CHAPTER 21
CBDT'S CIRCULAR MAKING POWER: FRONTIERS STILL TO BE SETTLED

SYNOPSIS

I repeat…that all power is a trust--- that we are accountable for its exercise—that, from the people, and for the people, all springs, and all must exist.

—Benjamin Disraeli, *Vivian Grey* BK VI Ch 7

The principles of a free constitution are irrevocably lost when the legislative power is nominated by the executive.

—Edward Gibbon in *Decline and Fall of the Roman Empire* Ch 3

1. A Point at the threshold

In course of a long constitutional struggle for democracy the British Parliament acquired a complete control over taxation. The annual Finance Act is not an inane ritual, but it is a device to make the executive bend before Parliament for grant of authority to raise revenue from the people. We have adopted this British practice in our Constitution. Thus, the Income-tax Act 1961 is a mere Parliamentary commission issued to a group of statutory authorities to collect revenue as per the detailed terms of the commission set forth in a statute. From this, one may form an impression that tax administration is wholly a statutory affair with controlled discretion immunized from the wishes of the political executive. Such

an impression is natural when one observes that the income-tax authorities are statutory civil servants (in contradistinction to the members of the Indian Administrative Service) appointed to the statutory posts with defined functions and structured role. But the Central Boards of Revenue Act, 1963, largely frustrated this scheme. Its Section 3(1) states:

> "The Central Government shall, in place of the Central Board of Revenue, constitute two separate Boards of Revenue to be called the Central Board of Direct Taxes and the Central Board of Excise and Customs, and each such Board shall, subject to the control of the Central Government, exercise such powers and such duties, as may be entrusted to the Board by the Central Government or by or under any law."

This provision makes the Board subject to the control of the Central Government in view of its statutory duty to exercise such powers and perform such functions as may be entrusted to it by the Central Government. Such directions by the Central Government are bound to shape the circulars or instructions or directions that the Board issues under Sections 119 and 118 of the Income-tax Act 1961. Section 118 contemplates the control of income-tax authorities by subjecting them to the discipline of administrative subordination. Section 119 has a wider sweep as it deals with the power to issue instructions to the subordinate authorities.

To the best of my knowledge circulars/ instructions are issued only under Section 119 of the Income-tax Act 1961. Unfortunately our Supreme Court in *Azadi Bachao* has held incorrectly:

> "As we have pointed out, Circular No.789 is a circular within the meaning of section 90: therefore it must have the legal consequences contemplated by sub-section (2) of section90. In other words, the circular shall prevail even if inconsistent with the provisions of Income-tax Act, 1961 insofar as assesses covered by the provisions of the DTAC are concerned."

This author is at a loss to understand how the Hon'ble Court states that "Circular No.789 is a circular within the meaning of section 90". There is no expression to suggest that this circular is in exercise of power under section 90 because there is nothing to empower the CBDT to issue a circular under section 90 of the Income Tax Act. There is nothing to indicate that this power is being discovered as a matter of judicial construction. This statement is, on account of overlooking the statutory provisions. It is respectfully submitted that never till this date the CBDT ever issued a circular in exercise of power under Section 90 of the Act. Observing how the Board itself looks at its Circular further proves this point. The CBDT circular 789 was substantially modified and explained by Circular No 1 of Feb. 10, 2005. The Board had not specified the section under which this Circular was issued. When, in course of

arguments before the Supreme Court, it was required to be clarified, the CBDT came out with a Corrigendum[1] to the aforementioned Circular stating:

> "While issuing the said circular, the name of the Central Board of Direct Taxes got inadvertently omitted. It is hereby informed that the said circular was issued by the Central Board of Direct Taxes under section 119 of the Income-tax Act 1961."

The Court, it is respectfully submitted, went wrong in holding that the Circular No 789 was "within the meaning of section 90". This mistake led it to commit the following two other mistakes:

(a) the view that the Circular No 789 "must have the legal consequences contemplated by 90." and

(b) the view that the said Circular "shall prevail even if inconsistent with the provisions of the Income-tax Act, 1961 in so far as assesses covered by the provisions of the DTAC are concerned"

The view stated above cannot be wrung out from section 90 of the Income-tax Act which says: "The Central Government may……. by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement". It is patently erroneous for the following reasons:

(a) The Section empowers only the Central Government to "make such provisions as may be necessary for implementing the agreement", not the CBDT to issue any such Circular.

(b) The CBDT is a creature of the Central Board of Taxes Act, 1964. It is distinct from the Central Government.

(c) There is nothing in the content of the Circular to indicate that it is issued under section 90(2). The Central Government can make provisions for *implementing* the Agreement by notifying them in the Official Gazette for the information both to the taxpayers and the tax-gatherers. The expression "implementation" implies that the Agreement exists *ab exrta* created *inters parte* India and Mauritius. It contemplates an Agreement conforming to the base provisions, and the pre-conditions prescribed under section 90(1).

(d) It is an elementary rule that one who exercises power is the best person to say wherefrom the power was derived. The Board never claimed that its source of power was any provision other than Section 119 of the Income-tax Act 1961: rather it clarified that the Circular 789 had been issued in exercise of power under Section 119 only. A point admitted need not be proved.

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[1]. F No 500/60/2000-FTD (PL) issued by Ministry of Finance & Company Affairs, Deptt. Of Revenue (Foreign Tax Division) New Delhi.

But in a different context, the Court in *Azadi Bachao* considers the Circular 789 is as circular under Section 119 of the Act. It says:

> "If, in the teeth of this clarification, the assessing officers chose to ignore the guidelines and spent their time, talent and energy on inconsequential matters, we think that the CBDT was justified in issuing 'appropriate' directions vide circular no.789, under its powers under section 119, to set things on course by eliminating avoidable wastage of time, talent and energy of the assessing officers discharging the onerous public duty of collection of revenue. The circular no.789 does not in any way crib, cabin, or confine the powers of the assessing officer with regard to any particular assessment. It merely formulates broad guidelines to be applied in the matter of assessment of assesses covered by the provisions of the DTAC."

