

The Suggested Answers for Paper 7: - Direct Taxes are based on the provisions applicable for A.Y. 2009-10, which is the assessment year relevant for June, 2009 examination.

PAPER – 7 : DIRECT TAXES

Answer all questions

Question 1

X, Y and HUF of Z (represented by Z) are partners with equal shares in profits and losses of a firm, M/s Popular Cine Vision, which is engaged in the production of TV serials and telefilms. In the previous year 2007-08, one partner 'A' retired, but his dues have been settled in the previous year 2008-09.

The earlier partnership deed did not authorise payment of remuneration or interest to partners. The partnership deed was revised by the partners on 1st June, 2008 to authorise payment of remuneration of Rs.1 lac per month to each working partner and simple interest at 15% per annum to X and Y on their capital. X, Y and Z are actively associated with the affairs of the firm.

The Profit & Loss Account of the firm for the year ended 31st March, 2009 shows a net profit of Rs.10 lacs after debiting/crediting the following:

- (a) Interest amounting to Rs.15 lacs paid to X and Y on the balances standing to their capital accounts from 1st April, 2008 to 31st March, 2009.
- (b) Remuneration to the partners including partner in representative capacity Rs.30 lacs.
- (c) Interest amounting to Rs.2 lacs paid to Z on loan provided by him in his individual capacity at 16% interest.
- (d) Royalty of Rs.5 lacs paid to partner X, who is litterateur and a professional script writer, for use of his scripts as per an agreement between the firm and X.
- (e) Two separate payments of Rs.18,000 and Rs.15,000 made in cash on 1st February, 2009 to Altaf, a hairdresser, against his bill for services rendered in January, 2009 and two payments of Rs.19,000 and Rs.10,000 made in cash on 1st February and 2nd February, 2009, respectively, to Priyam, an assistant cameraman, against her bill for services provided in January, 2009.
- (f) Amount of Rs.5 lacs provided in the books on 31st March 2009 as liability for remuneration to Shreyashi, a film artist and a non-resident. Tax deducted at source under section 195 from the amount so credited was paid on 3rd June, 2009.
- (g) Amount of Rs.6 lacs provided as gratuity for the year on the basis of actuarial valuation. Gratuity paid to retired employees is Rs.1.50 lacs.
- (h) Interest of Rs.1.20 lacs received on income-tax refund under section 244(1A) in respect of assessment year 2007-08.

The firm has also provided the following additional information:

FINAL EXAMINATION : JUNE, 2009

The amount due to A, the former partner, was Rs.15 lacs. The dues were settled on 30th September, 2008 by transferring a plot of land purchased two years back having a book value of Rs.10 lacs. The difference of Rs.5 lacs was credited to partners' capital accounts in their profit sharing ratio. The fair market value of the plot on the date of transfer was Rs.16 lacs.

Compute the total income of the firm for the assessment year 2009-10 stating the reasons for treatment of each item. (16 Marks)

Answer

Computation of Total Income of M/s. Popular Cine Vision for the A.Y.2009-10

	Rs.	Rs.
Profits and Gains from Business or Profession		
Net Profit as per Profit & Loss A/c		10,00,000
Add: Expenses disallowed or considered separately		
Interest to partners in excess of 12% (Note 1)	5,00,000	
Disallowance under section 40A(3) for aggregate cash payment exceeding Rs.20,000 in a single day (Note 5)	33,000	
Remuneration to non-resident film artist disallowed under section 40(a)(i) (Note 6)	5,00,000	
Provision for gratuity (Note 7)	4,50,000	
Partners' Remuneration	30,00,000	
Royalty paid to Partner X (Note 4)	5,00,000	49,83,000
		59,83,000
Less: Interest on income-tax refund (Note 8)		1,20,000
Book Profit		58,63,000
Less: Partners' remuneration allowable under section 40(b)(v)		
On first Rs.75,000 90%	67,500	
On next Rs.75,000 60%	45,000	
On balance Rs.57,13,000 40%	22,85,200	
		23,97,700
		34,65,300
Capital Gain		
Short-term capital gain on transfer of land (Note 9)		6,00,000
Income from other sources		
Interest on income-tax refund		1,20,000
Gross Total Income		41,85,300

PAPER – 7 : DIRECT TAXES

Deductions under Chapter VI-A	Nil
Total Income	<u>41,85,300</u>

Notes:

1. As per section 40(b) simple interest at 12% p.a. to partners relating to the period after the date of partnership deed is allowable. Therefore, interest to partners from 1st April to 31st May, 2008 should be disallowed. Further, the excess interest @ 3% paid from 1st June, 2008 to 31st March, 2009 should also be disallowed.

		Rs.
Interest for April and May, 2008	15,00,000 x 2/12	2,50,000
Excess interest from June'08 to March'09	(15,00,000 x 3/15) x 10/12	2,50,000
		<u>5,00,000</u>

Note – It is assumed that Rs.15 lacs is the cumulative interest paid to X and Y during the year, since the question does not mention Rs.15 lacs “each” paid to X and Y.

