

PAPER – 7 : DIRECT TAX LAWS

Answer all questions.

Question 1

(a) The net profit of ABC Ltd. for the year ending 31.03.2009 amounted to Rs.7,22,000 after debiting/crediting following items:

- (i) Payment of interest on money borrowed from bank for purchase of land and building Rs.2,22,000.
- (ii) Commission Rs.1,00,000 paid in the month of February, 2009 and Rs.1,25,000 paid in March, 2009. Tax deducted at source from the payments was deposited to the Government on 20.09.2009.
- (iii) Travelling expenses of Rs.90,000 on a foreign tour of a director for negotiating collaboration with a foreign manufacturer for initiation of new line of business.
- (iv) Securities transaction tax paid Rs.10,000. Income from trading in shares already credited to profit and loss account Rs.3,82,000.
- (v) As part of the restructuring of its debt, the company has converted arrears of interest of Rs.3,00,000 on term loan into a new term loan with a revised repayment schedule.

The company has paid Rs.50,000 towards such funded interest during the year. Entire Rs.3,00,000 has been debited to profit and loss account. However, out of this, a further sum of Rs.50,000 was paid before the due date of filing of return.

- (vi) Rs.5,00,000, being contribution to S Ltd. (wholly owned subsidiary company) for construction of a school for the benefit of its employees.
- (vii) Provision for gratuity based on actuarial valuation Rs.6,00,000. Actual gratuity paid Rs.1,50,000 was debited to provision for gratuity account.

Other information:

- (1) Provision for bonus for the year 2007-08 paid on 15.11.2008 Rs.98,000. It is inclusive of payment by bearer cheque of Rs.34,000.
- (2) The company has purchased a commercial vehicle of Rs.8,00,000 for the purpose of business on 21.03.2009 and calculated depreciation@15% for the full year. Depreciation debited to the profit and loss account is calculated on all other assets as per the rates prescribed in the Income-tax Act.

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

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- (3) The company collected Rs.3,00,000 from its customers towards sales tax in the year 1996-97 and remitted it to the State Government in due time. On the levy being challenged in the High Court, the Court held the levy as illegal and the State Government refunded the amount to the company in February, 2009. The company refunded Rs.2,00,000 to the customers and the remaining amount of Rs.1,00,000 was shown under the head "current liabilities".

Compute the income chargeable to tax in assessment year 2009-10 and work out the amount of tax payable on such income, ignoring the provisions of section 115JB.

(15 Marks)

- (b) Kalpesh Kumar is a musician deriving income of Rs.75,000 from concerts performed outside India. Tax of Rs.10,000 was deducted at source in the country where the concerts were performed. India does not have any double tax avoidance agreement with that country. His income in India amounted to Rs.2,25,000. Compute tax liability of Kalpesh Kumar for the assessment year 2009-10 assuming he has deposited Rs.10,000 in Public Provident Fund and paid medical insurance premium in respect of his father Rs.20,000. (5 Marks)

Answer

- (a) Computation of total income and tax liability of ABC Ltd. for A.Y.2009-10

| Particulars                                                                                                        | Rs.                      | Rs.              |
|--------------------------------------------------------------------------------------------------------------------|--------------------------|------------------|
| Profits & Gains of Business of Profession                                                                          |                          |                  |
| Net Profit as per Profit & Loss Account                                                                            |                          | 7,22,000         |
| Add: Items debited but to be considered separately or to be disallowed                                             |                          |                  |
| Commission paid in February, 2009, but TDS from such payment deposited after the end of the previous year (Note 2) | 1,00,000                 |                  |
| Travelling expenses on foreign tour in connection with new line of business (Note 3)                               | 90,000                   |                  |
| Interest on term loan converted into new term loan (Note 5)                                                        | 2,00,000                 |                  |
| Provision for gratuity                                                                                             | 6,00,000                 |                  |
| Less: Gratuity paid                                                                                                | <u>1,50,000</u> (Note 7) | 4,50,000         |
| Depreciation on commercial vehicle (Note 9)                                                                        | 1,20,000                 |                  |
| Sales tax refund not returned to the customers (Note 10)                                                           | <u>1,00,000</u>          | <u>10,60,000</u> |
|                                                                                                                    |                          | 17,82,000        |
| Less: Items credited but to be considered separately and those not charged but to be allowed                       |                          |                  |
| Bonus paid on 15.11.2008 in respect of previous year 2007-08 disallowed last year but allowable now (Note 8)       | 64,000                   |                  |
| Depreciation on commercial vehicle (Note 9)                                                                        | <u>2,00,000</u>          | <u>2,64,000</u>  |
| Business Income                                                                                                    |                          | 15,18,000        |

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|                                        |                  |
|----------------------------------------|------------------|
| Deduction under Chapter VI-A           | NIL              |
| Total Income                           | <u>15,18,000</u> |
| Tax payable @ 30%                      | 4,55,400         |
| Education cess @ 2%                    | 9,108            |
| Secondary and higher education cess@1% | <u>4,554</u>     |
| Total tax payable                      | <u>4,69,062</u>  |

Notes:

- (1) As per section 36(1)(iii), interest on borrowed capital is allowed as deduction, if the borrowed capital is used for the purpose of business of the assessee. The section does not distinguish between borrowed capital used for financing capital expenditure and borrowed capital used for the financing revenue expenditure. Assuming that land and building was acquired for business purpose, interest on money borrowed is allowable under section 36(1)(iii). It is presumed that the interest liability pertains to a period after the asset is put to use.
- (2) As per section 40(a)(ia), in case tax is deducted in the last month (March, 2009) but deposited on or before the due date for filing return of income under section 139(1) (i.e. 30<sup>th</sup> September, 2009), the related expenses shall be allowed in the year to which the expenses relate. However, if TDS relates to any other month of the previous year (i.e., April 2008 to February, 2009), the expenditure shall be allowed, only if tax is deducted and deposited before the end of the previous year. In the instant case, commission paid in March, 2009 is to be allowed, as the TDS was deposited before due date for filing income-tax return. TDS from commission paid in February, 2009 should be deposited on or before 31<sup>st</sup> March, 2009, for claiming deduction of the expenditure in the A.Y.2009-10. Since such TDS was deposited only on 20.9.2009, commission paid in February, 2009 shall be allowed only in the assessment year 2010-11.
- (3) Travelling expenses incurred on foreign tour of a director for initiating a new line of business is a capital expenditure. The same is, therefore, not deductible under section 37(1).
- (4) Securities transaction tax is allowable as deduction under section 36(1)(xv) if the income arising from taxable securities transaction is included in computing the income under the head "Profits and gains of business or profession". As income from trading in shares is included in computation of business income, securities transaction tax of Rs.10,000 is allowable as deduction.
- (5) As per section 43B, any sum payable by the assessee as interest on any loan or borrowing from, inter alia, any public financial institution or scheduled bank shall be allowed only in computing the income of that previous year in which sum is actually paid. In respect of the previous year in which the liability to pay such sum was

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incurred, deduction will also be allowed in relation to the sum or part thereof which is paid on or before the due date of filing of return for that year. As per Explanations 3C and 3D to section 43B, a deduction of any sum, being interest payable on any loan or borrowing from a public financial institution or scheduled bank shall be allowed, if such interest has been actually paid and such interest which has been converted into a loan or borrowing shall not be deemed to have been actually paid.

The manner in which the converted interest will be allowed as deduction has been clarified vide Circular No.7/2006 dated 17.7.2006. The unpaid interest, whenever actually paid to the financial institution or scheduled bank, will be in the nature of revenue expenditure deserving deduction in the computation of income. Therefore, irrespective of the nomenclature, the deduction will be allowed in the previous year in which the converted interest is actually paid.

Accordingly, out of Rs.3 lakh, only Rs.1 lakh (Rs. 50,000 + Rs. 50,000), being the funded interest actually paid, is allowable as deduction while computing business income of P.Y.2008-09. It is presumed that the installment of Rs. 50,000 paid before the due date of filling the return relates to P.Y.2008-09. Since the entire amount of Rs.3 lakh, representing arrears of interest converted into term loan, has been debited to the profit and loss account, the balance Rs.2 lakh (i.e., Rs.3 lakh – Rs.1 lakh) has to be added back.

- (6) Contribution to a wholly owned subsidiary company for construction of a school for the benefit of its employees is allowable under section 37(1).
- (7) Under section 40A(7), no deduction is allowed in respect of any provision made for the payment of gratuity to the employees on retirement or termination of employment for any reason. However, gratuity actually paid is admissible as deduction. Therefore, provision for gratuity of Rs.6,00,000 is to be disallowed. Actual gratuity paid Rs.1,50,000 debited to provision for gratuity account is allowable. Hence, only the net sum of Rs.4,50,000 has to be added back.
- (8) As per section 40A(3), expenditure in respect of which payment is made in a day in a sum exceeding Rs.20,000 otherwise than by account payee cheque or account payee bank draft is disallowed. In this case, provision for bonus for the previous year 2007-08 would have been disallowed under section 43B for non-payment by due date for filing of return of income for assessment year 2008-09. Payment of bonus made after the said date is allowed in the year of actual payment. However, such deduction allowable in the year of payment is subject to the provisions of section 40A(3). Hence, the sum of Rs.34,000 being bonus paid by bearer cheque shall not be allowed as deduction in the year of payment. Assuming that the balance amount of Rs.64,000 (i.e., Rs.98,000 – Rs.34,000) is paid by account payee cheque or account payee bank draft, it is admissible as deduction in the A.Y.2009-10.
- (9) Depreciation on commercial vehicle has been calculated @15% and, consequently, Rs.1,20,000 has been debited to profit and loss account. The same has to be added back for separate consideration.

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Depreciation will be allowed @ 50% on the purchase of new commercial vehicle after 1<sup>st</sup> January, 2009 but before 1<sup>st</sup> October, 2009 and put to use for the business before 1<sup>st</sup> October, 2009. Hence, the depreciation on purchase of commercial vehicle has to be calculated @ 25% (50% of the rate prescribed), as the asset was acquired and put to use for less than 180 days during the previous year 2008-09. Therefore, the eligible depreciation on commercial vehicle is Rs.2,00,000 (i.e., 25% of Rs.8 lakh) for A.Y.2009-10. It is presumed that the commercial vehicle was put to use during the previous year 2008-09.