The Circular 789 cannot both be under Section 90 and under Section 119. It is clear from the Court's reasoning that it upholds the Circular under Section 119 as it was issued for proper administration of the Act. This is a conventional approach and no fault can be found with it. But is difficult to understand how it is for better administration and management of revenue when it:

(a) promotes extraneous purpose of promoting the interests of the FIIs and the MNCs;

(b) makes a trespass on the legislative field by creating certain conclusive presumptions;

(c) builds and ensures the continuance of an opaque system impervious to public gaze by going counter to the basics of an open and transparent political society.

(d) promotes Fraud and Collusion on massive scale through the sinister stratagem of Treaty Shopping.

The Court says that the Circular did not "in any way crib, cabin, or confine the powers of the assessing officer with regard to any particular assessment". Can after this Circular the Assessing Officer investigate the issue of *residency* and *beneficial ownership* if the assessee produces a Certificate of Residence issued by a Mauritian tax authority? He cannot do so. Thus his statutory power remains cribbed, cabined, and confined.

2. The Terms of Section 119 of the Income -tax Act 1961

The Central Board of Direct Taxes is empowered under section 119 (1) of the Income tax Act to "issue such orders, instructions and directions to other income tax authorities as it may deem fit for the proper administration of this Act," Without prejudice to generality of such powers, sub-section 2 empowers the Board "for the purpose of proper and efficient management of the work of assessment and collection of revenue" to issue directions even by relaxing certain statutory provisions specified in the sub-section. The powers of Administration and Management cannot be stretched to confer Dispensing power. The powers and duties

of the Inland Revenue under the Taxes Management Act 1970 are analogous to the powers and duties of the Central Board of Direct Taxes. In *IRC v Federation of Self – Employed* (1981) 2 All ER 93 the limited scope of the powers of the Inland Revenue has been discussed. In *R v. Peters* (*Maxwell*, 12th ed. page 55; *Craies*, 7th ed. p. 161) Lord Coleridge Observed: "I am quite aware that dictionaries are not be taken as authoritative exponents of the meaning of words used in Acts of Parliament, but it is a well- known rule of courts of law that words should be taken to be used in their ordinary sense, and we are therefore sent for instruction to these books." The *New Shorter Oxford English Dictionary* defines these words comprehensively. The concept of *administration* is at work in a wider concept of *management*. In the discharge of the statutory role these terms mean the art of engineering the administrative resources through an application of managerial skill to ensure that correct assessment is made so that the commission given by Parliament through the Income tax Act, 1961 is well discharged by raising tax "*not a paisa less, not a paisa* more".

Sub-section (1) of Section 119 of the Income tax Act empowers the Central Board of Direct Taxes to issue such order, instructions and directions to other income-tax authorities *"as it may deem fit for the proper administration of this Act."* Sub-section (2) of section 119 confers on the Board certain powers "without prejudice to the generality" of the power conferred under sub-section (1). Under sub-section (2) the Board has three sets of powers set forth in clauses (a), (b) and (c). Under clause (a) "the Board may, if it considers it necessary or expedient so to do, for the purpose of *proper and efficient management of the work of assessment and collection of Revenue*" issue directions or instructions (not prejudicial to assessees) for certain purposes detailed in that sub-section. Sub-section (b) empowers the Board to direct admission of claims in certain cases even after limitation. Sub-clause (c) empowers the Board to relax the requirements in certain statutory provisions in order to avoid genuine hardship "provided that the Central Government shall cause every order issued order under this clause to be laid before each house of Parliament".

The Conditions Precedent for exercising the power are (i) proper administration of the Income tax Act, and (ii) proper and efficient management of the work and assessment and collection of Revenue. The word "proper" in its attributive sense means, "according to the rules; right or correct" (*Oxford Advanced Learner's Dictionary*, encyclopedic edition). The word "administration" means "management of public or business affairs." The word "efficient" means, "(esp. of tools, machines, systems, etc) producing a satisfactory result without wasting time or energy". And the word "management" means "the application of skill or care in the manipulation, use, treatment, or control of things or persons, or the conduct of an enterprise, operation etc." (The *New Shorter Oxford English Dictionary*)

From a critical analysis of the thematic structure of Section 119, the following affirmative and negative points emerge:

(i) Affirmative Points

(i) Section 119 grants discretion to the CBDT and the exercise of the discretion is mandated on statutory pre-conditions.

(ii) The exercise of the power is for the sole purpose of "proper administration" of the Income tax Act.

(iii) The "proper and efficient management of the work of assessment and collection of revenue" is an integral part of "the proper administration of the Act".

(iv) Section 119 (2) (a) relaxes certain provisions but does not relax the operation of sections 131 & 142 of the Income tax Act, as these are essential for exercising the statutory role as an investigator.

(v) Section 119 (2) (b) relaxes limitation in some cases in order to avoid genuine hardship.

(vi) Section 119 (2) (c) relaxes certain provision in certain cases for claiming deductions in order to avoid genuine hardship. The proviso prescribes that "the Central Government shall cause every order issued under this clause to be laid before each House of Parliament.

(ii) Negative Points

(i) "……., departmental instructions or announcements which, although general in application, normally neither create legally enforceable rights nor impose legally enforceable obligations since they are not made pursuant to express statutory authorities. Circulars issued by the Department of the Environment to local planning authorities on the manner in which they should exercise their statutory powers fall into this category."

de Smith's *Judicial Review of Administrative Action*, p. 73)

(ii) The *investigative* and *adjudicative* dimensions of the Assessing Officer's statutory jurisdiction cannot be curtailed or modified.

(iii) They must promote rather than frustrate the *object* of the Act. The frontiers under the Act must not be transgressed.