2. Even though Z is a partner in a representative capacity, he is still a partner. Therefore, remuneration to Z should also be subject to the limits prescribed in section 40(b). This view finds support from the decision of the Supreme Court in the case of Rashik Lal & Co. vs CIT (1998) 229 ITR 458 (SC).
3. As per Explanation 1 to section 40(b) where an individual is a partner in a firm in a representative capacity, the provisions of section 40(b) shall not apply to any interest payable by the firm to such individual in his personal capacity. Z represents his HUF in the firm. However, Z gave the loan in his individual capacity. Hence, assuming that the provisions of section 40A(2) do not get attracted in this case, such interest shall be allowed as deduction in full even though the interest rate is more than 12% p.a.
4. It may be noted that the limits specified under section 40(b)(v) are applicable in case of payment of salary, bonus, commission, or remuneration, by whatever name called, to a working partner. From a plain reading of the section, it is clear that any remuneration, by whatever name called, paid to a working partner, is subject to the limits laid down in section 40(b)(v). Therefore, the royalty of Rs.5 lakh paid to partner X would also be subject to the limits laid down in section 40(b)(v). Hence, the same has to be added back for computing book profits.
5. Section 40A(3), as amended by the Finance Act, 2008, provides for disallowance of any expenditure in respect of which aggregate of payments made otherwise than by an account payee cheque or account payee bank draft in a single day to a person exceeds a sum of Rs.20,000. Hence, the payments of Rs.18,000 and Rs.15,000 in cash on 1.2.2009 to Altaf, a hairdresser, shall be disallowed, since the aggregate payment of Rs.33,000 exceeds the limit of Rs.20,000.

FINAL EXAMINATION : JUNE, 2009

In case of payment of bill of the assistant cameraman, since the aggregate payment in cash on a single day does not exceed Rs.20,000, disallowance under section 40A(3) is not attracted.

Note – It is possible to take a view that 1st February, 2009 is a bank holiday since it falls on a Sunday and therefore, the exception contained in Rule 6DD(j) would apply in such a case and hence, disallowance under section 40A(3) would not be attracted. However, this view would hold good only if as per the agreement with the hairdresser, the payment is required to be made on a particular date and such date (1st February, 2009, in this case) happens to be bank holiday. Since the question does not mention of any such agreement, the problem has been solved assuming there was no specific requirement to make the payment only on 1st February, 2009 and therefore, the provisions of section 40A(3) would be attracted.

6. As per section 40(a)(i), any sum payable to a non-resident shall not be allowed as deduction, if tax has not been deducted at source or after deduction, has not been paid within the time limit prescribed in section 200(1). Tax deducted from the amount of remuneration credited to payee's account on 31st March 2009 has to be deposited latest by 31st May, 2009. However, the firm has paid the tax only on 3rd June, 2009. Hence, the remuneration shall be disallowed. However, the firm can claim deduction in respect of such remuneration in the assessment year 2010-11.
7. As per section 40A(7), any provision made for payment of gratuity to employees on their retirement or on termination of employment for any reason is disallowed. However, any provision made for the purpose of payment of a sum by way of any contribution to an approved gratuity fund or for the purpose of payment of gratuity which has become payable during the previous year shall be allowed as deduction. The question does not mention any approved gratuity fund. However, gratuity of Rs.1.50 lacs paid to retired employees is allowable as deduction. Hence, the balance provision of Rs.4.50 lacs (i.e., Rs.6 lacs – Rs.1.50 lacs) is to be disallowed.
8. Interest on income-tax refund is assessable under the head "Income from other sources".
9. Distribution of a capital asset by a firm to its partner on dissolution or otherwise attracts capital gains tax liability as per the provisions of section 45(4) and the fair market value of the asset on the date of transfer is deemed to be the full value of consideration received or accruing as a result of the transfer. The words "or otherwise" includes within its scope, cases of distribution of capital assets on retirement of a partner also. [CIT vs. A. N .Naik Associates 265 ITR 346 (Bom.)]. Therefore, distribution of a plot of land on retirement of a partner would attract section 45(4).

Rs.16 lacs, being the fair market value of the plot on the date of transfer, is deemed to be the full value of consideration. Therefore, the capital gain would be Rs.6 lacs (i.e., Rs.16 lacs – Rs.10 lacs).

Question 2

- (a) Mr. Bhargava, a leading advocate on corporate law, decided to reduce his practice and to accept briefs only for paying his taxes and making charities with the fees received on

PAPER – 7 : DIRECT TAXES

- such briefs. In a particular case, he agreed to appear to defend one company in the Supreme Court on the condition that he would be provided with Rs.5 lacs for a public charitable trust that he would create. He defended the company and was paid the sum by the company. He created a trust of that sum by executing a trust deed. Decide whether the amount received by Mr. Bhargava is assessable in his hands as income from profession. (3 Marks)
- (b) The Finance Act, 2008 brought in a new provision effective from 1st April, 2009 for granting deduction of 100% of profit derived by an undertaking from the business of operating and maintaining a hospital located anywhere in India, other than excluded area, subject to certain conditions. State briefly those conditions. (2 Marks)
- (c) Mr. Bansal, a resident Indian and aged 67 years, has derived the following income during the previous year 2008-09:

	Rs.
(i) Income from business in India	2,50,000
(ii) Commission (Gross) from a company in Hong Kong (Tax paid in Hong Kong Rs.60,000)	3,00,000
(iii) Dividend (Gross) from a company in Hong Kong (Tax paid in Hong Kong Rs.18,000)	90,000
(iv) Interest on fixed deposit and savings account with banks in India	2,00,000

India has no double tax avoidance agreement with Hong Kong. Compute the income and tax payable by Mr. Bansal for assessment year 2009-10. (5 Marks)

Answer

- (a) In the instant case, the trust was created by Mr. Bhargava himself out of his professional income. The client did not create the trust. The client did not impose any obligation in the nature of a trust binding on Mr. Bhargava. Thus, there is no diversion of the money to the trust before it became professional income in the hands of Mr. Bhargava. This case is one of application of professional income and not of diversion of income by overriding title. Therefore, the amount received by Mr. Bhargava is chargeable to tax under the head "Profits and gains of business or profession".
- (b) Sub-section (11C) has been inserted in section 80-IB by the Finance Act 2008 with effect from A.Y.2009-10 for granting deduction of 100% of profit derived by an undertaking from the business of operating and maintaining a hospital located anywhere in India, other than the excluded area, subject to the following conditions:
- (i) The hospital should be constructed and should start functioning between 1st April, 2008 to 31st March, 2013.
 - (ii) The hospital should have at least 100 beds for patients.
 - (iii) The construction of the hospital should be in accordance with the regulations or bye-laws of the local authority.

FINAL EXAMINATION : JUNE, 2009

- (iv) Audit report in the prescribed form signed and verified by a chartered accountant certifying that the deduction has been correctly claimed should be filed along with the return of income.
- (c) Mr. Bansal is entitled to relief under section 91, since :-
- (i) He is a resident in India during the relevant previous year.
 - (ii) Income, by way of commission and dividend, accrues or arises to him outside India (in Hong Kong) during the previous year.
 - (iii) Such income is not deemed to accrue or arise in India during the previous year.
 - (iv) The income in question, namely, commission and dividend, has been subjected to income-tax in Hong Kong in the hands of Mr. Bansal and he has paid tax on such income in Hong Kong.
 - (v) There is no agreement under section 90 for the relief or avoidance of double taxation between India and Hong Kong.

Therefore, he is entitled to the deduction under section 91, from the Indian income-tax payable by him, of a sum, calculated on such doubly taxed income at the Indian rate of tax or at the Hong Kong rate of tax, whichever is lower.

Computation of total income and tax liability of Mr. Bansal for A.Y.2009-10

Particulars	Rs.
Income from business in India	2,50,000
Commission received from a company in Hong Kong	3,00,000
Dividend received from a company in Hong Kong	90,000
Interest on fixed deposits and savings account with banks in India	2,00,000
Total Income	<u>8,40,000</u>
Tax on the above:	
Upto Rs.2,25,000	Nil
Over Rs.2,25,000 & upto Rs.3,00,000	7,500
Over Rs.3,00,000 & upto Rs. 5,00,000	40,000
Over Rs.5,00,000	<u>1,02,000</u>
	1,49,500
Education cess @ 2% and secondary and higher education cess @ 1%	4,485
Total tax liability	<u>1,53,985</u>
Average rate of income-tax in India: (1,53,985/8,40,000 x 100)	18.33%

PAPER – 7 : DIRECT TAXES

Average rate of income-tax in Hong Kong (78,000/3,90,000 x 100)	20%
Double tax relief under section 91 shall be @18.33% or 20% of foreign income, whichever is less [i.e., 3,90,000 x 18.33%]	71,487
Net tax liability (Rs.1,53,985 – Rs.71,487)	82,498

Question 3

- (a) Ayush, an employee of a management consultancy firm, was sent to UK in connection with a project of the firm's client for two months in a previous year. In addition to his salary, the firm paid per diem allowance for the period when he worked in UK to meet expenses on boarding and lodging. Tax was not deducted at source from such allowance by the employer. Ayush did not include such allowance in computation of his taxable salary for the relevant assessment year. In course of assessment of Ayush under section 143(3), the Assessing Officer sent a notice to him asking him to explain why the per diem allowance received by him should not be charged to tax? Ayush sought your advice. (4 Marks)
- (b) Sri Sajjan converted the capital asset, acquired by him in the year 1988, into stock-in-trade at the fair market value on 1st March, 2008. Sri Sajjan sold the entire stock-in-trade so converted, on 25th November, 2008. Sri Sajjan seeks your advice as to the tax implications of the transaction with reference to the provisions of Indian Income-tax Act for the assessment year 2009-10. (5 Marks)
- (c) Intelysis Limited charged depreciation on its fixed assets at the rates prescribed in the Income-tax rules in its accounts consistently. The Assessing Officer disallowed the same and considered depreciation computed at the rates prescribed in the Companies Act, 1956, for the purpose of computation of 'book profit' under section 115JB of the Income-tax Act for the assessment year 2008-09. Examine the correctness of the action of the Assessing Officer. (3 Marks)
- (d) East Bengal Club, a renowned football club, has engaged Raghu, a resident in India, as its coach at a remuneration of Rs.6 lacs annually. The club wants to know from you whether it is liable to deduct tax at source from such remuneration. (3 Marks)