- (10) Sales tax collected by the assessee is to be treated as a trading receipt of the assessee as held by the Supreme Court in the case of Chowringhee Sales Bureau Private Limited v. CIT (1973) 87 ITR 542 (SC). Sales tax paid by the assessee is to be deducted from its profits. If any deduction is so allowed and subsequently the sales tax is refunded by the Government, the refund so made has the character of a revenue receipt. Therefore, the amount is taxable as deemed income under section 41(1). However, the assessee is entitled to claim deduction of the amount of refund of sales tax as and when the same is refunded by the assessee to the purchaser. This view finds support from CIT v. Thirumalaiswamy Naidu and Sons v. CIT 230 ITR 534 (SC). In view of this, the amount not yet refunded to the customers is not deductible. Accordingly, the sum of Rs.1,00,000, being sales tax not refunded to the customers, has to be added back.
- (b) An assessee shall be allowed deduction under section 91 provided all the following conditions are fulfilled :-
- (a) The assessee is a resident in India during the relevant previous year.
  - (b) The income accrues or arises to him outside India during that previous year.
  - (c) Such income is not deemed to accrue or arise in India during the previous year.
  - (d) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee and the assessee has paid tax on such income in the foreign country.
  - (e) There is no agreement under section 90 for the relief or avoidance of double taxation between India and the other country where the income has accrued or arisen.

In view of the aforesaid provisions, deduction under section 91 will be calculated as follows:

| Particulars                              | Rs.    | Rs.           |
|------------------------------------------|--------|---------------|
| Indian Income                            |        | 2,25,000      |
| Foreign Income                           |        | <u>75,000</u> |
| Gross Total Income                       |        | 3,00,000      |
| Less: <u>Deduction under section 80C</u> |        |               |
| PPF Contribution                         | 10,000 |               |

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|                                                                                                         |               |                 |
|---------------------------------------------------------------------------------------------------------|---------------|-----------------|
| <u>Deduction under section 80D</u>                                                                      |               |                 |
| Medical insurance premium of father (See Note 2 below)                                                  | <u>20,000</u> | <u>30,000</u>   |
| Total Income                                                                                            |               | <u>2,70,000</u> |
| Tax on total income                                                                                     |               | 12,000          |
| Add: Surcharge                                                                                          |               | Nil             |
| Add: Education Cess @ 2%                                                                                |               | 240             |
| Secondary and higher education cess @ 1%                                                                |               | <u>120</u>      |
|                                                                                                         |               | <u>12,360</u>   |
| Average rate of tax in India [i.e. Rs.12,360/2,70,000 x 100]                                            |               | 4.58%           |
| Average rate of tax in foreign country<br>[i.e. Rs.10,000/ Rs.75,000 x 100]                             |               | 13.33%          |
| Doubly taxed income                                                                                     |               | 75,000          |
| Rebate under section 91 on Rs.75,000 @ 4.58%<br>(lower of average Indian tax rate and foreign tax rate] |               | 3,435           |
| Tax payable in India [Rs.12,360 – Rs.3,435]                                                             |               | 8,925           |

Notes:

- (1) It has been assumed that Mr. Kalpesh Kumar is a resident.
- (2) It has been assumed that Mr. Kalpesh Kumar's father is a senior citizen, and hence, deduction of Rs.20,000 in respect of medical insurance premium paid for father has been allowed in full under section 80D.

**Question 2**

- (a) Yaman Limited is a company in which 60% shares are held by Piloo Limited. Yaman Limited declared a dividend amounting to Rs.35 lacs to its shareholders for the financial year 2007-08 in its Annual General Meeting held on 10th May, 2008. Dividend distribution tax was paid by Yaman Limited on 15<sup>th</sup> May, 2008. Piloo Limited declared an interim dividend amounting to Rs.50 lacs on 15<sup>th</sup> October, 2008 for the year ended 31st March, 2009.

Compute the amount of tax on dividend payable by Piloo Limited.

What would be your answer, if 58% shares of Piloo Limited are held by Kafi Limited, an Indian company?

Does the position change further, if Kafi Limited is a foreign company? (6 Marks)

- (b) Does the Assessing Officer have power to make any adjustment to income disclosed by the assessee in the return of income in course of processing the return under section 143(1)? (5 Marks)

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- (c) Mahanadi Limited has taken a 3,000 sq. ft. flat on rent from Yamuna Limited to set up its Branch Office. The rent payable to Yamuna Limited for the flat is Rs.60,000 per month plus applicable service tax. Mahanadi Limited wishes to know whether tax is required to be deducted at source under section 194-I from gross amount of rent including service tax. Give your advice. (3 Marks)

Answer

- (a) As per section 115-O, dividend distribution tax at the rate of 16.995% (i.e., 15% plus surcharge@10%, education cess@2% and secondary and higher education cess@1%) is leviable on dividend declared, distributed or paid by a domestic company. As per sub-section (1A), inserted in section 115-O by the Finance Act, 2008, a holding company receiving dividend from its subsidiary company can reduce the same from dividend 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 Piloo Limited shall be 16.995% of Rs.29 lacs [Rs.50 lacs – (Rs.35 lacs x 60%)] i.e. Rs.4.93 lacs.

If 58% of shares of Piloo Ltd. are held by Kafi Ltd., then Piloo Ltd is a subsidiary company of Kafi Ltd. In that case, the condition (See condition no.3 above) laid down in section 115-O(1A) is not satisfied and Piloo Ltd. cannot reduce the amount of dividend received from Yaman Ltd. for computation of dividend distribution tax. Therefore, dividend distribution tax payable by Piloo Ltd. shall be 16.995% of Rs.50 lacs i.e. Rs.8.50 lacs.

