

***WIRC Direct Tax  
Refresher Course  
(DTRC 2015)***

**Deeming Fiction under  
Income-tax**

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## ***Discussion Points***

- Introduction and Principles of Interpretation
- Doctrine of “Reading Down”
- Deeming Fiction under Current Law
  - Key Aspects and Recent Developments
- ICDS Regime – Whether taxing Real Income?
- Summing Up

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# *Introduction and Principles of Interpretation*

## ***Deeming Provisions – A Legal Fiction***

- Primarily, to provide an artificial construction of a word/phrase (which otherwise will not prevail)  
*Eg. “Income” includes Govt. Grants, Subsidies [Finance Act, 2015]*
- Also, used to / as:
  - Remove uncertainty
  - Definition / Glossary
  - Formulate a general principle

“Deeming Fiction” has become increasingly common in modern statutes; sometimes used to include even what is impossible

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## ***Key Principles of Interpretation...***

- Courts required to ascertain for what purpose fiction is created – **the context** [*K.P. Varghese vs. ITO 131 ITR 597 (SC)*]
- Consequences and incidents flowing from legal fiction should also be deemed to be real [*Surat Cotton 202 ITR 932 (Bom.)*]
- Full effect must be given to the statutory fiction and it should be carried to its **logical conclusion**  
[*Eg. Liquidation, Conversion of Capital Asset into Stock-in-trade in S. 2(47)*]
- Deeming provision of one law cannot be incorporated in other laws  
[*Eg. A transaction treated as Gift under Gift-tax Act cannot be regarded as gift for Income-tax Act*]

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## ***...Key Principles of Interpretation***

- Interpretation not to lead to **injustice**  
*[CIT vs. Nathimal (89 ITR 190)(FB), CIT vs. Hindustan Petroleum (187 ITR 1)]*
- **Retrospective operation** possible to a past fact or event  
*[Eg. Indirect transfers S. 9(1)(i), Software under Royalty S. 9(1)(vi)]*
- To be **interpreted strictly** for the limited purpose

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## ***Powers of the Legislature***

- **Legislature is competent** to enact deeming provisions, for the purpose of assuming existence of a fact which does not really exist  
*[J.K. Cotton Spinning vs. UOI AIR 1988 SC 191]*
- Must be within the Constitutional framework

**Legality v/s. Making Economic Sense**

# The Constitutional Framework

## Legislative Competence to levy tax by authority of law (Art. 265)

### **“Income”** (Entry 82 of List I)

- To be construed liberally and in a very wide manner
- To curb Tax Evasion also covered
- Some rational connection required between item taxed and concept of income

*[Navnitlal C. Javeri 56 ITR 198 (SC),  
United Provinces vs. Atiqa Begum  
(1954) F.C.R. 110]*

### **Not violating Fundamental Rights**

- Right to Equality - Art. 14  
(Arbitrary, Discrimination,  
Inequality, Fairness)
- Freedom of Trade – Art. 19(1)(g)  
(To practice profession, carry on  
business)



## *Deeming Fiction and Real Income Theory*

- **Only “Real Income” should be taxed**
  - Unconditional legal right to receive the income is established
  - In line with commercial reality
  - Notional income should not be brought to tax net

*[Refer E D Sassoon (26 ITR 27) (SC), Godhra Electricity (225 ITR 746) (SC)]*

Deeming fiction could lead to taxation of  
notional income  
[eg. S. 50C]

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# *Doctrine of “Reading Down”*

# 1. *UOI vs. A. Sanyasi Rao [219 ITR 330 (SC)]*

- **S. 44AC** - Presumptive income for specified businesses (liquor, etc.)  
**S. 206C** – TCS on purchase price
- S. 28-43C not to apply; Income computed based on **% of purchase price**

## Key Observations

- Parliament perfectly competent to enact S. 44AC and S. 206C (deeming fiction)
- Adoption of purchase price as a measure for determining tax was feasible – income nexus established
- S. 44AC read down as not to be an independent provision; Merely adjunct to and explains S. 206C
- **Denial of reliefs under S. 28-43C had no nexus with object of Section**
  - Hence, non-obstante clause in S. 44AC to be read down being **unfair and arbitrary**
  - Assessee to have right to demonstrate lower income in assessment

