



N.A. Shah Associates

NEWSLETTER

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1 Accounting and Auditing

1 Expert Advisory Opinion

Treatment of capital expenditure on assets not owned by the company

Facts of the case

- § The company is a public sector undertaking engaged in refining and marketing of petroleum products.
- § The querist has stated that when a new project (like setting up of refinery) is undertaken, expenditure on the construction/development of certain assets, like electricity transmission lines, railway siding, roads, bridges, etc needs to be incurred in order to facilitate construction of project and subsequently to facilitate its operations. The ownership of such assets (enabling assets) as well as land on which they are situated does not vest with the company.
- § The existing accounting policy of the company with respect to such 'enabling assets' is to accumulate such expenditure as unallocated capital expenditure which is presented in the Balance Sheet as capital work-in-progress (CWIP) and charge the same to Profit & Loss Account in the year of completion of such projects.
- § The above policy is based on the opinion of the Expert Advisory Committee of the ICAI about the treatment of such capital expenditure & gist of which is as follows:

Situation	Treatment
Fixed Assets <i>owned</i> by company built on land <i>not owned</i> by company	Capitalise under relevant head
Fixed Assets <i>not owned</i> by company built on land <i>not owned</i> by company	Classify as capital expenditure and written off to Profit & Loss a/c on commencement of commercial operations

- § According to the Statutory Auditors the above mentioned treatment is incorrect and correct treatment will be as follows:

Situation	Treatment
Fixed Assets <i>owned</i> by company built on land <i>not owned</i> by company	Capitalize under relevant head
Fixed Assets <i>not owned</i> by company built on land <i>not owned</i> by company Or Expense on enabling assets which is used for completing its own project and subsequently for operational purposes	<ul style="list-style-type: none"> - Treat as CWIP till enabling asset is ready to use - On completion of asset, capitalize - Should be amortized over period of utility but not exceeding 5 years - Amount amortized to be treated as expenditure during

	construction period till completion of the project for which the enabling asset was created. After completion the amortized amount to be charged to the profit and loss account over the balance utility period.
Upgrading or widening of certain stretches of road etc not owned by the company	To be accounted as expenditure incidental to construction
Upgrading, widening and repairing certain portion of road culverts etc	To be charged to profit and loss account

Query

- § Whether the accounting policy followed by the company or as suggested by the auditors is correct?
- § If the answer to above is in negative, what should be the correct accounting treatment

Points considered by the Committee

- § An expenditure incurred by an enterprise can be recognized as an asset only if it is a 'resource controlled by the enterprise'. The committee has therefore examined whether the expenditure results into recognition of a tangible or an intangible asset.
- § The above mentioned expenditure can be considered to result into a tangible asset only when the company is able to control such asset(s) i.e. deal with the asset as it pleases. The company has no say on the use of such enabling assets by others since assets are available for general public use also. Therefore the expenditure incurred cannot be capitalised as a separate tangible asset.
- § The expenditure incurred on enabling assets not owned by the company does not meet the definition of the terms 'asset' and 'intangible asset' as per AS 26, even though the economic benefits are expected to flow from such facilities, the company does not have control over such facilities. Accordingly it cannot be capitalized as an intangible asset. The committee also noted that on Accounting Standard 26 – Intangible assets being made effective, the "Guidance note on Treatment of Expenditure during Construction Period" to the extent it was contrary to AS 26 is deemed to have been withdrawn and hence the expenditure on enabling asset should have been charged to Profit and Loss Account as required by para 56 of AS 26.
- § The basic principle to be applied while capitalizing an item of cost to the cost of a fixed asset/ project under construction is that it should be directly attributable to the construction for bringing it to its working condition for its intended use. The Committee's view is that the above expenditure incurred on enabling asset cannot be considered as directly attributable cost and accordingly the same cannot be capitalized as a component of fixed asset.

Opinion

- § The current accounting policy of the company and the treatment suggested by the auditors is incorrect.
- § The expenditure incurred on enabling assets not owned by the company should be charged off to revenue in the accounting period in which the expenditure is incurred.
- § Expenditure on such assets appearing as CWIP, being an error should be rectified and disclosed as a 'prior period item' as per the requirements of AS 5 in the financial statements of the period in which such rectification is carried out.