(iv) The administrative act under Section 119 of the Act are subject to (a) the Constitutional limitations, (b) the provisions of the Income–tax Law, (c) Principles of Administrative Law, and (d) the mandatory norms of Public Policy, (e) Judicially evolved principles constituting the rich corpus of the Common Law *in* India, and (f) the Principles of International Taxation.

3. The Object & Purpose of the Income -tax Act 1961

Statutory Mission and Parliamentary commission would be clear from the following:

(i) The preamble and the scheme of the Income tax Act, 1961 suggests that the purpose is to collect tax in accordance with the law.

(ii) Lord Scarman explained the role of the authorities administering the Law of income tax in the United Kingdom in *Inland Revenue Comrs v. National Federation of Self-Employed and Small Businesses Ltd*[2]. His observation is relevant as the role of the Central Board of Direct Taxes and that of the Board of the Inland Revenue are analogous. Lord Scarman observed: "The duty has to be considered as one of several arising within the complex comprised in the care and management of a tax, *every part of which it is their duty, if they can, to collect*."[Italics supplied].

(iii) In the same Case Lord Diplock, explaining the function of the Board of Inland Revenue, says "All that I need say here is that the Board are charged by statute with the care, management and collection on behalf of the Crown of income tax, corporation tax and capital gains tax. In the exercise of these functions the Board have a wide managerial discretion as to the best means of obtaining for the national exchequer from the taxes committed to their charge the highest net return that is practicable having regard to the staff available to them and the cost of collection."

(iv) Lord Hewart observed in *Rex v. Special Commissioner* (20TC 381 at 384, quoted by *Kanga & Palkhivala* at p. 1509) that the duties imposed upon the Commissioners of Income tax are "in the interest of the general body of tax payers, to see what the true assessment ought to be, and that process, a public process directed to public ends."

(v) And the Indian Revenue's slogan that every probationary officer is taught at the National Academy of Direct Taxes is: not a paisa less, not a paisa more.

The power to issue instructions under section 119 of the Income-tax Act is given to promote certain statutory purposes explained above. If the Board issues any circular/instruction transgressing the scope for its exercise or for any extraneous purpose it clearly acts *ultra vires*; and such an act amounts to malice in law.[3] Commenting upon nature and reach of the CBDT's power the Delhi High Court, in *Shiva Kant Jha's Case*, had observed in its Judgment observed:

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[2]. (1981) 2 ALL ER 93 at 107 (H L).

[3]. *Education Sec v. Tameside* BC(50) 1977 AC 1014, quoted at page 1535 of Seervai's *Constitutional Law*, Vol – II; Lord Somervell quoting *Brett v. Brett* in *AG v Prince Earnest Agustus* 1957 AC 436 at 473 [quoted in Seervai, *Cons. Law* pg. 189]; per Justice Krishna Iyer in *M.P v. Orient Paper Mills* (AIR 1977 SC 687 overruled on another point in *Orissa v. Titagarh Paper Mills Ltd*. AIR 1985 SC 1293; per Lord Esher M.R. in *R. v. Vestry of St. Pancras*; *Federation of Self-employed and Small Business Ltd*. (1981) 2 ALL ER 93 at 107 (HL) quoted in *S.P. Gupta v. President of India & Ors*. (AIR 1982 SC 149 at page 190.; *Rohtash Industries Ltd. v. S.P. Agarwall*, AIR 1969,SC 707.; *The Cheng Poh v. Public Prosecutor*, (1980, AC 458, PC) discussed by H.M. Seervai on opp. 1125-1128 of his *Constitutional Law*, vol -II.; Lord Denning in *Breen v. A.E.U* (1971) 2 QB 175.; *Padfield v. Minister of Agriculture, Fisheries and Food* (quoted by Seervai, *Constitutional Law of India*, Vol-II 4th ed.P. 1529).

> "Power of issuance of a circular in terms of section 119 of the Income tax Act has been delegated in Central Board of Direct Taxes for a limited purpose…. Delegated authority must act within four corners of delegated legislation. It is not only to act having regard to the purpose and object for which the power has been delegated, it must act having regard to the provisions of the statute as also the delegated legislation."

In effect the Court appears to apply the well-settled principles of Administrative Law felicitously expressed in a number of decisions: to mention a few:

(a) In *R. v. Vestry of St. Pancras,* Lord Esher M. R. observed: [4]

> "If people who have to exercise a public duty by exercising their discretion take into account matters which the Courts consider not to be proper for the guidance of their discretion, then in the eye of the law they have not exercised their discretion."

(b) In *Breen v. A.E.U.* Lord Denning observed:[5]

> "The discretion of a statutory body is never unfettered. It is discretion, which is to be exercised according to law. That means at least this: the statutory body must be guided by relevant considerations and not by irrelevant."

(c) In *Teh Cheng Poh v. Public Prosecutor* the Privy Council observed:[6]

> "But, as with all discretions conferred upon the executive by Act of Parliament, this does not exclude the jurisdiction of the court to inquire whether the purported exercise of the discretion was nevertheless *ultra vires* either because it was done in bad faith (which is not in question in the instant appeal) or because as a result of misconstruing the provision of the Act by which the discretion was conferred upon him the Yang di-Pertuan Agong has purported to exercise the discretion when the conditions precedent to its exercise were not fulfilled or, in exercising it, he has taken into consideration some matter which the Act forbids him to take into consideration or has failed to take into consideration some matter which the Act requires him to take into consideration."

(d) In *State of UP v. Hindustan Aluminium Corporation* the Supreme Court of India observed:[7]

> "Challenge to an Order of the State Government on the ground of malice in law is another aspect of the doctrine of ultra vires, for an offending act can be condemned simply for the reason that it is unauthorized. Bad faith has often been treated as interchangeable with unreasonableness and taking a decision on extraneous considerations. In that sense, it is not really a distinct ground of invalidity. If a discretionary power has been exercised for an unauthorized

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4. (1990) 24 Q B D 371, 375.
5. (1971)2 Q B 175.
6. 1980 L R 458 P C at p.472.
7. AIR 1979, SC, 1459.

purpose that is enough to invite the Court's review, for malice is "acting for a reason and purpose knowingly foreign to the administration".

