, in terms of rupees, as received by the assessee is gains which would partake the nature of income under the head income from other sources. Appeal before the CIT(A) was not futile. In appeal before the ITAT, the department argued that although the receipt of the amount is in capital account, the appreciation in the rupee value of foreign currency denomination loan is income as it results in gain to the assessee and such gain is not explicitly exempted under the provisions of the Income-tax Act, 1961.

The ITAT however held that the Assessing Officer and the CIT(A) erred in deciding the head under which the income will be taxed, i.e. interest income or income from other sources before deciding whether the amount falls under the definition of income itself or not. The ITAT held that all 'gains' are not covered under the scope of 'income' under the provisions of Income-tax Act, 1961. It was of the view that as per the definition of 'income' under Section 2(24), income includes only those capital gains which are chargeable to tax under Section 45 and a capital gain which is

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not taxable under Section 45 or which is not specifically included in the definition of income cannot be deemed to be a taxable income.

The ITAT was of the view that where the loan was foreign currency denominated and the amount advanced as loan, as also received back as repayment, was exactly the same, there was no question of interest component at all. Since the transaction in question was on capital account, which is not taxable under Section 45, the surplus amount in terms of INR was held to be capital receipt not chargeable to tax. [*Aditya Balkrishna Shroff* v. *ITO* – Order dated 17 May 2021 in ITA No. 4472/Mum/2019, ITAT Mumbai]

Remand by ITAT to AO for further verification incorrect when CIT(A) had accepted the claim after verifying same

The assessee while filing its return of income, failed to claim deduction under Section 80JJAA of the Income-tax Act, 1961 and prior period expenses. These deductions were claimed before the Assessing Officer during assessment proceedings by filing the Chartered Accountant's report in Form 10DA. The details concerning prior period expenses were also provided. The Assessing Officer, however, did not entertain the two deductions on the ground that fresh claims cannot be entertained, and the assessee should have a filed the revised return of income.

Aggrieved by the order of the Assessing Officer, the assessee preferred appeal before CIT(A). Before the CIT(A), the assessee placed on record the necessary evidence in support of its claim for deduction. The CIT(A) held that fresh claim made by the assessee can be entertained and thus, upon analyzing the evidence placed on record allowed the claim of deduction. The Revenue filed an appeal before the ITAT against the order of the CIT(A). The ITAT while sustaining the view of CIT(A) that a fresh claim can be entertained, remanded the matter to the Assessing Officer for fresh verification in respect of both the deductions.

Aggrieved by the remand back of the matter, especially, when all the details with respect to the claim of deductions have been thoroughly examined by the CIT(A), the assessee preferred appeal before the High Court of Delhi.

The Delhi High Court held that when the ITAT accepted the view taken by CIT(A) that fresh claims can be entertained, it was required to examine whether the CIT(A) had correctly verified the materials placed before it or not. The Court noted that the ITAT, however, instead of examining this aspect of the matter, incorrectly observed that because an opportunity was not given to the AO to examine the material, the matter is required to be remanded to the AO for a fresh verification.

The High Court held that unless the ITAT has sufficient reason to conclude that there was some error in the examination made by the CIT(A), a remand was not called for by it. The order of the ITAT was set aside and the claim of deductions was allowed. [*International Tractors Ltd.* v. *DCIT* – Order dated 7 April 2021 in ITA No. 35/2019, Delhi High Court]

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