Answer

- (a) Per-diem allowance is exempt from tax under section 10(14), as it is an allowance granted and spent to meet the ordinary daily charges incurred by an employee on account of absence from his normal place of duty. As per the clarification issued in Circular No.8/2005 dated 29.8.2005, such per-diem allowance would be liable to fringe benefit tax in the hands of the employer and employee will not be liable to pay income-tax on any surplus accruing to him from such allowance.
- (b) Conversion of a capital asset into stock-in-trade falls within the definition of transfer under section 2(47). Therefore, in this case, transfer has taken place during the previous year 2007-08. However, as per section 45(2), the capital gains liability arises only in the

FINAL EXAMINATION : JUNE, 2009

year in which the stock-in-trade is sold i.e. previous year 2008-09 in this case. It is a long-term capital gain since the asset was acquired in 1988. The fair market value (FMV) on the date of conversion i.e. on 1.3.2008 is deemed to be the full value of consideration accruing as a result of transfer of the capital asset.

Therefore, in the year of sale of stock-in-trade (i.e. P.Y. 2008-09), both business income and capital gains would arise.

Business income = Sale consideration – FMV on the date of conversion
of stock-in-trade

Capital gains = FMV on the date of conversion – Indexed cost of acquisition / improvement
conversion

- (c) This issue was settled by the Supreme Court in *Malayala Manorama Co. Ltd. v. CIT* (2008) 300 ITR 251. The Apex Court observed that for the purpose of computation of book profit under section 115JB, the Assessing Officer's power is restricted to examining whether the books of account are certified by the authorities under the Companies Act as having been properly maintained in accordance with the Companies Act. Thereafter, he only has the limited power of making additions and deductions as provided for in Explanation 1 to section 115JB. The Assessing Officer does not have the jurisdiction to go behind the net profit shown in the profit and loss account except to the extent provided in Explanation 1 to section 115JB. Where an assessee is consistently charging depreciation in its books of account at the rates prescribed in Income-tax Rules and the accounts of the assessee have been prepared and certified as per the provisions of the Companies Act, the Assessing Officer does not have any jurisdiction under section 115JB to rework the net profit of the assessee by substituting the rates of depreciation prescribed under the Companies Act.

Applying the ratio of the Supreme Court decision to this case, it may be concluded that the action of the Assessing Officer is not correct.

Note - The rates of depreciation prescribed in Schedule XIV to the Companies Act are the minimum rates at which depreciation is to be charged in the profit & loss account. The rates prescribed in the Income-tax Rules are higher than those prescribed in the Companies Act. A company is, therefore, not precluded from adopting higher rates of depreciation, if the circumstances justify. Thus, even if a company adopts the higher rates of depreciation prescribed in the Income-tax Rules, it can be said that the company has prepared the accounts in the manner provided under the Companies Act.

- (d) Section 194J requires deduction of tax at source @10% from the amount credited or paid by way of fees for professional services, where such amount or aggregate of such amounts credited or paid to a person exceeds Rs.20,000 in a financial year. As per Explanation (a) to section 194J, professional services includes, inter alia, services rendered by a person in the course of carrying on such other profession as is notified by the CBDT for the purpose of section 194J. Accordingly, the CBDT has, vide Notification

PAPER – 7 : DIRECT TAXES

No.88 dated 21.8.2008, in exercise of the powers conferred by clause (a) of the Explanation to section 194J notified the services rendered by, inter alia, coaches and trainers in relation to the sports activities as professional services for the purpose of section 194J. Therefore, the club is liable to deduct tax at source under section 194J from the remuneration payable to the Coach, Raghu.

Question 4

- (a) A shareholder of a demerged Indian company received shares from the resulting company in the scheme of demerger. The shareholder wants to transfer the said shares received subsequent to the demerger for consideration. Your advice is sought on the tax consequences as to the shares received on demerger and sought to be transferred. (4 Marks)
- (b) The assessment was made under section 143(1) for assessment year 2005-06. The assessee has received a notice under section 148 on 6th April, 2008 for reopening of assessment. Can the assessee challenge the legality of the notice on the ground of change of opinion? (3 Marks)
- (c) Is it possible for the Assessing Officer to initiate proceeding under section 147 in respect of income involving matters which are the subject matter of an appeal? (2 Marks)
- (d) The Assessing Officer has no power to make any adjustment to the income returned by the assessee while processing the return of income under section 143(1). Examine the correctness of the statement. (5 Marks)

Answer

- (a) As per the provisions of section 47(vid), any transfer or issue of shares by the resulting company to the shareholders of the demerged company in a scheme of demerger is not regarded as a transfer for the purposes of capital gains under section 45, if the transfer or issue is made in consideration of the demerger of the undertaking.

As a consequence of the demerger, the existing shareholders of the demerged company will receive shares in a resulting company. When the shareholder subsequently intends to transfer the said shares, the cost of such shares will have to be arrived at as per the provisions of section 49(2C). According to the said provision, the cost of acquisition of shares in the resulting company will be the amount which bears to the cost of acquisition of shares held by the assessee in the demerged company, the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger.

As per the provisions of section 2(42A)(g), for determining the period of holding of such shares, the period for which the shares of the demerged company were held by the assessee would also be considered.

