

TAX FLASH NEWS

Exempt capital gains are to be excluded while computing book profits under the provisions of MAT

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Shivalik Venture Pvt Ltd.¹ (the taxpayer) held that exempt gains on the transfer of a capital asset are to be excluded while computing book profits under the Minimum Alternate Tax (MAT) provisions². The Tribunal observed that the notes to accounts should be read along with the profit and loss account. Hence, the net profit shown in the profit and loss account should be adjusted with the items given in the notes to accounts. In the present case, the taxpayer had specifically mentioned in the notes to accounts that the capital gain on the transfer of an asset to its wholly owned subsidiary are not includible in the net profit. Accordingly, it was held that such gains should be excluded from the net profit for the computation of MAT. The Tribunal held that since the said gains do not fall under the definition of 'income' and does not enter into the computation provisions at all, there is no question of including the same in the book profits under Section 115JB of the Income-tax Act, 1961 (the Act).

Facts of the case

- The taxpayer is engaged in the business of development and leasing of commercial complexes and rehabilitation of buildings under the slum rehabilitation scheme. The taxpayer was formed by conversion of a partnership firm into a company under the provisions of the Companies Act, 1956.
- The taxpayer owns a wholly owned subsidiary company in India. The taxpayer held a parcel of land as a capital asset and the said land was attached with development rights/Floor Space Index (FSI).

- During the Assessment Year 2009-10, the taxpayer transferred the development rights/FSI to its wholly owned subsidiary. The said transfer generated a Long-Term Capital Gain (LTCG) and the taxpayer disclosed the same as 'extraordinary income' in the profit and loss account.
- The taxpayer claimed that the LTCG is exempt under Section 47(iv) of the Act and hence was not regarded as 'capital gains' under Section 45 of the Act while computing total income under the normal provisions of the Act. Further, the taxpayer did not offer the LTCG while computing the book profits under Section 115JB of the Act by mentioning in the notes to accounts that it is a capital receipt and that the transaction is not regarded as a transfer under the Act. The company interprets that since it is not being in the nature of income, it does not fall within the purview of Section 115JB of the Act.
- The Assessing Officer (AO) did not agree with the contentions of the taxpayer and accordingly, included the capital gain while computing book profits under the provisions of Section 115JB of the Act.
- The Commissioner of Income-tax (Appeals) upheld the order of the AO.

Tribunal's ruling

Computation of book profits under Section 115JB of the Act by mentioning in the notes to accounts

- The taxpayer had mentioned in the notes forming part of the accounts that the profits arising on transfer of the capital asset to its subsidiary company do not come within the purview of Section 115JB of the Act.

¹ Shivalik Venture Pvt. Ltd. v. DCIT (ITA No.2008/Mum/2012) – Taxsutra.com
² Under Section 115JB of the Act

- The taxpayer relied on the decision of the Delhi High Court in the case of Sain Processing & Wvg. Mills (P) Ltd³, which was also followed by the Pune Tribunal in the case of K.K. Nag Ltd⁴. In that case, the incremental liability towards leave encashment was not debited to the profit and loss account, but otherwise disclosed in the notes to accounts. The Pune Tribunal held that the said liability would have to be deducted while determining the book profits under Section 115JB of the Act.
- An identical issue was considered by the Visakhapatnam Tribunal in the case of Hindustan Shipyard Ltd⁵ wherein the Tribunal, after considering the decision of Delhi High Court in the case of Sain Processing & Wvg. Mills (P) Ltd. held that the AO is entitled to include the waiver benefit that was disclosed in the notes to accounts.
- In the above decisions, it has been held that the items disclosed in the notes to accounts are required to be adjusted to the net profit disclosed in the profit and loss account.
- The Tribunal observed that for the purpose of making such adjustments, it is not necessary that those items should have been specified in Explanation 1 to Section 115JB of the Act, since the net profit itself is arrived at by adjusting the effects of notes given in the notes to accounts.
- The Tribunal observed that the profit and loss account should be read along with the notes to accounts and it should be applied uniformly in all kind of situations and hence due adjustments need to be done for the effect of items disclosed in the notes to accounts.
- The facts prevailing in the instant case are distinguishable from the facts of the case before the special bench of the Tribunal in the case of Rain Commodities Ltd.⁶. Therefore, it cannot be applied straightly in the instant case.
- Accordingly, the notes to accounts should be read along with the profit and loss account. Hence, the net profit shown should be adjusted with the items given in the notes to accounts. The profits arising on the sale of a capital asset to its wholly owned subsidiary company should be excluded while computing book profits under Section 115JB of the Act.

Transfer of capital asset is not treated as income under Section 2(24) of the Act

- The provisions of Section 2(24) of the Act define the term 'income'. The provisions of Section 45 of the Act dealing with capital gains postulate three

conditions⁷. If all the three conditions are satisfied, then the profits or gains arising from the transfer of a capital asset shall be chargeable to tax under the head 'capital gains' and the same is included in the definition of 'income' under Section 2(24) of the Act.