The above position does not change even if Kafi Ltd. is a foreign company.

- (b) A significant amendment has been made by the Finance Act, 2008 with regard to the procedure to be followed for summary assessment under section 143(1). As per the amended section 143(1), the total income or loss of an assessee shall be computed 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.

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

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

Thus, the Assessing Officer, in course of processing the return of income under section 143(1), has the power to make the above adjustments to the income disclosed by the assessee in the return.

- (c) CBDT Circular No.4/2008 dated 28.04.2008 has clarified that service tax paid by the tenant does not partake the nature of income of the landlord. The landlord only acts as a collecting agency for Government for collection of service tax. Therefore, tax deduction at source under section 194-I would be required to be made on the amount of rent paid/payable without including the service tax.

**Question 3**

- (a) Ishwar is a commission agent receiving commission from his principal. He collected certain amount as deposit towards sales tax and showed the amount so received under the head "Contingency deposit" in the Balance Sheet. He did not deposit the amount to the Government. The Assessing Officer invoked section 43B and added back the said amount to the business income of Ishwar. Examine the correctness of the action of the Assessing Officer. (4 Marks)
- (b) 3 Star & Company, a partnership firm, entered into a contract to purchase an immovable property. The agreement was not honoured by the seller. Therefore, the firm filed a suit for specific performance of contract against the owner of the property. Ultimately, a compromise was arrived at. In terms of the compromise, the owner agreed to pay 3-Star & Company Rs.15 lacs as consideration. State with reasons whether the receipt should be treated to be in the nature of capital gain in the hands of the firm. (4 Marks)
- (c) (i) Can a rectification order under section 254 of the Income-tax Act be passed by the Income-tax Appellate Tribunal beyond four years from the date of the order sought to be revised? (3 Marks)
- (ii) Sumit voluntarily filed a revised return of income within the prescribed time limit after discovering that interest received from bank was not disclosed in the original return. Can he be absolved of penalty under section 271(1)(c)? (3 Marks)

**Answer**

- (a) The facts of the case are similar to that in *Ishwardas Sons v. CIT* (2007) 295 ITR 473 (Ker). The issue is whether sales tax collected and kept as a contingency deposit can be considered as a trading receipt. The assessee collected certain amount as deposit towards sales tax and showed the amount so collected under the head "contingency deposit" account in the balance sheet. He did not deposit the amount to the Government. The Kerala High Court observed that the amount of sales tax collected

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formed part of the trading receipts of the assessee. The mere fact that the assessee created a head of account "Contingency Deposit" would not alter the nature of receipt. The court held that the sales tax collected by the assessee and shown under the head "Contingency Deposit" had to be considered as a trading receipt and included in the total income of the assessee. The disallowance under section 43B would be attracted for non-payment of sales tax collected irrespective of the nomenclature used and the accounting head under which it is categorized.

Therefore, the action of the Assessing Officer in adding back the amount by invoking section 43B in this case, is correct.

- (b) The assessee, 3-Star & Company, entered into a contract to buy an immovable property,. On failure on the part of the seller, the assessee filed a suit for specific performance of the contract. Subsequently, the assessee received Rs.15 lacs from owner in terms of a compromise agreed to by the parties.

In the case of CIT v. Smt. Laxmidevi Ratani (2008) 296 ITR 363 (MP), the High Court, on identical facts, held that the receipt is exigible to capital gains tax as it involved transfer of property within the meaning of section 2(47). The action on the part of the assessee in giving up its right to claim the property and instead accepting money compensation is a clear case of extinguishment of right in the property resulting in transfer as defined in section 2(47).

- (c) (i) The issue as to whether a rectification order can be passed by the Income-tax Appellate Tribunal under section 254 beyond four years from the date of its order sought to be rectified has been addressed in Sree Ayyanar Spinning and Weaving Mills Ltd. v. CIT (2008) 301 ITR 434 (SC). Section 254(2), dealing with the power of the Appellate Tribunal to pass an order of rectification of mistakes, is in two parts. The first part refers to the suo motu exercise of the power of rectification by the Appellate Tribunal, whereas the second part refers to rectification on an application filed by the assessee or Assessing Officer bringing any mistake apparent from the record to the attention of the Appellate Tribunal. Where the application for rectification is made within four years from the date of the order, the Appellate Tribunal is bound to decide the application on merits and not on the ground of limitation.
- (ii) On this issue, the Gujarat High Court, in CIT v. Manibhai & Brothers (2007) 294 ITR 501 (Guj.), observed that for imposition of penalty under section 271(1)(c), there should be a deliberate concealment of particulars or furnishing of inaccurate particulars by the assessee. For this purpose, the conduct of the assessee from the beginning till the end of the assessment proceedings in totality should be considered. If a revised return of income is filed by the assessee after the omission or wrong statement in the original return is discovered by the Assessing Officer in the course of assessment proceedings, then the Assessing Officer can impose penalty under section 271(1)(c). However, if the assessee voluntarily files a revised return of income suo motu before the assessment order is passed, after he himself discovers an omission or wrong statement in the original return, then, penalty cannot be levied under section 271(1)(c).

In view of above legal position, Sumit can be absolved of penalty under section 271(1)(c).