If the shares are held for more than one year, and transferred through a recognized stock exchange and securities transaction tax has been paid on such sale, the long-term capital gain arising therefrom would be exempt under section 10(38). If the total holding period does not exceed one year, then the short-term capital gains arising on sale of such shares would be taxable @15% under section 111A.

FINAL EXAMINATION : JUNE, 2009

- (b) Under the scheme of section 143(1), only the adjustments relating to any arithmetical error in the return and incorrect claim which is apparent from any information in the return are permitted. In short, what is permissible is only correction of errors apparent on the basis of the return filed. Thus, while making the adjustments under section 143(1), the Assessing Officer has no power to go beyond the information given in the return and make any allowance or disallowance. Therefore, the intimation given under section 143(1) cannot be treated as an order of assessment. Hence, there being no assessment under section 143(1), the question of change of opinion does not arise.

Therefore, the assessee cannot challenge the legality of the notice issued under section 148 reopening the assessment on the grounds of change of opinion in a case where no assessment is made under section 143(3), but only an intimation is issued under section 143(1). This inference is supported by the Supreme Court ruling in ACIT vs. Rajesh Jhaveri Stock Brokers P. Ltd. (2007) 291 ITR 500.

- (c) The Finance Act, 2008 has inserted a second proviso in section 147 with effect from 1st April, 2008 to provide that the Assessing Officer may assess or reassess an income which is chargeable to tax and has escaped assessment, other than the income involving matters which are the subject matter of any appeal, reference or revision. Therefore, in respect of income involving the matters which are the subject matter of an appeal, it is not possible for the Assessing Officer to initiate proceeding under section 147.
- (d) The Finance Act, 2008 has substituted section 143(1) to provide for computation of total income of an assessee after making the following adjustments to the returned income:
- (i) any arithmetical error in the return; or
 - (ii) an incorrect claim, if such incorrect claim is apparent from any information in the return.

Thus, section 143(1) now seeks to allow the Assessing Officer to make adjustments for correcting arithmetical mistakes and incorrect claims apparent from the return filed.

For the purpose of section 143(1), "an incorrect claim apparent from any information in the return" shall mean such claim on the basis of an entry, in the return of income,-

- (i) of an item, which is inconsistent with another entry of the same or some other item in such return;
- (ii) in respect of which, information required to be furnished to substantiate such entry, has not been furnished;
- (iii) in respect of a deduction, where such deduction exceeds specified statutory limit which may have been expressed as monetary amount or percentage or ratio or fraction.

Therefore, the statement is not correct.

Question 5

- (a) Tai Ltd. filed its return of income for assessment year 2008-09 on 6th June, 2008. The return is selected for regular assessment under section 143(3) for which notice under

PAPER – 7 : DIRECT TAXES

- section 143(2) is served on the company on 3rd October, 2009. The company responded to the notice under section 143(2). State whether the service of the notice is within time and if not, whether the assessment order can be challenged by the assessee. (4 Marks)
- (b) Ms. J, a Sikkimese woman, married Mr. K, a non-Sikkimese, on 1st January, 2008. During the previous year 2008-09, she received rent of Rs.12 lacs from letting out of house properties situated in the State of Sikkim. Is she liable to income-tax for assessment year 2009-10? Will your answer be different, if she married Mr. K on 16th April, 2008? (3 Marks)
- (c) Betki Limited is a company in which 70% shares are held by Ruhu Limited. Betki Limited, in its annual general meeting held on 18th May, 2008, declared a dividend amounting to Rs.40 lacs to its shareholders for the year ended 31st March, 2008 and it paid dividend distribution tax on 28th May, 2008. Ruhu Limited did not declare any dividend for the year ended 31st March, 2008. It, however, declared an interim dividend amounting to Rs.60 lacs on 1st December, 2008 for the year ended 31st March, 2009. What is the amount of tax on dividend payable by Ruhu Limited? What would be your answer, if 60% of shares in Ruhu Limited are held by Hilsha Limited, a domestic company? Does the position further change, if Hilsha Limited is a foreign company? (6 Marks)

Answer

- (a) The time limit for service of notice under section 143(2) is six months from the end of the financial year in which the return of income was furnished by the assessee. The return of income for assessment year 2008-09 was filed by the assessee on 6th June, 2008. Therefore, the notice under section 143(2) has to be served by 30th September, 2009. However, the notice was served on the assessee only on 3rd October, 2009. Hence the notice issued under section 143(2) is time-barred.

As per section 292BB, inserted by the Finance Act, 2008, where an assessee had appeared in any proceedings or co-operated in any enquiry relating to an assessment or reassessment, it shall be deemed that any notice required to be served upon him, has been duly served upon him in time in accordance with the provisions of the Act and such assessee shall be precluded from raising any objection in any proceeding or enquiry that the notice was (a) not served upon him or (b) not served upon him in time or (c) served upon him in an improper manner. However, the above provision shall not be applicable where the assessee has raised such objection before the completion of such assessment or reassessment. Therefore, in the instant case if the assessee, Tai Limited, had raised an objection to the proceeding, on the ground of non-service of the notice under section 143(2) upon him on time, then the validity of the assessment order can be challenged. In absence of such objection, the assessment order cannot be challenged.