In short the principle at work is: "A power is exercised fraudulently if its repository intends to achieve an object other than that for which he believes the power to have been conferred."[8]

4. Summary of Points relating to the powers of the CBDT to issue Circulars

The relevant propositions are thus summarized:

(i) As it is a constitutional principle that nobody should be taxed under executive fiat nor untaxed through executive concession, the power of the CBDT under sections 118 & 119 must be strictly construed so that these sections are made neither the vanishing point of the Income tax law nor sources of power to create impervious coverlet of the gross legal errors.

(ii) Section 119 prescribes certain conditions precedent governing the CBDT's power to issue mandatory instructions in the form of Circular or Instructions. The base provisions are set forth in Section 119 (i) of the Income tax Act. The condition precedent is "for the proper administration of the Act". The case comes within the " precedent condition" category. It is for the Court to decide whether the precedent condition has been satisfied.

(iii) No *exemption* from the incidence of tax can be granted in exercise of power under section 119 of the Income tax Act, as grant of such benefits is a legislative function.[9].

(iv) As the powers and duties of the CBDT are analogous to those of the Commissioners of Inland Revenue in the UK under the Indian Revenue Regulation Act 1890 and the Taxes Management Act 1970, it would be appropriate to adopt the legal perspective which the House of Lords adopted in *IRC v. National Federation of Self Employed* (1981) 2 All ER 93.

(v) The observations on the CBDT's powers to issue Circular in *Navneet Lal C. Javeri v. K. K. Sen*[10], *Ellerman Lines Ltd. V. CIT*[11], and *K. P. Varghese v. ITO*[12], are *obiter* having no bearing on the actual decisions.

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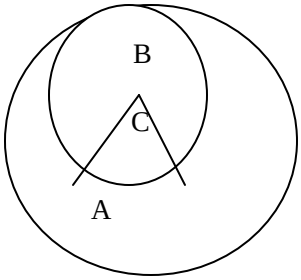
[8]. de Smith, *Judicial Review of Administrative Action*, 4th ed. p. 335.
[9]. AIR 1964, Raj. 205 at 213.
[10]. 56 ITR 198: AIR 1965 SC 1375.
[11]. 82 ITR 913 : AIR 1972 SC 524.
[12]. 131 ITR 509, AIR 1981, SC 1922.

The Supreme Court in *UCO Bank v. CIT*[13], set forth the permissible ambit of the Board's powers.

(vi) It is high time to declare law as to the Board's power to issue circulars that are beneficial to certain taxpayers but injurious to Public Interest.

A. The whole set of Circulars
B. A sub-set of Circulars,
(the beneficial Circulars)
C. Circulars beneficial to the assessees but injurious to public interest.



The Board cannot be given powers to issue circulars beneficial to certain taxpayers but prejudicial to public interest

(vii) Section 119 does not confer on the Board any dispensing power.

(viii) The Boards power to issue Circulars \ Instructions should be considered in the light of the paradigm shift in the tax law and keeping in view what Lord Diplock said in IRC *v. National Federation of Self Employed* (at p.103): "Any judicial statements on matters of public law if made before 1950 are likely to be misleading guide to what the law is today.".

5. The Supreme Court on the CBDT's Circular Making Power

In *Navnit Lal's Case*[14] the Supreme Court considered whether section 12(1B) read with S. 2(6A) (e) was constitutionally valid. The Court had held that "it is now well settled that even tax legislation must stand the scrutiny of the fundamental rights guaranteed by the Constitution, and so, there can be no doubt that if the impugned provision invades the fundamental rights of the appellant and the invasion is not constitutionally justified, it would be invalid." The combined effect of these two provisions was that three kinds of payments made to the shareholder of a company to which the said provisions apply, were treated as taxable dividend to the extent of the accumulated profits held by the company. These three kinds of payments were: (I) payments made to the shareholder by way of advance or loan; (2) payments made on his behalf; and (3) payments made for his individual benefit. There were five conditions, which must be satisfied before S. 12(1B) can be invoked against a shareholder. The first condition was that the company in question must be one in which the public are

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[13]. (1999) 237 ITR 889 at 890.
[14]. *Navnit Lal C. Javeri v. K. K. Sen*, AIR 1965 SC 1375.

not substantially interested within the meaning of S. 23A as it stood in the year in which the loan was advanced. The second condition was that the borrower must be a shareholder at the date when the loan was advanced; it is immaterial what the extent of his shareholding is. The third condition was that the loan advanced to a shareholder by such, a company can be deemed to be a dividend only to the extent to which it is shown that the company possessed accumulated profits, at the date of the loan. The fourth condition was that the loan must not have been advanced by the company in the ordinary course of its business. And the last condition was that the loan must have remained outstanding at the commencement of the shareholder's previous year in relation to the assessment year 1955-56. The Court felt that in dealing with the question about the constitutionality of the impugned provisions, it is necessary to bear in mind these respective conditions, which govern the application of the said provisions. Then the Court observed:

> "There is another material circumstance which cannot be ignored. It appears that when these amendments were introduced in Parliament, the Hon'ble Minister for Revenue and Civil Expenditure gave an assurance that outstanding loans and advances which are otherwise liable to be taxed as dividends in the assessment year 1955-56 will not be subject to tax if it is shown that they had been genuinely refunded to the respective companies before the 30th June, 1955. It was realized by the Government that unless such a step was taken, the operation of S.12 (1B) would lead to extreme hardship, because it would have covered the aggregate of all outstanding loans of past years and that may have imposed an unreasonably high liability on the respective shareholders to whom the loans might have been advanced. In order that the assurance given by the Minister in Parliament should be carried out, a circular [No. 2 (XXI-6)/55] was issued by the Central Board of Revenue on the 10th May 1955. It is clear that a circular of the kind which was issued by the Board would be binding on all officers and persons employed in the execution of the Act under S. 5(8) of the Act. This circular pointed out to all the officers that it was likely that some of the companies might have advanced loans to their shareholders as a result of genuine transactions of loans, and the idea was not to affect such transactions and not to bring them within the mischief of the new provision. The officers were, therefore, asked to intimate to all the companies that if the loans were repaid before the 30th June, 1955 in a genuine manner, they would not be taken into account in determining the tax liability of the shareholders to whom they may have been advanced. In other words, past transactions which would normally have attracted the stringent provisions of S.12 (1B) as it was introduced in 1955, were substantially granted exemption from the operation of the said provisions by making it clear to all the companies and their shareholders that if the past loans were genuinely refunded to the companies, they would not be taken into account under S. 12(1B). Section 12(1B) would, therefore, normally apply to loans granted by the companies to their respective shareholders with full notice of the provisions prescribed by it."