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**Question 4**

- (a) The business profit of T Ltd., a tea growing and manufacturing company, is Rs.120 lakh (before deduction under section 33AB) for the assessment year 2009-10. It deposits Rs.50 lakh with NABARD for claiming deduction under section 33AB. It wants to claim set-off of brought forward business loss of Rs.40 lakh. Find out the taxable income of T Ltd. for the assessment year 2009-10. (5 Marks)
- (b) What do you mean by substantial question of law? (5 Marks)
- (c) Mr. X filed the return of A.Y.2005-06 declaring an income of Rs.3,25,000. He had been assessed under section 143(3) and the Assessing Officer made the following additions:
- (i) Unexplained cash credit for want of confirmation from creditors Rs.2,00,000.
  - (ii) Disallowance in respect of travelling expenditure of Rs.46,000 for tour to Chennai for effecting sales there, as Mr. X failed to establish that the expenditure had been incurred for the purpose of business.

At a later stage, he has been served with a notice under section 148 for income escaping assessment in respect of A.Y. 2005-06. During the course of reassessment proceeding, the Assessing Officer sought to add unaccounted sales of Rs.4,00,000 made at Chennai.

During the course of hearing, the assessee produced confirmation from creditors and requested to delete the addition for unexplained cash credit of Rs.2,00,000 and to allow deduction of travelling expenditure of Rs.46,000. Discuss the validity of the contention raised by the assessee. (4 Marks)

**Answer**

- (a) An assessee, engaged in growing and manufacturing tea in India, is entitled to a deduction under section 33AB, in respect of the amount deposited by the assessee to an account maintained with NABARD as per scheme approved by Tea Board, to the extent of lower of the following two amounts –
- (i) Amount deposited to the account maintained with NABARD within 6 months from the end of the previous year or before the due date for filing the return of income, whichever is earlier;
  - (ii) 40% of profits of such business computed under the head “Profits and Gains of Business or Profession” before making any deduction under this section.

The above deduction will be allowed before setting off brought forward business loss under section 72.

**Computation of taxable income of T Ltd. for the A.Y.2009-10**

| Particulars                                                                                                     | Rs. in<br>lakh | Rs. in<br>lakh |
|-----------------------------------------------------------------------------------------------------------------|----------------|----------------|
| Profit before deduction under section 33AB                                                                      |                | 120.00         |
| Less: Deduction under section 33AB for deposit to the account with NABARD being lower of the following amounts: |                |                |

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|                                                                  |           |              |
|------------------------------------------------------------------|-----------|--------------|
| Amount deposited with NABARD                                     | 50        |              |
| 40% of business profit i.e., 40% of Rs.120 lacs                  | <u>48</u> | <u>48.00</u> |
|                                                                  |           | 72.00        |
| Less: 60% of Rs.72 lakh, being agricultural income as per Rule 8 |           | <u>43.20</u> |
|                                                                  |           | 28.80        |
| Less: Set of brought forward loss under section 72               |           | <u>28.80</u> |
| Taxable business income                                          |           | <u>Nil</u>   |

Total Income Nil

Note - The balance business loss of Rs.11.20 lakh (i.e., Rs.40 lakh – Rs.28.80 lakh) can be carried forward to the next year, assuming that the time limit of 8 years for carry forward of business loss has not expired.

- (b) The expression “substantial question of law” has not been defined anywhere in the Act. However, it has acquired a definite meaning through various judicial pronouncements. The tests are:
- (1) whether directly or indirectly it affects substantial rights of the parties; or
  - (2) the question is of general public importance; or
  - (3) whether it is an open question in the sense that issue is not settled by the pronouncement of the Supreme Court or Privy Council or by the Federal Court; or
  - (4) the issue is not free from difficulty; and
  - (5) it calls for a discussion for alternative view.
- (c) Where reassessment is made under section 147 in respect of income which had escaped tax, the Assessing Officer’s jurisdiction is confined only to such income which has escaped tax and does not extend to reopening or reconsidering the whole assessment or permitting the assessee to reargue questions which had been decided in original assessment proceedings, unless relatable to an item sought to be taxed as “escaped income”[CIT v. Sun Engineering Works (P) Ltd. [1992] 198 ITR 297(SC)].

Therefore, considering the Supreme Court decision in the above case, the assessee cannot seek a review of a concluded item, i.e., unexplained cash credit, which is unconnected with escaped income. However, request for allowing traveling expenditure can be considered because it is relatable to income which is sought to be assessed as escaped income i.e., unaccounted sales effected in Chennai.

**Question 5**

- (a) JK Associates is an Association of Persons (AOP) consisting of two members, J and K. Shares of the members are: 60% (J) and 40%(K). Income of the AOP for the previous year 2008-09 is Rs.6 lakh.