## 2) *K. P. Varghese vs. ITO [131 ITR 597 (SC)]*

### S. 52: Consideration for transfer in cases of under-statement

*“(1) Where the person who acquires a capital asset from an assessee is directly or indirectly connected with the assessee and the Income-tax Officer has reason to believe that the transfer was effected with the object of avoidance or reduction of the liability of the assessee under section 45, the full value of the consideration for the transfer shall, with the previous approval of the Inspecting Assistant Commissioner, be taken to be the fair market value of the capital asset on the date of the transfer.*

*(2) Without prejudice to the provisions of subsection (1), if in the opinion of the Income-tax Officer the fair market value of a capital asset transferred by an assessee as on the date of the transfer exceeds the full value of the consideration declared by the assessee in respect of the transfer of such capital asset by an amount of not less than fifteen per cent of the value so declared, the full value of the consideration for such capital asset shall, with the previous approval of the Inspecting Assistant Commissioner, be taken to be its fair market value on the date of its transfer.” (Emphasis supplied)*

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## **2) *K. P. Varghese vs. ITO [131 ITR 597 (SC)]***

### *Key Observations*

- Literal interpretation led to absurd results
- S. 52(2) to be construed having regard to its **object and purpose**
- Provision invoked only if there was understatement of consideration with an object to avoid tax
- No application in bonafide transactions where consideration was fully declared

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# *Deeming Fiction – Key Aspects and Recent Developments*

## *Some Examples under Current Law...*

### Charge and Scope

- Income definition [S. 2(24)]
- Deemed dividend [S. 2(22)(e)]
- House Property Income [S. 22]

### Place of Accrual

- Business Connection [S. 9(1)(i)]
- Royalty / FTS taxation [S. 9(1)(vi) / (vii)] – Source Rule

### Person

- Clubbing Provisions [S. 60, 61, 64]
- Representative Assessee [S. 160(1)]

### Time of Accrual

- Dividend Income [S. 8]
- Interest on compensation [S. 145A]

## *...Some Examples under Current Law*

### Anti-abuse Provisions

- GAAR [S. 95-102]
- Transfer Pricing [S. 92]
- Specific anti-abuse provisions [S. 14A, 68, 93, 94]

### Penal and Procedural

- Penal interest [S. 201(1A)]
- Deemed prejudicial to interest of revenue [S. 263]
- Penalty for concealment [S. 271(1)(c)]



# ***Presumptive Basis Taxation***

## **Current presumptive taxation provisions**

<b>Section</b>	<b>Business of Assessee</b>	<b>Deemed Profits</b>
44AD	SME businesses (<10 mn INR)	8% of gross receipts
44AE	Plying, hiring, leasing goods carriages	Rs. 7,500 p.m. per carriage
44BB	Services, supply of machinery on hire in connection with mineral oil exploration	10% of revenues
44BBB	Civil construction, etc. business	10% of revenues
115VG	Tonnage tax scheme	Specified daily tonnage income

Above Sections provide option to taxpayers to compute income under normal provisions

[S.28-43C]

## ***Definition of “Income” - S. 2(24)***

- Value of benefit or perquisite obtained from company by a director
- Deemed Dividend
  - Distribution of accumulated profits entailing release of assets, bonus shares to preference shareholders;
  - Loan to shareholder of closely held company, etc.
- Assistance in form of subsidy, grant, cash incentive, duty drawback, concession, etc. (other than those reduced from actual cost) to be treated as “income”
  - “Purpose” test ignored – Ponni Sugars (306 ITR 392)(SC), Sahney Steels (228 ITR 253)(SC), Reliance Industries (339 ITR 632)(Bom.)