The following comments are worthwhile:

(i) It was a sort of conditional legislation as the Parliament had enacted the provision only after a specific assurance by the Minister who piloted the bill.

(ii) The CBDT's circular clarified the purpose of the newly inserted provisions The Court said: "It is clear that a circular of the kind which was issued by the Board would be binding on all officers." The expression 'this kind of +(a circular)' would mean a circular of the type of the circular which represents the Legislature's understanding while enacting certain provisions.

While issuing the abovementioned circular the CBDT basically discharged a ministerial function. It just carried out the instruction of the Central Government which it is bound to do under Section 3 of the Central Boards of Revenue Act, 1963 quoted in para 1 of this Chapter.

In *Ellerman Lines Ltd. v. Commissioner of Income-tax*[15] what the Supreme Court has said on the CBDT's Circular is a mere casual obiter. For better comprehension of the case it is worthwhile to take into account the bare facts and the actual decision in this case. To quote from the head note from the AIR:

> "The assessee was a non-resident British Shipping Company whose ship plied in waters all over the world including the Indian waters. For the assessment years the Income-tax Officer computed its total income taxable under the Act by taking into account the ratio certificates issued by the Chief Inspector of Taxes U. K. which were based on the assessments made on the assessee in U. K. During the relevant period there was in U. K. "investment allowance" corresponding to "development rebate" under the Act. The certificates issued by the Chief Inspector contained the percentage ratio of the total world profits of the assessee to its world earnings and similarly the percentage ratio of the wear and tear allowance and the investment allowance to its total world earnings. In making the assessment the income-tax officer proceeded under R. 33 of the Income Tax Rules and computed the income on the second of the three bases mentioned in the rule. He did not take into account, the investment allowance granted to the assessee in its U. K. assessments.
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> Held, that the authority in following the second basis mentioned in R. 33 of the Income Tax Rules and in not taking into account investment allowance had committed an error and the decision of the Tribunal determining the tax due on the basis of the ratio certificate given by the U. K. authorities which was also in accordance with the instructions given by the Central Board of Revenue was reasonable."

The Court observed:

> "The learned Solicitor-General appearing for the Revenue at one stage of his argument contended that the instructions issued by the Board of Revenue cannot have any binding effect and those instructions cannot abrogate or modify the provisions

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15. AIR 1972 SC 524.

of the Act. But he did not contend that Rule 33 is ultra vires the Act. The instructions in question merely lay down the manner of applying Rule 33."

The arguments set forth in the judgment amply reveal that the Court could have come to the same conclusion even without taking cognizance of the Board's circular. It is clear from what was held by the Court that the CBDT Circular merely illustrated what was just in tune with the Rule 33. It is in this context that the Court observed:

> "Now coming to the question as to the effect of instructions issued under Section 5 (8) of the Act, this Court observed in *Navnit Lal C Javeri v. A. K. Sen, Appellate Assistant Commissioner of Income-tax, Bombay*[16],. "It is clear that a circular of the kind which was issued by the Board would be binding on all officers and persons employed in the execution of the Act under Section 5 (8) of the Act. This circular pointed out to all the officers that it was likely that some of the companies might have advanced loans to their shareholders as a result of genuine transactions of loads, and the idea was not to affect such transactions and to bring them within the mischief of the new provision."
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> "The directions given in that circular clearly deviated from the provisions of the Act, yet this Court held that the circular was binding on the Income-tax Officer."

The following comments are deserved:

(i) Even without the aforementioned CBDT circular, the Court could have come to the same conclusion to which it reached. This is the result of an application of Professor Wambaughs method of determing the ratio of a case. This method is known as the "The "reversal" test of Professor Wambaugh. [17] It suggests that we should take proposition of law put forward by the judge, reverse or negate it, and then see if its reversal would have altered the actual decision. If so, then the proposition is the ratio or part of it; if reversal would have made no difference, it is not. In other words the *ratio* is a general rule without which the case would have been decided otherwise."[18]

(ii) The aforementioned observation merely supported the judicially approved reasoning. It is no more than a mere buttress to the judicial view formed on other good grounds;

(iii) Things would have been different if the Solicitor-General would have pleaded that Rule 33 was *ultra vires* the Act. But not challenging the *vires* of Rule 33, the Solicitor General helped the Court to adopt a view to which it would have come even without the said circular.

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16. 56 ITR 198 = (AIR 1965 SC 1375).
17. Wambaugh, *Study of Cases* 2nd pp 17-18.
18. Salmond, *Jurisprudence* 12th ed. p. 180.