- (b) Section 10(26AAA), inserted by the Finance Act, 2008, provides that the following income, which accrues or arises to a Sikkimese individual, shall be exempt from income-tax:
- (1) Income from any source in the State of Sikkim; and
 - (2) Income by way of dividend or interest on securities.

FINAL EXAMINATION : JUNE, 2009

However, the aforesaid exemption will not be available to a Sikkimese woman who marries a non-Sikkimese individual on or after 1st April, 2008.

Since Ms. J, the assessee, married Mr.K on 1st January, 2008, income derived by her by way of rent from properties situated in the State of Sikkim shall be exempt under section 10(26AAA).

However, if she had married Mr. K on 16th April, 2008, the exemption would not be available.

- (c) As per section 115-O, dividend distribution tax at the rate of 15% (plus surcharge @ 10%, education cess @ 2% and secondary and higher education cess @ 1%) is levied on dividend, declared, distributed or paid by a domestic company. As per sub-section (1A), inserted to section 115-O by the Finance Act, 2008, a holding company receiving dividend from its subsidiary company can reduce the same from dividends declared, distributed or paid by it. For this purpose, the matching principle does not apply. This means that even if the dividend received and dividend distributed relate to different periods, the same can be adjusted for the purpose of computing dividend distribution tax of the holding company. However, the dividend shall not be considered for reduction more than once.

The conditions to be fulfilled for this purpose are as follows:

- (1) The subsidiary company should have actually paid the dividend distribution tax;
- (2) The holding company should be a domestic company;
- (3) The holding company should not be a subsidiary company of any other company.

For this purpose, a holding company is a company which holds more than 50% of the nominal value of equity shares of another company.

On the basis of the aforesaid provision, dividend distribution tax payable by Ruhu Limited shall be 16.995% of [(Rs.60,00,000 - (Rs.40,00,000 x 70%)] i.e. Rs.5,43,840.

If 60% of shares of Ruhu Limited are held by Hilsha Limited, then Ruhu Limited is a subsidiary company of Hilsha Limited. In that case, the condition (See condition no.3 above) laid down in section 115-O(1A) is not satisfied and Ruhu Limited cannot reduce the amount of dividend received from Betki Limited for computation of dividend distribution tax. Hence, dividend distribution tax payable by Ruhu Limited shall be 16.995% of Rs.60,00,000 i.e. Rs.10,19,700.

The above situation remains same even if Hilsha Limited is a foreign company.

Question 6

- (a) Antaryami settled 1/4th share of his property under a trust for the education and maintenance of his minor daughter, Poulomi. Under the terms of the trust deed, the income accruing to the trust, after meeting the expenses of maintenance and education of Poulomi, was to be accumulated and paid over to her on her attaining majority. The Assessing Officer assessed the income arising from 1/4th share of the property, settled

PAPER – 7 : DIRECT TAXES

for the benefit of Poulomi, in the hands of Antaryami. Examine the correctness of the assessment. (4 Marks)

- (b) Happy Home is a public charitable trust created under a trust deed for providing relief to physically challenged persons and registered under section 12A of the Income-tax Act. The following are the particulars of receipts of the trust during the year ended 31st March, 2009 :

	Rs. in lacs
(i) Income from properties held by trust (net)	15
(ii) Income (net) from business (incidental to main objects)	14
(iii) Voluntary contributions from public (including the corpus donation of Rs.7 lacs)	18

The trust applied Rs.18 lacs towards various activities and programmes undertaken for the benefit of physically challenged persons during the year. The trust has also paid Rs.8 lacs towards repayment of a loan taken two years back for the purpose of construction of its centre for training the handicapped persons in various handicraft works and sports.

Determine the tax liability, if any, of the trust for the assessment year 2009-10 and also state how the trust can mitigate such liability. (6 Marks)

Answer

- (a) As per section 64(1A), the income of a minor child should be included in the total income of that parent, whose total income before such inclusion is higher.

The Supreme Court, in CIT v. M.R. Doshi (1995) 211 ITR 1, held that where the income from the trust was to be accumulated until the child attained majority, the clubbing provisions would not get attracted, since no benefit accrues to the minor child during the period when such child is a minor.

However, in this case, the minor daughter Paulomi is eligible for the benefits during the period when she is a minor, since income from the trust is being used for meeting her education and maintenance expenses. Only the remaining income is to be accumulated and paid over to her on her attaining majority. Therefore, since benefit under the terms of the trust deed is accruing, even though to a limited extent, to the minor daughter Paulomi during the period when she is a minor, the ratio applicable in the Supreme Court decision cited above cannot be applied in this case. Accordingly, the clubbing provisions under section 64(1A) will get attracted.

Therefore, the stand taken by the Assessing Officer to tax the income in the hands of Antaryami is correct. However, only so much of income as is used for meeting the education and maintenance expenses of Paulomi during the current year should be clubbed in the hands of Antaryami after providing for an exemption of Rs.1,500 under section 10(32).