**Inclusive definition of “income” provides various deeming fictions and has wide connotation**

## ***Overseas Transfers (Vodafone type situations)***

- Shares of a Foreign Co. deemed to be situated in India, if more than 50% of its value is derived from assets located in India

### ***Some Thoughts***

- Deeming fiction has sufficient nexus with income
- Cannot be presumed and need to be brought into law specifically
- Can it apply retrospectively to WHT obligation?  
*[Channel Guide India (2012) (25 taxman.com 25)(Mum Tribunal), New Bombay Park Hotel Pvt Ltd (ITA No. 7641/Mum/2011)(Mum.)]*

*“I can see no ground for calling in aid a ‘deeming’ section when that which is to be deemed has in fact taken place without its assistance. If notional transfer is to supersede the real transfer with consequences detrimental to the tax payer this should, I think, be made plain by unambiguous language.”*

*- St Aubyn vs. AG (1952) 2 All ER 473 (HL)*

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## ***Royalty Definition – S. 9(1)(vi)***

- Explanation 4
  - Transfer of all or any rights in respect of any right, property or information includes transfer of all or any right for use or **right to use a computer software** (including granting of a license) irrespective of the medium through which the right is transferred
- Expln. 5 and Expln. 6 also introduced on similar lines

### ***Some Thoughts***

- Applicability restricted to S. 9(1)(vi); Deeming fiction should not extend to S. 40(a)(ia) [*Sonata Information (54 SOT 233) (Mum. Tribunal)*]
- Does it make economic sense?

# *Transfer of Land or Building*

## **Builders and Real Estate Developers (S. 43CA)**

- Whether “deemed consideration” recognised on year-to-year basis under POCM for tax purposes?
- Applies only when land or building is in existence and transfer take place
- Whether Allotment Letter regarded as Sale Agreement?

## **Land / Building held as Capital Asset (S. 50C)**

- Applicable in case of transfer of leasehold rights?
- S. 45(3) v/s. S. 50C controversy
- Does it apply to Slump sale cases (S. 50B)?

## ***S. 50C – Constitutional Validity***

- Constitutional validity upheld  
*[Palanisamy KR (306 ITR 61)(Mad.), Bhatia Nagar Society (334 ITR 145)(Bom.)]*
  - Legislature competent; wide interpretation of legislative entries
  - Purpose of enactment - To prevent tax evasion
- S. 50C presumes that capital asset is sold either at stamp duty value (or FMV as ascertained by DVO) as on the date of transfer
- **No provision in S. 50C to allow seller to prove that Actual sale price is below stamp duty value**
  - No remedy where real transaction value is lesser than stamp duty value (unlike S. 44AC as read down in Sanyasi Rao's case)

Stark contrast vis-à-vis doctrine of “reading down” – Needs review?

## ***Deemed Gift [S. 56(2)]***

### **Receipts in cash or kind by Individual / HUF – Zero or Inadequate consideration [S. 56(2)(vii)]**

- Receipt under a will or by inheritance excluded; Family Arrangements covered?
- Disproportionate rights issue [*Sudhir Menon HUF 162 TTJ 425(Mum.)*]

### **Receipt of shares of specified company by another Firm / Private Company [S. 56(2)(viii)]**

- Interest in LLPs not covered; FMV based on book value
- Whether applies to fresh issue of shares, Bonus issue, Buyback?
- Applicability to Foreign company?

### **Specified receipts for Issue of Shares by closely-held company [S. 56(2)(viib)]**

- Valuation based on DCF (unquoted shares)
- What if the company gets listed before end of FY?
- Applicability in case of conversion of CCD / CCPS / Bonds?

# *Transfer Pricing*

## Deemed Associated Enterprise [S. 92A(2)]

- Business of I-Co wholly dependant on the use of know-how, patents, copyrights of F-Co
- At least 90% of raw materials for manufacturing / processing of goods
- Goods manufactured / processed by I-Co are sold to F-Co. and prices relating thereto are influenced by F-Co.

## Deemed International Transaction [S. 92B(2)]

- Transactions between two residents now included?