In *K.P. Varghese v. Income Tax Officer*[19] the Court was considering the effect of the Section 52 (2) of the Income tax Act in relation to an assessment of Capital Gains tax. It was held that sub-Section (2) has no application in case of an honest and *bona fide* transaction where the consideration in respect of the transfer has been correctly declared or disclosed by the assessee, even if the condition of 15% difference between the fair market value of the capital asset as on the date of the transfer and the full value of the consideration declared by the assessee is satisfied. If therefore the Revenue seeks to bring a case within sub-section (2), it must show not only that the fair market value of the capital asset as on the date of the transfer exceeds the full value of the consideration declared by the assessee by not less than 15% of the value so declared, but also that the consideration has been understated and the assessee has actually received more than what is declared by him. These are two distinct conditions which have to be satisfied before sub-section (2) can be invoked by the Revenue and the burden of showing that these two conditions are satisfied rests on the Revenue. *K.P. Varghese* was decided as a matter of statutory construction. Its ratio emanates from this judicial exercise only. The reference to the CBDT circulars is merely by way of a supportive factor considered judicially relevant as a *contemporanea expositio.* This becomes clearer when one considers the following observation by the Court:

> "There is also one other circumstance which strongly reinforces the view we are taking in regard to the construction of sub-section (2)."

In this context the Court said:

> "This was quite contrary to the instructions issued in the circular which was binding on the Tax Department and the Central Board of Direct Taxes was, therefore, constrained to issue another circular on 14th January, 1974 whereby the Central Board, after reiterating the assurance given by the Finance Minister in the course of his speech, pointed out:
>
> "It has come to the notice of the Board that in some cases the Income-tax officers have invoked the provisions of Section 52 (2) even when the transactions were *bona fide*. In this context reference is invited to the decision of the Supreme Court in Navnit Lal C. Jhaveri v. K. K. Sen ((1965) 56 ITR 198) : (AIR 1965 SC 1375) and Ellerman Lines Ltd. v. Commr. of Income-tax, West Bengal wherein it was held that the circular issued by the Board would be binding on all officers and persons employed in the execution of the Income-tax Act. Thus the Income-tax officers are bound to follow the instructions issued by the Board."

It is worthwhile to make the following comments:

(i) The judgment is founded on the construction of Section 52(2) of the Income-tax Act. The actual decision does not require any reference to any CBDT circular.

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19. AIR 1981 SC 1922.

(ii) An issue pertaining to CBDT circular came up under circumstances under which nothing could be fairly decided:

(a) the CBDT had every reason to be happy to know that through its circulars it could override the law (an analogous power was last exercised by the Stuarts): such a power is the most delicious to the executive;

(b) the assessee had no reason to strike a different note as it was clearly a beneficiary of the view the Board had taken in the circulars;

(c) the Court, under the adversarial situation, could not have raised the issue of legality of its own.

(iii) In none of the cases discussed, the status and the legality of the CBDT circulars were raised as a contested issue which could have been argued by the counsels of the opposite sides. A decision on a point, not contested and argued, is of no consequence. Salmond has well said: "For the fundamental notion is that the law should result from being applied to live issues raised between actual parties and argued on both sides……In course of his judgment, however, a judge may let fall various observations not precisely relevant to the issue before him…. Here of course, since the issue is not one that arises between the parties, full argument by counsel will be lacking, so that it would be unwise to accord the observation equal weight with that given to his actual decision" [20].

(iv) Neither on the application of Professor Wambaugh's "reversal" test, nor the application of Dr Goodhart's "material facts" test takes us to view the reference to the CBDT circulars of any relevance in the determination of the *ration* which is binding and declarative of law.

In *UCO Bank, Calcutta v. Commissioner of Income-tax* (AIR 1999 SC 2082), the Court held that in assessing the 'Profits and gains of business' of a Bank maintaining books of accounts in a hybrid system, interest earned by Bank on 'Sticky' advances (i.e. on doubtful loans and not brought to profit and loss account) could not be included in income of assessee if for three years such interest is not actually received. The Court held that the CBDT Circular dated, 9th Oct. 1984 clarified the way in which these amounts were to be taxed; and this was not inconsistent with provisions of S. 145 of the Income-tax Act 1961. The decision invites the following comments:

(i) Once the Court held that the assessee maintained a hybrid system of accounting, whereunder the interest on the sticky advances could be accounted for only on cash basis, the whole case stood decided in the

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20. Salmond, *Jurisprudence* 12th ed.

assessee's favour. Further judicial quest was clearly unwarranted for arriving at an actual decision.

(ii) Once the Court held that the concerned CBDT circulars were consistent with the provisions of Section 145 of the Income-tax Act, nothing survived to consider as the circulars issued by the CBDT would become illustrative of the principles emanating from Section 145.

(iii) The decision is based on an old and established principle that it is the real income alone which is chargeable to tax. When it was found as a matter of fact that the interest on sticky advances could not be recovered for more than 3 years, it obviously ceased to be a species of chargeable income. The Court rightly felt that to subject the assessee to tax on such an interest income was to inflict hardship on the assessee. The assessee had not received income, and the likelihood to receive that was not there, or was highly uncertain. To ask him, placed under such circumstances, to pay tax on that sort of income would be causing hardship. Thus it was a clear case of hardship, which the Board alleviated in a complete conformity with the law. The Board can derive such a power from Section 119 of the Act itself. The Court could not have taken this view in the case of the Treaty Shoppers, as they suffered no hardship; rather they caused hardship to others through their unfair stratagem of causing wrongful gains to themselves. In fact, the Supreme Court itself observed: "The power is given for the purpose of just, proper and efficient management of the work of assessment and in public interest. It is a beneficial power given to the Board for proper administration of fiscal law so that undue hardship may not be caused to the assessee and the fiscal law may be correctly applied".

(iv) In this case also the CBDT's circular-making power was not put under central focus to be addressed by the counsels of both the sides. Besides, the matter cropped up under circumstances wherein a fair consideration of this issue was impossible. Both the sides were interested in establishing the hegemony of the CBDT circulars, for their own reasons.

In *Azadi Bachao* the CBDT's Circular 789 was certainly under the central focus. It was a fit case where the Court could have decided the issue after considering all the arguments, for or against. But this did not happen. The Court quoted a long paragraph from *K.P. Varghese* already quoted in the context of the examination of *Varghese*. It referred to *CIT v. Anjum M. H. Ghaswala*[21] which says the same. Then the Court referred to *Collector of Central Excise v. Dhiren Chemical Industries*[22] wherein the Supreme Court had observed:

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[21]. [2001] 252 ITR 1 (SC).
[22]. [2002] 254 ITR 554.