2 Exposure Draft on Accounting Standards for local bodies

Two Exposure draft have been issued by the 'Committee on Accounting Standards for local bodies' namely

- § ASLB 1 - Presentation of Financial Statements
- § ASLB 7 - Inventories

3 Position paper on tax issues arising out of IFRS

ICAI had constituted a group for identifying tax related issues arising out of convergence with IFRS.

On the basis of suggestions received from group some major tax issues arising out of convergence with IFRS were identified in form of 'position paper'. The Position Paper is to be submitted to the Ministry to assist the concerned ministries in policy formulation.

4 Amounts to be rounded off in multiples of 50 paise

The Central Government, Ministry of Finance has notified on December 20, 2010 to call in from circulation the coins of denomination of 25 paise and below, with effect from June 30, 2011 after which these coins will not be accepted in transactions.

The minimum denomination coin acceptable for transaction will be 50 paise from that date. Also, in accounting, i.e. the entries in books of accounts, pricing of products / services / taxes shall also be rounded off to 50 paise or whole rupee from that date.

2 Service Tax

1 Exemption for hire charges on electricity meters

Electricity meter installed in consumers' premises and hire charges collected by service providers (DISCOMS / TRANSCOS) is covered by exemption for transmission and distribution of electricity since supply of electricity meters for hire to the consumers is an essential activity having direct and close nexus with the transmission and distribution of electricity.

2 Notifications Issued

i. Conditional exemption in respect of certain services provided in relation to packaged / canned software (No. 53/2010)

New 100% Exemption scheme in respect of taxable services for packaged or canned software has been introduced based on the satisfaction of the following conditions:

§ The value of the said goods domestically produced or imported, for the purposes of levy of the duty of Central Excise or the additional duty of customs leviable under Customs Tariff Act, 1975, if imported, as the case may be, has been determined under Central Excise Act 1944.

§ the appropriate duties of excise on such value have been paid by the manufacturer, duplicator or the person holding the copyright to such software, as the case may be, in respect of software manufactured in India;

or

the appropriate duties of customs including the additional duty of customs on such value, have been paid by the importer in respect of software which has been imported into India;

§ Declaration made by service provider on invoice relating to the service that no amount in excess of retail sale price declared on the said goods has been recovered from the customer.

Hence, all previously issued notifications in respect of exemption for services provided in relation to packaged / canned software have been rescinded by way of notifications 51/2010 and 52/2010.

ii. Amendments / Inclusion of terms in definition of services

Services in connection to the management, maintenance and repair of bridges, tunnels, dams, airports, railways and transport terminals have been exempted from the levy of service tax. Earlier, the exemption was restricted only to the maintenance of roads

iii. Change in applicability of effective date (No. 55/2010, 56/2010 and 57/2010)

The effective date for withdrawal of exemption in relation to transport of goods by rail (through government rail) has been postponed to April 2011 instead of January 2011. Similarly the effective dates for other related / similar notifications have also been changed.

iv. 100% exemption for general insurance service provided under Weather Based Crop Insurance Scheme (WBCIS) or Modified National Agricultural Insurance Scheme (MNAIS) (No. 58/2010)

100% exemption from service tax has been provided for the taxable services in relation to general insurance business provided under the WBCIS or MNAIS approved by the Government of India and implemented by the Ministry of Agriculture.

3 SEBI

1. Amendments to the Equity Listing Agreement

SEBI has made certain amendments to the equity listing agreement (LA). The key amendments are as under:

i. Disclosures relating to shareholding pattern

- § Entities are required to submit their shareholding pattern to the stock exchange one day prior to the date of listing.
 - § Entities are also required to submit their revised shareholding pattern to the stock exchange within 10 days from the date of allotment of shares pursuant to any capital restructuring done by the company resulting in a change exceeding +/- 2% of the total paid up share capital.
 - § Entities which have issued Depository Receipts (DRs) overseas shall segregate the present disclosure pertaining to 'shares held by custodians and against which DRs have been issued' into those pertaining to the 'promoter / promoter group' and to the 'public'.
- ii. Since all listed companies are required to maintain a minimum public shareholding of 25% the LA has accordingly been modified and it provides the following methods to achieve the 25% criteria:
- § Issuance of shares to public through prospectus
 - § Offer for sale of shares held by promoters to public through prospectus
 - § Sale of shares held by promoters through the secondary market (Prior approval of the stock exchange to be taken by the company)
- iii. LA now provides the procedure for dealing with unclaimed shares in regard to companies which had issued shares in the physical mode in the past and which remained unclaimed by the shareholders due to insufficient / incorrect information or for any other reason.
- iv. All listed companies shall mandatorily have a pre – announced fixed pay date for payment of dividends and for credit of bonus shares which shall be intimated to the stock exchange on closure of the Board Meeting.
- v. All listed entities shall disclose details in respect of agreements entered into by them with media companies on their websites and also notify the stock exchange.
- vi. All listed entities shall mandatorily maintain a functional website that contains certain basic information about them duly updated for all statutory filings.

2. Acceptance of third party address as correspondence address

SEBI has authorized acceptance of third party address on behalf of the owner of the demat account for correspondence purpose subject to compliance with the KYC norms by such third party. However this facility is not extended to PMS clients.

4 NBFC

1. Notification of the CIC Directions 2011

RBI had issued a regulatory framework for Core Investment Companies (CICs) in August 2010. RBI has now notified the Core Investment Company (Reserve) Directions 2011. The key changes are provided below:

- i. RBI has modified the following definitions in the guidelines:
 - § Adjusted Networth –Revaluation Reserve arising from revaluation of investments in quoted investments is not to be considered for calculation of Adjusted Networth.
 - § Net assets –RBI has now notified that investments in money market mutual funds will also be excluded for calculation of net assets (earlier only investments in money market instruments were excluded)
 - § Outside Liabilities – Instruments compulsory convertible in equity shares not to be considered for determining Outside Liabilities
 - § Systematically Important CIC – Only CICs that raise funds or hold public funds (public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance excluding instruments compulsory convertible in equity shares) apart from having assets of more than 100 Crores will be considered as Systematically Important CIC
 - § Companies in the same group has now been defined as any arrangement involving two or more entities related to each other through any of the following relationships:
 - Subsidiary – parent (defined in terms of AS 21),
 - Joint venture (defined in terms of AS 27),
 - Associate (defined in terms of AS 23),
 - Promoter-promotee (as provided in the SEBI (Acquisition of Shares and Takeover) Regulations, 1997) for listed companies,
 - A related party (defined in terms of AS 18),
 - Common brand name, and
 - Investment in equity shares of 20% and above.
- ii. RBI has also declared that companies which are not Systematically Important CIC are not required to get themselves registered with RBI.

5 Others

1. Amendment to the Public Provident Fund Scheme, 1968

Currently the PPF Scheme provides the facility to continue the operation of the PPF account even after the expiry of 15 years from the date of initial subscription for a further block of 5 years subject to the limits specified therein.

However as an HUF is banned from opening new PPF accounts with effect from 13th May 2005, the Central Government has now discontinued the above mentioned extension facility available post maturity to the accounts opened on behalf of the HUF. Accordingly all accounts opened on behalf of a HUF prior to 13th May 2005 shall be closed after the expiry of 15 years. In case wherein the period of 15 years has already been completed, those accounts shall be closed as at 31st March 2011.

2. Issuance of Non Convertible Debentures (NCDs)

A corporate entity is eligible to issue NCDs of maturity upto one year if it has been sanctioned working capital limit or term loan by banks or all-India financial institutions. The Reserve Bank has now exempted NBFCs including primary dealers from complying with this condition.

Financial institutions are now eligible to invest in NCDs of maturity of upto one year.

6 Income Tax

1. Case Laws

- i. **S. 2(22)(e) applicable only to loans given in the year and further not applicable if lending is not "trivial" part of business**

CIT vs. Parle Plastics Ltd (Bombay High Court)

Facts:

- § The assessee had taken loans and advances of Rs. 2.18 crores from a closely held company ("AMPL") of which Rs. 0.17 crores was received during the year.
- § Out of the total assets of AMPL 40% were deployed by way of loans and advances, and its interest income was substantial compared to the total income.
- § Shareholders holding majority of the share capital in the assessee also held the majority of the shareholding in AMPL.
- § The AO took the view that the said loan / advance was assessable as "deemed dividend" u/s 2(22)(e) in the hands of the assessee. However, the CIT (A) held that only the loan / advance received during the year was assessable as "deemed dividend" and not the brought forward balance.
- § On appeal by the assessee, the Tribunal deleted the addition on the ground that the granting of loans was a substantial part of the business of AMPL.