Compute tax liability of the AOP and the members in the following situations:

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- (i) J and K have their income, other than income from AOP, amounting to Rs.1 lakh and Rs.1.70 lakh, respectively.
- (ii) J and K's income, other than income from AOP, amount to Rs.1 lakh and Rs.1.20 lakh, respectively. (6 Marks)
- (b) During the financial year 2008-09, Mr. A received a sum of Rs.1,80,000 (Rs.60,000 p.a.) by way of enhancement for the last three years as the Government department (tenant) enhanced the rate of rent with retrospective effect. Will the sum of Rs.1,80,000 be taxable in the assessment year 2009-10 ? Can it be spread over the last three years? (3 Marks)
- (c) A charitable trust derives its income from the business of providing mineral water to various companies situated in software technology park in Hyderabad. A sum of Rs.10 lakh has been derived as net income from such business activity, which has been applied for the object of general public utility. Examine the taxability of application of the income, if the income so derived relates to the previous year 2008-09. Would your answer be different, if the trust runs a school in a backward district and applies the profits from the business for such school's activity? (5 Marks)

**Answer**

- (a) Computation of tax of AOP is governed by section 167B of the Income-tax Act. Tax on total income of AOP is computed as follows:
  - (i) If individual share of a member is known, and the total income of any member exceeds the basic exemption limit, then the AOP will pay tax at the maximum marginal rate.
  - (ii) If individual share of a member is known and no member has total income exceeding the basic exemption limit, then the AOP will pay tax at the rates applicable to an individual.

Section 86 provides for assessment of share in the hands of members of AOP as follows:

A member's share in the total income of AOP will be treated as follows:-

- (i) If an AOP has paid tax at the maximum marginal rate or a higher rate, the member's share in the total income of AOP will not be included in his total income and will be exempt.
- (ii) If the AOP has paid tax at regular rates applicable to an individual, the member's share in the income of AOP will be included in his total income and he will be allowed rebate at the average rate of tax in respect of such share.

**Tax Liability of J K Associates, AOP**

- (i) As K's income, other than that from the AOP, exceeds the basic exemption limit, the AOP shall pay tax at maximum marginal rate of 33.99% (i.e. 30% plus surcharge@10% plus education cess@2% plus secondary and higher education cess@1%). Thus the tax payable by AOP = Rs.6,00,000 x 33.99% = Rs.2,03,940.

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- (ii) Since none of the members have income, other than income from the AOP, exceeding the basic exemption limit, the AOP would be taxed at the rates applicable to an individual. Therefore, the AOP's tax liability = Rs.85,000 + Rs.2,550 = Rs.87,550.

### Tax Liability of J and K

| Particulars |                                                                      | J<br>Rs.        | K<br>Rs.        |
|-------------|----------------------------------------------------------------------|-----------------|-----------------|
| (i)         | Share of profit from AOP                                             | Exempt          | Exempt          |
|             | Income from other sources                                            | <u>1,00,000</u> | <u>1,70,000</u> |
|             | Total Income                                                         | <u>1,00,000</u> | <u>1,70,000</u> |
|             | Tax liability                                                        | NIL             | 2,000           |
|             | Education cess@2% + SHEC@1%                                          | —               | <u>60</u>       |
|             | Total tax payable                                                    | <u>NIL</u>      | <u>2,060</u>    |
| (ii)        | Share of profit from AOP                                             | 3,60,000        | 2,40,000        |
|             | Income from other sources                                            | <u>1,00,000</u> | <u>1,20,000</u> |
|             |                                                                      | <u>4,60,000</u> | <u>3,60,000</u> |
|             | Tax liability                                                        | 47,000          | 27,000          |
|             | Education cess@2% + SHEC@1%                                          | <u>1,410</u>    | <u>810</u>      |
|             | Total tax payable                                                    | <u>48,410</u>   | <u>27,810</u>   |
|             | Average rate of tax                                                  | 10.524%         | 7.725%          |
|             | Total tax liability                                                  | 48,410          | 27,810          |
|             | Less: Rebate under section 86 in respect of share of profit from AOP | <u>37,890</u>   | <u>18,540</u>   |
|             | Tax liability of members                                             | <u>10,520</u>   | <u>9,270</u>    |

- (b) As per section 25B, the arrears of rent shall be taxable in the previous year in which such arrears are received. The assessee shall be allowed deduction @ 30% of such amount received. Further, it is not necessary that the assessee should be owner of such house property in the previous year in which such arrears are received.

As the arrear rent of Rs.1,80,000 is received in the previous year 2008-09, the same is taxable in the A.Y.2009-10. Thus, the net sum of Rs.1,26,000 (i.e. Rs.1,80,000 – Rs.54,000) shall be chargeable to tax under the head "Income from house property".

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There is no provision in the Income-tax Act enabling the assessee to spread over the arrears of rent over the last three years.

- (c) Section 2(15) defines "charitable purpose" to include relief of the poor, education, medical relief and the advancement of any other object of general public utility. Section 2(15) was amended by the Finance Act, 2008 to provide that "advancement of any other object of general public utility" would not be a charitable purpose, if it involves the carrying on of any activity in the nature of trade, commerce or business or, any activity of rendering of any service in relation to any trade, commerce or business, for a fee or cess or any other consideration, irrespective of the nature of use or application of the income from such activity or the retention of such income, by the concerned entity.

Based on the above amendment, in the first case, net income from the business of supplying mineral water to various companies i.e. Rs.10 lakh is not eligible for exemption under section 11. This is because "advancement of any object of general public utility" would not be a charitable purpose if it involves carrying on of any activity in the nature of trade, commerce or business, for example, supply of mineral water for a consideration, as in this case. It is immaterial that the net income from such business is applied for the object of general public utility.

On the other hand, where the trust runs a school in a backward district, this restriction is not applicable. The reason is that the restriction contained in section 2(15) is applicable only to the fourth limb of the definition of "charitable purpose" i.e. advancement of object of general public utility. It does not affect the other three limbs of the definition viz. "relief of the poor", "education", and "medical relief".