FINAL EXAMINATION : JUNE, 2009

(b) Computation of taxable income of Happy Home for the A.Y. 2009-10

Particulars	Rs.	Rs.
Income from properties held by trust	15,00,000	
Income from business incidental to the main objects of the trust	14,00,000	
Voluntary Contribution other than corpus donation (Note 1)	11,00,000	40,00,000
Less: 15% of income accumulated or set apart under section 11(1)(a)		6,00,000
		<u>34,00,000</u>
Less: Amount applied for charitable purposes		
Activities and programmes for the benefit of physically challenged persons	18,00,000	
Repayment of loan taken for construction of training centre (Note 2)	8,00,000	26,00,000
Taxable Income		<u>8,00,000</u>

Tax Payable:

Upto Rs.1,50,000	Nil	
Rs.1,50,000 - Rs.3,00,000	15,000	
Rs.3,00,000 - Rs.5,00,000	40,000	
Balance Rs.3,00,000	90,000	1,45,000
Add: Education cess @ 2%		2,900
Add: Secondary and higher education cess @ 1%		1,450
		<u>1,49,350</u>

In order to mitigate the tax liability, the trust, by notice in writing to the Assessing Officer can opt to accumulate or set apart the income for the purpose of investment in the next 5 succeeding years. The Trust must apply in Form No.10 indicating the purpose of accumulation. The notice of accumulation must be given before the expiry of the time allowed under section 139(1). The amount set apart must be kept in investments/deposits specified in section 11(5). If the above trust has opted for such accumulation, then the tax burden would be reduced to the extent of such accumulation.

Notes:

- (1) Section 11(1)(d) excludes from the total income of the person, any income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution.

PAPER – 7 : DIRECT TAXES

- (2) In CIT vs. Janmabhumi Press Trust (2000) 242 ITR 457, the Karnataka High Court held that where a debt is incurred for the purpose of the trust, the repayment of the debt would amount to an application of the income for the purpose of the trust. Therefore, repayment of loan taken for construction of training centre for physically challenged persons can also be considered as application for charitable purpose.

Question 7

- (a) EF Limited, an Indian company, is engaged in manufacturing electronic components. 74% of shares of the company are held by EF Inc., incorporated in USA. EF Limited has borrowed funds from EF Inc. at LIBOR plus 150 points. The LIBOR prevalent at the time of borrowing is 4% for US \$. The borrowings allowed under the External Commercial Borrowings guidelines issued under Foreign Exchange Management Act are LIBOR plus 200 basis points. Discuss whether the borrowing made by EF Limited is at arm's length ('LIBOR' means London Inter-Bank Offer Rate). (5 Marks)
- (b) Sridhar purchased a residential flat from Devraj in 2005. However, the deed of conveyance has not been registered in the name of Sridhar till date. Sridhar has let out the flat at a monthly rent of Rs.15,000 to Mohan. Sridhar claims that rent received is not chargeable under the head "Income from house property", but the same is chargeable under the head "Income from other sources" and he can claim deduction for expenses on repair and insurance premium on actual basis and also depreciation. Examine the correctness of Sridhar's claim. (3 Marks)
- (c) IT Limited, under its Employment Stock Option Plan, allotted 500 equity shares to its finance manager, Ms. Cynthia on 15th May, 2008, when she exercised her option. The option was granted on 15th January, 2007 and the shares vested with Cynthia on 15th January, 2008. The company's shares are quoted in Bombay Stock Exchange, where the opening price and closing price on the date of vesting were Rs.250 and 256, respectively. The company recovered Rs.50 per share from Cynthia. Compute the value of fringe benefit for the assessment year 2009-10. If fringe benefit tax thereon is recovered by the company from Cynthia, can she claim such tax as a part of cost when she sells the shares? (4 Marks)

Answer

- (a) One of the methods for determination of arm's length price in an international transaction is Comparable Uncontrolled Price method (CUP). Under the CUP method, the price charged or paid for property transferred or services rendered in a comparable uncontrolled transaction, or a number of such transactions, is identified. Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions, which could materially affect the price in the open market. The adjusted price so arrived at is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction.
- EF Inc., USA and EF Limited, the Indian company shall be deemed to be associated enterprises since the former holds more than 26% voting power in the latter.

FINAL EXAMINATION : JUNE, 2009

The arm's length rate of interest can be determined by using CUP method having regard to the rate of interest on external commercial borrowing permissible as per guidelines issued under Foreign Exchange Management Act. The interest rate permissible is LIBOR plus 200 basis points i.e., $4\% + 2\% = 6\%$, which can be taken as the arm's length rate. The interest rate applicable on the borrowing by EF Limited, India from EF Inc., USA, is LIBOR plus 150 basis points i.e., $4\% + 1.5\% = 5.5\%$. Since the rate of interest, i.e. 5.5% is less than the arm's length rate of 6%, the borrowing made by the EF Ltd. is not at arm's length. However, in this case, the taxable income of EF Ltd., India, would be lower if the arm's length rate is applied. Hence, no adjustment is required since the law of transfer pricing will not apply if there is a negative impact on the existing profits.