> "We need to make it clear that, regardless of the interpretation that we have placed on the said phrase, if there are circulars which have been issued by the Central Board of Excise and Customs which place a different interpretation upon the said phrase, that interpretation will be binding upon the Revenue."

After reviewing the aforementioned decisions of our Supreme Court the Court upheld the CBDT Circular 789 reversing the view that the Delhi High Court had taken. The Court observed:

> 'It was contended successfully before the High Court that the circular is ultra vires the provisions of section 119. Sub-section (1) of section 119 is deliberately worded in general manner so that the Central Board of Direct Taxes is enabled to issue appropriate orders, instructions or directions to the subordinate authorities "as it may deem fit for the proper administration of the Act".'

The following comments are made with utmost respect:

(i) Explaining the expression 'is satisfied' the House of Lords in *Education Sec. v. Tameside B.C.*[23] held that a section of a statute has to be considered within the structure of the Act. Each statute or type of statute must be individually considered. The Court, it is respectfully felt, did not examine the expression, "as it may deem fit for the proper administration of the Act", in the light of the genius and structure of the Income-tax Act 1961. The authorities who function under the Act are quasi-judicial authorities discharging public law functions.

(ii) The Court referred to several decisions which were all based on *Navnit Lal's Case.* The Court did not examine the issue on the first principles. One feels recalling what C.K. Allen had written[24]:

> "And yet it is remarkable how sometimes a dictum which is really based on no authority, or perhaps on a fallacious interpretation of authority, acquires a spurious importance and becomes inveterate by sheer repetition in judgments and textbooks."

(iii) It was a case where what mattered was not the semantics of the terms of Section 119 but the operative facts of (a) Treaty Shopping, and (b) the jurisdiction of the quasi-judicial authorities discharging their statutory duties.

(iv) The Court could not visualize that its upholding of the Circular 789 would cripple the investigative power of the Assessing Officers. This has now been brought out by the CAG in his Report 13 of 2005. The CAG wants the Board "to clarify to its assessing officers as to whether profits arising to FIIs would be assessable as business profits or capital gains". But how can an officer discharge this function if he finds himself pitted

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23. (1977) A.C.1014.
24. *Law in the Making* pp 263-264.

against the CBDT's own Circular preventing that pursuit. The CAG further writes:

> "Audit noticed that the department did not have any proactive strategy or action plan to identify investors belonging to third countries routing their transactions/investment through Mauritius for the sole purpose of enjoying treaty benefits, to the detriment of revenues (3.7.9.)"

In *Commissioner of Customs, Calcutta v. Indian Oil Corporation Ltd.* [2004 (165) E.L.T. 257 (S.C.), decided on February 2004, the Supreme Court considered the status of the CBDT circulars. Justice P. Venkataraman Reddy J took note not only of *Dhiren Chemical Industries, Navnit Lal C. Javeri v. K. K. Sen, Ellerman Lines Ltd. v. CIT, K. P. Varghese v. ITO, Sirpur Paper Mills Ltd v. CWT,*[25] *Keshavji Raiji & Co v. CIT*[26]*, Bengal Iron CTO*[27]*, CST v. Indra Industries*[28]*, Wilh, Wilhelmsen v. CIT*[29] but also of *UOI v. Azadi Bachao Andolan*[30]*. Hindustan Aeronautics v. CIT*[31]. Justice Reddy referred to *Sirpur Paper Mills Case* on which the Hon'ble Delhi High Court too had relied for formulating the propositions governing the CBDT's power under consideration. He observed:

> "It is now trite law that by reason of any power conferred upon any statutory authority to issue any circular, the jurisdiction of a quasi judicial authority in relation thereto can[not] be taken away".

Hon'ble Justice Reddy concludes his judgment expressing his desire that the matter should go to the Constitution Bench. The Hon'ble Lordship was pleased to observe:

> "I have referred to these cases to demonstrate that a common thread does not run through the decisions of this Court. The dicta/observations in some of the decisions need to be reconciled or explained. The need to redefine succinctly the extent and parameters of the binding character of the circulars of Central Board of Direct Taxes or Central Excise looms large. *It is desirable that a Constitution Bench hands down an authoritative pronouncement on the subject."*(emphasis supplied)

In *Azadi Bachao* the Division Bench of the Supreme Court has relied on *Dhiren Chemicals*. Now, a Division Bench of 3 Hon'ble Judges [32] in their judgment dated February 23, 2005 in *Commissioner of Central Excise, Bolpur v. M/s Ratan Melting & Wire Iindustries, Calcutta*[33] has directed a reference to a Constitution Bench in these words:

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[25]. (1970) 1 SCC 795.
[26]. (1990) 2 SCC 231.
[27]. (1994) Supp 1 SCC 310.
[28]. (200) 9 SCC 66.
[29]. (1996) 161.
[30]. 2003(8) SCALE 287, 306.
[31]. (2000) 5 SCC 365.
[32]. Ruma Pal, Arijit Pasayat and C.K. Thakker, JJ.
[33]. Case No: Civil Appeal No. 4022 of 1999.

"Though the view expressed in Kalyani's case (supra), and our view about invalidation might clarify the observations in para 11 of Dhiren Chemical's case (supra), we feel that the earlier judgment in Dhiren Chemical's case (supra) being by a Bench of five Judges, it would be appropriate for a bench of similar strength to clarify the position. In the circumstances, we refer the matter to a larger bench of five Hon'ble Judges. Let the papers be placed before Hon'ble the Chief Justice of India for constituting an appropriate Bench."

It is interesting to note that the propositions which the Delhi High Court had formulated find favour with the Supreme Court in *Pahwa Chemicals Pvt Ltd v. the Commissioner of Central Excise*[34] in which a Division Bench of 3 Hon'ble Judges laid down the following:

(1) '*It is the Act which confers jurisdiction on the concerned Officer/s.* If, therefore, the Act vests in the Central Excise Officers jurisdiction to issue show-cause-notices and to adjudicate, *the Board has no power to cut down that jurisdiction*.'