## Determining ALP

- “Mean” v/s. “Range” (Median)



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## ***Speculative Business Loss – Explanation to S. 73***

- Pre-2014: Assessee deemed to carry on speculative business, if his business involves purchase and sale of shares of other companies, unless income is mainly IFHP, CG, IFOS, etc.
- Judicial view – S. 73 attracted even when main business was trading in shares
- Post amendment in 2014 – Losses incurred by a company, whose principal business is in trading of shares, will not be subject to S. 73

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## ***Revision of orders – Explanation 2 to S. 263***

- Revision of orders ‘prejudicial to Revenue’ clarified to include:
  - Order passed/relief allowed without inquiries or verification
  - Not in accordance with Board instructions
  - Does not follow jurisdictional Court judgement against taxpayer

Objective: To provide clarity in interpreting the phrase “erroneous in so far as it is prejudicial to the interests revenue”

# *ICDS Regime – Whether taxing Real Income?*

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## ***ICDS – the TAS avatar***

- **Income Computation & Disclosure Standards (ICDS)** - the new Tax Accounting Standards under Section 145(2) of IT Act
- Objective to eliminate accounting variations; ensure consistency & clarity
- 10 ICDS notified – Effective from April 1, 2015 (FY 2015-16)
- Applicable to all taxpayers following mercantile system of accounting (and not just companies)
- Separate books of accounts not mandatory
- Thrust on disclosures – Tax Audit and Return forms likely to be amended
- IT Act to override ICDS provisions (in case of inconsistency)

# *List of notified ICDS*

<b>ICDS</b>	<b>Corresponding ICAI-AS</b>
● Accounting policies	AS-1
● Inventories	AS-2
● Construction Contracts	AS-7
● Revenue Recognition	AS-9
● Accounting for tangible fixed assets	AS-10
● Effects of changes in FX rates	AS-11
● Government Grants	AS-12
● Securities	AS-13
● Borrowing costs	AS-16
● Provisions, Contingent Liabilities & Assets	AS-29

*ICDS primarily based on current ICAI-AS with deviations*

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# *Key Deeming Fictions under ICDS...*

## ICDS I – Accounting Policies

- **Prudence and Materiality** given a GO-BY
  - Prepone income accrual (contingent assets, etc); Postpone Expense / anticipated loss claims
  - Whether warranted in absence of a Loss carry back provisions?
- **MTM Loss or expected loss** shall not be recognised unless specifically permitted

## *...Key Deeming Fictions under ICDS...*

### ICDS III – Construction Contracts

- Percentage of Completion Method – Now mandatory
  - Impact on Real Estate, EPC, etc sector; Clarity for PPP projects
- **Retention monies** to be recognised
  - legal right to receive essential; “Real income” taxation
- **Recognition** of revenue / cost of future activity as asset
  - Even if recoverability uncertain eg. disputed claims, etc.
- **Anticipated / Expected losses**
  - Only to the extent of “stage of completion”
  - **Only if incurred ? Lacks clarity**
- Borrowings Costs to be allocated – Amendment in S. 36(1)(iii) to align

## *...Key Deeming Fictions under ICDS...*

### ICDS IV – Revenue Recognition

- **Services Sector** - % completion method
  - Practical hardship in maintaining engagement-wise records - Cost allocation, intangible parameters, etc.
  - Specific instances of Outcome-based billing, etc.
- **Interest income** to be recognised on time basis

### ICDS VI – Effects of Changes in Forex Rates

- **MTM Forex adjustment (AS-11)** to be allowed (except on Forward Contracts for **probable**, trading & speculative transactions) –
  - Limited deviation vis-à-vis CBDT Internal Instruction 3/2010
  - Covers all possible hedging instruments? Commodity Hedging?
  - Parity in treatment of Gains & Loss; but notional income taxed
  - Distinction between capital and revenue items not recognised



## *...Key Deeming Fictions under ICDS*

- **Government Grants / Subsidies (AS-12)** treated as Revenue receipt or reduced from cost of fixed asset (reduced deprn claim)
  - Amendment made in S. 2(24) to overcome settled judicial principle to **determine treatment based on intent**
- Recognition of **Contingent Assets / Provisions (AS-29)**
  - **“Reasonably certain”** versus **“Virtually Certain” / “Probable”**

**More such aspects under the Ind AS (IFRS)  
regime – Fair Value Accounting**

# *Summing Up*

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## ***Summing Up...***

***Objective to reduce uncertainty and prevent tax evasion; Deeming provisions may be upheld as Constitutionally Valid***

***But***

***Should not lead to Injustice***

***Any rampant usage of deeming fictions affects India's Credibility on Global Stage***

***Lawmakers need to be mindful of India's image while enacting laws***

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# *Thank You*

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