- (b) In order to assess income under the head "Income from house property" the assessee must be the owner of the house property. The need for registration of document in favour of a person to enable him to be treated as the owner of the house property for the purpose of section 22, was considered by the Supreme Court in the case of CIT vs. Poddar Cement Pvt. Ltd. (1997) 226 ITR 625. It was held that so long as a person is entitled to receive income from the house property in his own right and not on behalf of some one else, it is not necessary that the sale deed must be registered in favour of the person to treat him as the owner of the property for the purpose of section 22. In such a case, the income derived from the property is chargeable to tax under the head "Income from house property". The fact that registration is not yet complete does not affect the chargeability of such income under the head "Income from house property". Therefore, the claim of Sridhar that rent should be assessed under the head "Income from other sources" and deduction of various expenses and depreciation should be allowed therefrom is not tenable.

- (c) As per section 115WC(1)(ba), the value of fringe benefit in the case of issue of shares allotted under the Employees' Stock Option Plan is the fair market value of shares on the date on which the option vests with the employee as reduced by the amount actually paid by, or recovered from, the employee in respect of such shares.

As per Rule 40C, in case of shares listed in one recognized stock exchange, fair market value means the average of opening price and closing price of the share on the said stock exchange as on the date of vesting.

Therefore, in this case, the fair market value would be $\frac{250 + 256}{2} = \text{Rs.}253$

Thus, the value of fringe benefit would be $= (253 \times 500) - (50 \times 500) = \text{Rs.}1,01,500$.

Under section 49(2AB), for the purpose of computing capital gain from the transfer of shares received under ESOP, cost of acquisition of such shares shall be the fair market value which has been taken into account while computing the value of fringe benefits under section 115WC(1)(ba). This being a deeming provision, only such fair market value (in this case, Rs.253) shall be considered as cost.

Therefore, even if fringe benefit tax on such shares is recovered by the company from Cynthia, she cannot claim such FBT as part of cost of acquisition of shares, when she sells the shares. This has also been clarified by CBDT Circular no.9/2007 dated 20th December 2007 (Q. No.24).

PAPER – 7 : DIRECT TAXES

Question 8

- (a) Mr. Manocha has a house property in Delhi, which was lying vacant for last 3 years. He constructed the property in 1990 at a cost of Rs.40 lacs. He has let out the same at a monthly rent of Rs.30,000 for a period of three years with effect from 1st January, 2009. The quarterly corporation tax is Rs.30,000. He took a premium of Rs.1,20,000 from the tenant and also security deposit of Rs.1,00,000. The house was constructed on a land measuring 4,000 sq.ft. It has three floors each measuring 960 sq.ft. Compute the value of the house property for wealth tax purpose as at valuation date 31.3.2009. (7 Marks)
- (b) An association of persons (AOP), comprising of two members Akash and Vikash, owns an urban land valued at Rs.60 lakh on the valuation date 31.3.2009. Examine the tax implications under the Wealth Tax Act. (3 Marks)

Answer

- (a) Computation of value of the house property for wealth tax purpose

Particulars	Rs.	Rs.
Computation of Actual Rent & Annual Rent		
Actual Rent (Rs.30,000 x 3)		90,000
Add: Adjustment for premium received from tenant (Rs.1,20,000/3) x 3/12		10,000
15% p.a. of Security Deposit i.e. 15% x Rs.1,00,000 x 3/12		3,750
Actual Rent for 3 months		1,03,750
Annual Rent (Rs.1,03,750 x 12/3)		4,15,000
Computation of Net Maintainable Rent (NMR)		
Gross Maintainable Rent, being the annual rent		4,15,000
Less: Corporation Tax (Rs.30,000 x 4)	1,20,000	
15% of Gross Maintainable Rent	62,250	1,82,250
Net Maintainable Rent (NMR)		2,32,750
Capitalised value of NMR		
Capitalised value (Rs.2,32,750 x 12.5)	29,09,375	
Cost of acquisition	40,00,000	
Capitalised value is the higher of the above		40,00,000
Add: Premium		
(i) Aggregate Area	4000 Sq.Ft.	
(ii) Specified Area (60%)	2400 Sq.Ft.	

FINAL EXAMINATION : JUNE, 2009

(iii) Built up area	960 Sq.Ft.	
(iv) Unbuilt Area	3040 Sq.Ft.	
(v) Excess of unbuilt area over specified area	640 Sq.Ft.	
% of excess area on aggregate area		
$(640/4000) \times 100$	16%	
(vi) Premium to be added when (v) is 16%		16,00,000
(40% of capitalized value i.e., 40% of Rs.40 lakh)		

Value of house property for wealth-tax purpose	56,00,000
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- (b) The tax implications of an asset owned by an association of persons under the Wealth-tax Act are as follows:
- (i) As per section 3, only individuals, Hindu Undivided Families and Companies are liable to wealth tax. Therefore, an association of persons (AOP) is not chargeable to wealth-tax.
 - (ii) However, as per section 4(1)(b), the value of interest of a member of an AOP in the assets of the AOP is to be included in his net wealth. Schedule III lays down the manner of determination of the value of such interest.
 - (iii) Section 21AA deals with a situation where the shares of the members of an AOP are indeterminate or unknown. Where assets chargeable to wealth-tax are held by an AOP and the individual shares of the members are indeterminate or unknown on the date of formation or at any time thereafter, wealth tax is to be levied in the like manner and to the same extent as applicable to an individual.