- Section 47 of the Act provides that certain transactions shall not be regarded as a 'transfer'. Even if a transaction falls under the definition of transfer as per the provisions of Section 2(47) of the Act, it shall not be chargeable to tax under Section 45 of the Act, in view of the provisions of Section 47 of the Act.
- Section 10 of the Act provides various types of income, which do not form a part of the total income. All those items of receipts shall otherwise fall under the definition of the term 'income' as defined in Section 2(24) of the Act, but they are not included in total income in view of the provisions of Section 10 of the Act.
- Since items mentioned under Section 10 of the Act are considered as 'incomes not included in total income' for some policy reasons, the legislature, in its wisdom, had decided not to tax such income under Section 115JB of the Act also, except otherwise specifically provided for. The logic of these provisions, is that an item of receipt which falls under the definition of 'income', are excluded for the purpose of computing book profits, since the said receipts are exempt under Section 10 of the Act while computing total income.
- Thus, it is seen that the legislature seeks to maintain parity between the computation of total income and book profits, in respect of an exempted category of income. If the said logic is extended further, an item of receipt which does not fall under the definition of 'income' at all and hence falls outside the purview of the computation provisions of the Act, cannot also be included while computing book profits under Section 115JB of the Act.
- A careful perusal of the decision rendered by the special bench in the case of Rain Commodities Ltd would indicate that the above said legal contentions were not considered by the special bench. The special bench considered various decisions⁸ and in all those cases, the Courts were dealing with the issue of inclusion of capital gains in the computation of book profits, but such capital gains were otherwise chargeable to capital gain tax under Section 45 of the Act.

³ CIT v. Sain Processing & Wvg. Mills (P) Ltd. [2010] 325 ITR 565 (Del)

⁴ K.K. Nag Ltd v. ACIT [2012] 52 SOT 381 (Pune)

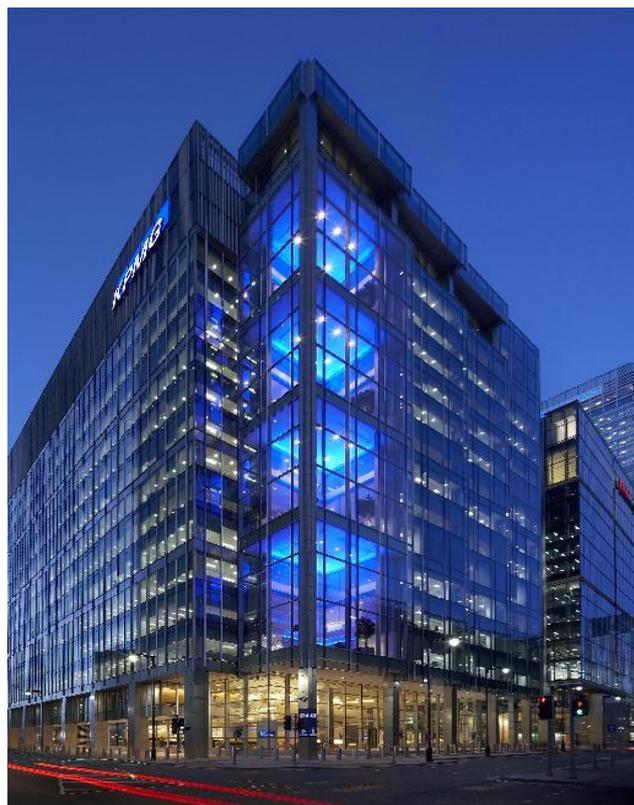
⁵ Hindustan Shipyard Ltd v. DCIT [2010] 6 ITR (T) 407 (Visakhapatnam)

⁶ Rain Commodities Ltd v. DCIT [2010] 40 SOT 265 (Hyd) (SB)

⁷ (a) There is a capital asset (b) There is a transfer of the said capital asset (c) The said transfer results in any profits or gains.

⁸ Malayala Manorama Co. Ltd v. CIT [2008] 300 ITR 251 (SC), N.J. Jose & Co. (P) Ltd v. ACIT [2010] 321 ITR 132 (Ker), CIT v. Veekayal Investment Co. (P) Ltd [2001] 249 ITR 597 (Bom)

- However, in the present case the profits and gains arising on the transfer of capital asset does not fall within the definition of 'transfer' and the same were not chargeable under Section 45 of the Act. Consequently, such gains do not fall within the purview of the definition of 'income' given under Section 2(24) of the Act.
- The special bench did not have an occasion to consider the argument urged that the profits and gains arising on transfer of a capital asset by a holding company to its wholly owned Indian company does not fall under the definition of 'income' under Section 2(24) of the Act. Hence, the same does not enter into the computation provisions of the Act at all.
- In this case, the taxpayer had attached a note in the notes to accounts. However, in the case before the special bench, no such note was attached. Hence, the decision rendered by the special bench is distinguishable.
- Since the said profit does not fall under the definition of 'income' and it does not enter into the computation provisions, there is no question of including the same while computing book profits under Section 115JB of the Act.



Our comments

The issue of whether exempt capital gains credited to the profit and loss account can be excluded while computing book profits under the provisions of MAT has been a subject matter of debate before the Tribunal. The special bench of the Tribunal in the case of Rain Commodities Ltd. held that exempt capital gains credited to the profit and loss account are liable to MAT in the absence of any specific adjustment in the MAT provision.

The Mumbai Tribunal observed that the decision of the special bench was distinguishable on the basis of the facts of the case. In the present case, the Mumbai Tribunal, after considering the special bench's decision, held that the exempt gains on the transfer of capital asset are to be excluded while computing book profits under the provisions of MAT. The taxpayer had specifically mentioned in the notes to accounts that the capital gain on transfer of asset to its wholly owned subsidiary are not includible in the net profit. The Tribunal held that since the said gains do not fall under the definition of 'income' and does not enter into the computation provisions at all, there is no question of including the same while computing the book profits under Section 115JB of the Act.

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