(2) 'However, *for the purposes of better administration of levy and collection of duty* and for purpose of classification of goods the Board may issue directions allocating certain types of works to certain Officers or classes of Officers'.

(3) 'It is thus clear that the Board has *no power to issue instructions or orders contrary to the provisions of the Act or in derogation of the provisions of the Act.*'

(4) 'The instructions issued by the Board have to be within the four corners of the Act.'

(5) 'The Circulars relied upon are, therefore, nothing more than administrative directions allocating various types of works to various classes of Officers.'

(6) 'These *administrative directions cannot take away jurisdiction vested in a Central Excise Officer under the Act*.''But if an Officer still issues a notice or adjudicates contrary to the Circulars it would not be a ground for holding that he had no jurisdiction to issue the show cause notice or to set aside the adjudication.'

6. Can a circular deviate even from the Act?

The Supreme Court said in *Ellerman Lines Ltd*: " The directions given in that circular clearly deviated from the provisions of the Act, yet this Court held that the circular was binding on the Income-tax Officer". But this view taken by the Court depends on what view we take of our government and its

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34. (2005) 2 SCC 720 at p. 27.

right to raise taxes. Perhaps, the Court thinks that taxation is the executive-government's esoteric affair. Once Parliament grants it a mandate to raise taxes, the executive's discretion is supreme. The executive fiat traveling through Section 119 may exempt a group of persons from the incidence of taxation when others similarly placed are doomed to groan under its burden. It may liberally grant concessions to those it likes. This view is founded on the famous British case: *the Treasury case in 1872*. But this view is no longer valid in our democratic polity. This point has been discussed in the Chapter on "The Paradigm Shift in Tax Jurisprudence" vide the opinion of Lord Scarman. The Circular No. 789 is also not in tune with to a Constitutional Principle to which Lord Wilberforce refers in *Vesty v. IRC* (1979) 3 ALL ER 976 at 984 :

> "A proposition that whether a subject is to be taxed or not, or that, if he is, the amount of his liability is to be decided (even though within a limit) by an administrative body, represents a radical departure from constitutional principle. It may be that the Revenue could persuade Parliament to enact such a proposition in such terms that the courts would have to give effect to it: but unless it has done so, the courts, acting on constitutional principles, not only should not, but cannot validate it."

The point to be seen is: whether in exercise of power to issue circulars under Section 119 the issuing authority is promoting a purpose extraneous to the Income-tax Act. Circular 789 says in so many words that it was designed to serve the interests of the FIIs. Then the proper question is to ask: Whether the Central Government was right in issuing the impugned circular for the benefit of the FII... If the purpose is to grant them benefits, the right course was to frame a law facilitating the incoming of foreign funds. This would ensure transparency. The Authority for Advance Ruling had aptly observed:[35]

> "*In order to encourage inflow of funds form the Emirates to India, the Government of India could bring about a legislation granting relief to such inflow of funds and income earned by investments of such funds. The Government of India has not chosen to do so. Therefore it will not be right to hold that the real object of this agreement instead of avoiding double taxation was to encourage inflow of foreign funds into India by reducing rates of taxes even when there was no double taxation of income at all.* The object of the agreement was avoidance of double taxation of income and prevention of fiscal evasion. The agreement was entered into in exercise of the power conferred by section 90 of the Income-tax Act, section 24A of the Companies Profits (Surtax)Act and section 44 of the Wealth-tax 1957. Such an agreement could only be entered into, (a) for granting relief in respect of tax actually paid twice on the same income under the tax laws in force in both the countries, or (b) for avoidance of double taxation of income under the Income-tax Act and the Corresponding law in force in the foreign country." (*Emphasis supplied*.)

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[35] (1999) 239 ITR 650 at 674.

Lord Edmund-Davies in *Vestey v. IRC*[36] said that Lord Radcliffe "never understood the procedure of extra-statutory concessions in case of a body to whom at least the door of Parliament is open every year for adjustment of the tax code."

7. The Rule of Law

To grant an overriding power to the executive whereby it can ride roughshod even over a Parliamentary enactment is to act to the prejudice of Parliamentary Supremacy and the Rule of Law. None should be untaxed by an executive clemency: none should be taxed under the executive fiat. Besides, even the law declared by the Court cannot be ignored. Our Supreme Court has said so in *Hindustan Aeronautics Ltd v. CIT*[37]*:*

> "…. when the Supreme Court or the High Court has declared the law on the question arising for consideration it will not be open to a Court to direct that a circular should be given effect to and not the view expressed in a decision of the Supreme Court or the High Court."

8. The Role of the Statutory Authorities

It is dangerous to allow the executive through circular making powers to interfere in the functioning of the quasi-judicial authorities. The evil nexus between the politicians in power and the superior bureaucrats, which the Shah Commission of Inquiry considered the 'root of all evils', operates through such executive powers as are given under Section 119. There are good reasons, already in the public domain, suggesting that the Board's Circular 789 emanated from such an evil nexus. A Bench of 3 Judges of the Supreme Court had observed in *Sirpur Paper Mills Ltd v. CWT* [(1977) 1 SCC 795] that the instructions issued by the Board may control the exercise of power of the departmental officials in matters administrative but not quasi-judicial.

9. The issue in a wider gestalt

It is hoped that when the issue comes up before a Constitution Bench, in view of reference made in *Commissioner of Central Excise, Bolpur v. M/s Ratan Melting & Wire Iindustries, Calcutta*[38] , the Court would consider the issue in a wider gestalt.

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[36] (1997) 3 All ER 976 at 1002.
[37] AIR 2000 SC 2178 at 2180.
[38] Case No: Civil Appeal No. 4022 of 1999.
[38] (2005) 2 SCALE 280.