Issue: Whether s. 2(22)(e) is applicable to the assessee company if lending is a "substantial" part of business of the lending company?

Held:

- § The H'ble Tribunal held that S. 2(22)(e) covers only the amount received during the previous year by way of loans / advances and not amounts received in an earlier year.
- § Further, s. 2(22)(e) excludes loans and advances where (i) the loan or advance was made by the lending-company in the ordinary course of its business and (ii) lending of money is a "substantial part" of the business of the lending-company.
- § The first condition was satisfied as the business of the assessee was complimentary to the business of AMPL. As regards the second condition, the expression "substantial part" does not connote an idea of being the "major part" or the part that constitutes majority of the whole.
- § On the facts, about 40% of the total assets of AMPL were deployed by way of loans and advances, and its interest income was substantial compared

to the total income. Since lending of money was a substantial part of the business of AMPL, the money given by it by way of advance or loan to the assessee could not be regarded as a dividend, as it has to be excluded from the definition of "dividend" by virtue of clause (e) of Section 2(22) of the Act.

- ii. **S. 14 A disallowance has to be on the basis of nexus between income and expenditure and not on adhoc estimate basis.**

Minda Investments vs. DCIT (ITAT Delhi)

Facts:

The assessee earned exempt dividend income of Rs. 70 lakhs and claimed that no expenditure had been incurred to earn the dividend. Hence s.14A disallowance was not permissible. The AO held that some expenditure had been incurred to earn the dividend and made a disallowance u/s 14A on an estimated basis. The CIT(A) followed the judgement of the Special Bench in Daga Capital 26 SOT 603 and directed the AO to compute the disallowance under Rule 8D on the basis that Rule 8D was retrospective.

Issue: Whether disallowance u/s. 14A can be made on adhoc estimate basis?

Held:

- § The H'ble Tribunal relied on decision in case of CIT vs Hero Cycles 323 ITR 518 (P&H) and held that that disallowance u/s 14A required finding of incurring of expenditure and where it was found that for earning exempt income no expenditure had been incurred, disallowance u/s 14A could not stand.
- § Further, in Godrej Boyce Mfg. Co. 328 ITR 81 (Bom) it was held that the AO could adopt a reasonable basis to identify the expenses in relation to the earning of exempt income and Rule 8D is applicable w.e.f AY 2008-09 only.
- § The assessee had urged that no expenditure has been identified to have been incurred to earn exempt income. Neither the AO nor the CIT (A) has rebutted this submission. The AO has made an adhoc estimate which is not sustainable in the light of Hero Cycle. Accordingly, in view of Vegetable Products 88 ITR 192 where it was held that if two views are possible, one favoring the assessee should be adopted. Therefore the precedent laid down in Hero Cycles is followed and no disallowance u/s 14A can be made on adhoc basis.

iii. S. 50C applies to transfer of development rights in property.

Arif Akhatar Hussain vs. ITO (ITAT Mumbai)

Facts:

The assessee being co-owner of inherited property entered into an agreement with the developer for development of the property for a consideration of Rs. 63 lakhs and the assessee offered his share of the consideration to capital gains. The Stamp Duty Valuing Authority valued the property at Rs.4.73 crores though the DVO valued it at Rs. 1.81 crores. The AO invoked s. 50C and adopted the DVO's valuation as the consideration which was confirmed by CIT(A).

Issue: Whether 50C applies to transfer of development rights in property.

Held:

§ The H'ble Tribunal held that when the assessee received the sale consideration and handed over possession of the property vide the development agreement, the condition prescribed in s. 53A of the Transfer of Property Act was satisfied and u/s 2(47)(v) the transaction of transfer was completed.

§ The argument that transfer of development rights does not amount to transfer of land or building and section 50C is not applicable, is not acceptable because section 2(47)(v) of the Act states that "giving of possession in part performance of a contract as per s. 53A of the Transfer of Property Act is deemed to be a transfer".