Section 11(4) clarifies that "property held under trust" includes a business undertaking so held. As per section 11(4A), exemption can be availed in respect of profits and gains of business, if such business is incidental to the attainment of the objectives of the trust and separate books of account are maintained in respect of such business. Therefore, in this case, the profit from the business of providing mineral water shall be eligible for exemption under section 11, assuming that the said business is incidental to the attainment of the objects of the trust (i.e., education) and books of account for such business activity is maintained separately.

### Question 6

- (a) Specify with reason whether the following acts can be considered as (i) tax management; or (ii) tax planning; or (iii) tax evasion:
- (i) P deposits Rs.50,000 in PPF account so as to reduce his total income from Rs.3,40,000 to Rs.2,90,000.
  - (ii) PQR Industries Ltd. installed an air conditioner costing Rs.75,000 at the residence of a director as per terms of his appointment; but treats it as fitted in quality control section in the factory. This is with the objective to treat it as plant for the purpose of computing depreciation.

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- (iii) SQL Ltd. maintains register of tax deduction at source effected by it to enable timely compliance.
- (iv) R. Ltd. issues a credit note for Rs.40,000 for brokerage payable to Suresh, who is son of R, managing director of the company. The purpose is to increase his income from Rs.1,40,000 to Rs.1,80,000 and reduce its income correspondingly. (4 Marks)
- (b) Mr. Kadam is entitled to a salary of Rs.25,000 per month. He is given an option by his employer either to take house rent allowance or a rent free accommodation which is owned by the company. The HRA amount payable was Rs.5,000 per month. The rent for the hired accommodation was Rs.6,000 per month at New Delhi. Advice Mr. Kadam whether it would be beneficial for him to avail HRA or Rent Free Accommodation. Give your advice on the basis of "Net Take Home Cash benefits". (6 Marks)
- (c) I Limited, an Indian Company supplied billets to its holding company, U. Limited, UK during the previous year 2008-09. I. Limited also supplied the same product to another UK based company, V. Limited, an unrelated entity. The transactions with U. Limited are priced at Euro 500 per MT (FOB), whereas the transactions with V. Limited are priced at Euro 700 per MT (CIF). Insurance and Freight amounts to Euro 200 per MT. Compute the arm's length price for the transaction with U. Limited. (4 Marks)

**Answer**

- (a) (i) It is a case of tax planning, since depositing money in PPF and claiming deduction under section 80C is as per the provisions of law.
- (ii) It is a case of tax evasion, as the air conditioner fitted at residential place is furniture, depreciable@10%, whereas the rate of depreciation applicable for plant and machinery is higher. The wrong treatment unjustifiably increases the amount of depreciation and consequently, reduces profit.
- (iii) It is tax management because maintaining register of payments subject to TDS helps in complying with the obligations under the Income-tax Act.
- (iv) Net effect of the transaction is reduction of tax liability of the company by improper means. The company is liable to tax at a flat rate of 30% whereas Suresh would be liable to pay tax @10% slab rate on Rs.30,000, being the excess of Rs.1,80,000 over the basic exemption limit of Rs.1,50,000. The issue of credit note to reduce the liability of company amounts to tax evasion.
- (b) Computation of tax liability of Kadam under both the options

| Particulars                                                      | Option I<br>– HRA | Option II<br>– RFA |
|------------------------------------------------------------------|-------------------|--------------------|
| Basic Salary (Rs.25,000 x 12 Months)                             | 3,00,000          | 3,00,000           |
| Perquisite value of rent-free accommodation (15% of Rs.3,00,000) | N.A.              | 45,000             |
| House rent Allowance (Rs.5,000 x 12 Months)                      | 60,000            |                    |
| Less: Exempt u/s 10(13A) – least of the following -              |                   |                    |
| - 50% of Basic Salary                                            | 1,50,000          |                    |

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|                                          |               |               |                             |
|------------------------------------------|---------------|---------------|-----------------------------|
| - Actual HRA                             | 60,000        |               |                             |
| - Rent less 10% of salary                | <u>42,000</u> | <u>42,000</u> | 18,000                      |
| Income taxable under the head "Salaries" |               |               | 3,18,000    3,45,000        |
| Less: Deduction under Chapter VIA        |               |               | -               -           |
| Total Income                             |               |               | <u>3,18,000    3,45,000</u> |
| <br>Tax on total income                  |               |               | <br>18,600       24,000     |
| Add: Education cess@1% and SHEC @ 2%     |               |               | 558           720           |
| Total tax payable                        |               |               | <u>19,158       24,720</u>  |

**Cash Flow Statement**

| Particulars              | Option I<br>– HRA | Option II<br>– RFA |
|--------------------------|-------------------|--------------------|
| Inflow : Salary          | 3,60,000          | 3,00,000           |
| Less: Outflow: Rent paid | (72,000)          | -                  |
| Tax on total income      | (19,158)          | (24,720)           |
| Net Inflow               | <u>2,68,842</u>   | <u>2,75,280</u>    |

Since the net cash inflow under option II (RFA) is higher than in Option I (HRA), it is beneficial for Mr. Kadam to avail Option II, i.e., Rent free accommodation.

- (c) In this case, I Ltd., the Indian company, supplied billets to its foreign holding company, U Ltd. Since the foreign company, U Ltd., holds more than 26% shares in I Ltd., I Ltd. and U Ltd. shall be deemed to be associated enterprises within the meaning of section 92A.