§ It also pointed out that the stamp duty law made a distinction between transfer of development rights and transfer of the property by imposing different rates of duty. Therefore s. 50C applies to transfer of development rights in property.

iv. The sale/transfer of stock-in-trade cannot be equated with the transfer of capital asset under section 2(47).

R. Gopinath (HUF) vs. ACIT (ITAT Chennai)

Facts:

§ The assessee had converted land measuring 44,000 sq.ft. into stock-in-trade. Thereafter the assessee entered into a development agreement wherein, the assessee provided the said land to the developer and in return the developer was, to give the assessee a built-up area of 25,285 sq.ft.

- § The assessee offered capital gain on the land under the provisions of Section 45(2) of the Income Tax Act, 1961 (the Act) in different years in which he sold the built-up area and thereby split the income on long term capital gain to the assessment years 2004-2005 and 2005-2006.
- § The Assessing Officer was of the view that the long term capital gain on transfer of land was assessable in the year in which the assessee handed over the possession of the land to the developer in pursuant to the agreement.
- § The CIT(A) held that since the possession of land was handed over to the developer in pursuant of the agreement, the capital asset viz. the land stands transferred in accordance with the provisions of Section 2(47) of the Act r.w.s.53A of Transfer of Property Act and upheld the action of the Assessing Officer.

Issue: Whether the sale/transfer of stock-in-trade can be equated with the transfer of capital asset under section 2(47)?

Held:

- § The H'ble Tribunal held that the property in question was converted from capital asset to stock-in-trade, therefore section 45(2) of the Act will be applicable for determining the year of taxing of the capital gain arising from the conversion of the capital asset into stock-in-trade.
- § However, the lower authorities have not taken a correct view by analyzing the transaction by applying the provisions of Section 2(47) of the Act which is applicable only in case of capital asset. As per Section 2(14) of the Act capital asset does not include stock-in-trade. Therefore, once capital asset is converted into stock-in-trade provisions of section 2(47) becomes irrelevant and does not apply.
- § Under the Act by inserting Clause (v) and (vi) of Section 2(47), the definition of the term transfer includes the transaction which fulfills the conditions provided u/s.53A of Transfer of Property Act. Therefore, Section 53A of the Transfer of Property Act is borrowed only with respect to the transfer of capital asset as provided u/s.2(47) of the Act and the same is not applicable in other cases which do not fall u/s 2(47) of the Act.
- § Therefore, the time of chargeability to income tax of capital gain arising from the conversion of capital asset to stock-in-trade is the point when the stock-in-trade is sold or otherwise transferred. Thus sale / transfer of stock-in-trade cannot be equated with the transfer of capital asset under section 2(47).

- v. TPO entitled to substitute 'CUP' for 'TNMM' to determine arms' length price. For generic drugs, CUP is appropriate method despite quality differences

Serdia Pharmaceuticals(I)Pvt Ltd vs. ACIT (ITAT Mumbai)

Facts:

- § The assessee, a pharmaceutical company, imported 'Active Pharmaceutical Ingredient' ('API's) from its foreign associated enterprises ('AE') and used them for manufacture of drugs.
- § For transfer pricing purposes, the assessee adopted the 'Transactional Net Margin Method' ("TNMM") as the most appropriate method and claimed that its transactions with the AE's were at arm's length on the basis that the assessee's operating profit on net sales was higher than that of its comparable competitors.
- § However, the TPO held that the assessee had purchased the APIs from the AE at prices that were higher than that paid for similar APIs by other companies in India. He rejected the contention of the assessee that the higher prices paid by the assessee were justified owing to their superior quality.
- § The TPO held that the TNMM was not a "reliable" method and that the Comparable Uncontrolled Price ('CUP') was, on facts, the most appropriate method and computed the arm's length price ('ALP') on that basis. On appeal, the CIT (A) upheld the stand of the TPO.

The arguments of the assessee in justifying TNMM method were as follows:

- § section 92C does not set out any hierarchy or order of preference amongst the various methods for computing the ALP, the assessee has discretion to adopt the TNMM and the TPO is not entitled to reject that method without showing deficiencies/ defects therein.
- § drug purchased was of high quality standards as compared to its competitors.
- § product is patented and research and development costs are incurred by the assessee, the higher pricing of the drug vis-à-vis prices of generic drugs manufactured by competitors can be justified on the ground of heavy R&D costs;
- § fact that another arm of the Government (customs) considered the price paid by the assessee to be an arm's length price, consequently the ALP for transfer pricing purposes is also justified;

Issue: Whether CUP method is preferable over TNMM method for transfer pricing purpose in case of import of generic drugs from AE?

Held:

The H'ble Tribunal held, dismissing all the arguments of the assessee, as under: -

- § The exercise of selecting the "most appropriate" method u/s 92C r.w. Rule 10C implies that the appropriateness of method is to be ranked in some order. Accordingly, it is open to the TPO to reject the TNMM and adopt the CUP method on the basis that the latter is "most appropriate" on the facts of the case;
- § TNMM is a "method of last resort" and should be adopted only when the standard methods (CUP, Resale Price Method and Cost Plus Method) cannot be reasonably applied. The tribunal followed the judgement in case of ACIT Vs. MSS India(32 SOT 132) wherein it was held that the standard (transaction) methods have an inherent edge over the profit method (TNMM) in most situations and wherever both methods can be applied in an equally reliable manner, the transaction methods should be preferred over TNMM
- § The argument of the assessee that the APIs are "unique" on the ground that they are better, of proven effectiveness and manufactured using WHO – GMP practices was rejected because while the high quality standards does confer a certain degree of comfort, it does not affect the comparability of the API with the same API manufactured by competitors
- § It was held that while innovators of drugs are allowed monopolistic pricing during the period when patents are in force so as to recoup the research and development costs, once the patent period expires, the higher pricing of the drug vis-à-vis prices of generic drugs manufactured by competitors cannot be justified on the ground of heavy R&D costs. Since in the present case, the patent has expired, the argument was not justified.
- § The fact that another arm of the Government (customs) considered the price paid by the assessee to be an ALP does not mean the assessee is relieved of the burden of establishing that it is an ALP for transfer pricing purposes;
- § Further, the facts also showed that the prices at which the generic drugs were purchased by the assessee from its AEs were not driven by market forces but on considerations which had no role to play in a typical arm's length transaction. The assessee's AE had reduced prices of the APIs to compensate the assessee for the low selling price of the drugs which would not have happened in an arms' length transaction. The price movements and demand sensitivity to the price indicate that the APIs imported by the assessee were not unique items and that such business models being adopted by pharmaceutical companies leave ample scope for them to manipulate API prices so as to regulate profitability of their controlled entities in the end use jurisdiction
- § Thus, it was held that CUP method was justified over TNMM method on the merits of the case.

vi. 115JAA MAT credit to be set off before computing advance-tax shortfall and liability for s. 234B/C interest

CIT vs. Tulsyan NEC (Supreme Court)

Facts:

The AO, in computing the tax under the normal provisions of the Act, took the view that though MAT credit was available, the same could not be deducted whilst computing the liability to pay advance tax and interest u/s 234B & 234C.

Issue: Whether MAT credit can be set off against advance-tax and interest u/s 234B/C?

Held:

- § S. 115JAA inserted by Finance Act 1997 w.e.f. 1.4.1997 provides that when tax is paid u/s 115JA or 115JB, a tax credit being the difference of the tax paid u/s 115JA/115JB and the tax payable under the normal provisions of the Act shall be allowed as set-off in the subsequent year when tax becomes payable under the normal provisions of the Act.
- § Further the scheme of s. 115JA (1) and 115JAA shows that right to set-off the tax credit follows as a matter of course once the conditions of s. 115JAA are fulfilled. The grant of credit is not dependent upon determination by the AO except that the ultimate amount of tax credit to be allowed depends upon the determination of total income for the first assessment year. Accordingly, the assessee is entitled to take into account the set off while estimating its liability to pay advance tax.
- § The fact that the Form & Rules provided for set off of MAT credit balance after computation of interest u/s 234B is irrelevant because it is directly contrary to a plain reading of s. 115JAA (4).

From:

N.A. Shah Associates
Chartered Accountants

Address: 65- C, Mittal Tower, Nariman Point, Mumbai – 400 021

Tel: 91-022-4073 3000, Fax: 91-022-4073 3090

E-mail Id: nashah@nashah.com