As I Ltd. supplies similar product to an unrelated entity, V Ltd., UK, the transactions between I Ltd. and V. Ltd. can be considered as comparable uncontrolled transactions for the purpose of determining the arm's length price of the transactions between I. Ltd. and U Ltd. Comparable Uncontrolled Price (CUP) method of determination of arm's length price (ALP) would be applicable in this case.

Transactions with U Ltd. are on FOB basis, whereas transactions with V Ltd. are on CIF basis. This difference has to be adjusted before comparing the prices.

**Amount in Euro**

|                                              |            |
|----------------------------------------------|------------|
| Price per MT of billets to V. Ltd.           | 700        |
| Less: Cost of insurance and freight per M.T. | <u>200</u> |
| Adjusted Price per M.T.                      | <u>500</u> |

Since the adjusted price for V. Ltd., UK and the price fixed for U Ltd. are the same, the arm's length price is Euro 500 per MT. Since the sale price to related party (i.e., U Ltd.) and unrelated party (i.e., V Ltd.) is the same, the transaction with related party U Ltd. has also been carried out at arm's length price.

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**Question 7**

- (a) Mrs. A furnishes the following particulars for the computation of her wealth tax liability for the assessment year 2009-10:
- (1) Gifts of jewellery and gold ornaments received from her mother on the occasion of her marriage aggregating Rs.5,00,000. However, the said jewellery were forcibly taken away from her by her mother-in-law after marriage.
  - (2) She owns two residential house properties each valuing Rs.10,00,000.
  - (3) She is one of the partners in the business with her husband. The value of her interest in assets of the firm as at 31<sup>st</sup> March, 2009 is Rs.12,75,500. The said business is conducted in one of the house properties owned by Mrs. A.
  - (4) She has two motor cars of Rs.12,50,000, one of which is imported by her for Rs.7,50,000.
  - (5) She has invested Rs.10,00,000 in a bank deposit for five years to meet the future expense of children on their education.
  - (6) Mrs. A has signed "agreement to sell" for purchase of new residential house property of Rs.20,00,000 and has made advance payment of Rs.5,00,000 on 1<sup>st</sup> March, 2009 and has taken possession. However, the sale deed has not been executed till 31<sup>st</sup> March, 2009. She has taken loan of Rs.15,00,000 from bank for purchase of said property.
  - (7) She has cash balance of Rs.75,000.

Compute the wealth tax payable by Mrs. A for assessment year 2009-10. (7 Marks)

- (b) Under what circumstances can the Assessing Officer make a reference to the Valuation Officer for the purpose of making an assessment under the Wealth Tax Act? (3 Marks)

**Answer**

- (a) Computation of wealth-tax payable by Mrs.A for A.Y.2009-10

| Asset            | Amount<br>in Rs. | Reason                                                                                                                                                                                   |
|------------------|------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Jewellery        | Nil              | Jewellery forcibly taken by mother-in-law and not in the possession of the assessee, is not chargeable to wealth-tax in the hands of the assessee.                                       |
| House Property 1 | Nil              | A house used exclusively for residential purpose is treated as an asset under section 2(ea), but the same is exempt under section 5(vi).                                                 |
| House Property 2 | Nil              | Building owned by a partner but used in firm's business is deemed to be used by the partner for his business purposes and is, hence, not an asset chargeable to tax under section 2(ea). |

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|                                         |                  |                                                                                                                                                                                                                                                                       |
|-----------------------------------------|------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Value of interest in assets of the firm | 12,75,500        | Included in the net wealth of Mrs. A by virtue of section 4(1)(b). It has been assumed that the assets are those covered under section 2(ea).                                                                                                                         |
| Motor Cars                              | 12,50,000        | Motor cars, whether indigenous or imported, are assets chargeable to wealth-tax under section 2(ea).                                                                                                                                                                  |
| Bank Deposit                            | Nil              | Not an asset under section 2(ea) and hence, not chargeable to tax under the Wealth-tax Act.                                                                                                                                                                           |
| House Property 3                        | 20,00,000        | Since the possession of the house property is taken, it is deemed as an asset and is chargeable to wealth-tax. It may be noted that only one house property is exempt under section 5(vi) and this exemption has already been availed in respect of House Property 1. |
| Cash balance                            | 25,000           | For an individual, cash in hand in excess of Rs.50,000 shall be chargeable to wealth tax (Rs.75,000 – 50,000)                                                                                                                                                         |
| Gross Wealth                            | <u>45,50,500</u> |                                                                                                                                                                                                                                                                       |
| Less: Loan borrowed from Bank           | 15,00,000        | Money borrowed by the assessee for purchase of House Property 3 is deductible under section 2(m), since the value of House Property 3 is included in gross wealth.                                                                                                    |
| Net Wealth                              | <u>30,50,500</u> |                                                                                                                                                                                                                                                                       |

Wealth-tax payable by Mrs. A will be Rs.15,505 i.e. 1% of Rs.15,50,000 (i.e., Rs.30,50,500 – Rs.15,00,000).

- (b) Under section 16A of the Wealth-tax Act, a reference to the Valuation Officer may be made by Assessing Officer, where the market value of any asset is to be taken into account in the wealth tax assessment. Such reference can be made in the following cases -
- Where the value of the asset adopted by the assessee is on the basis of the estimate by a registered valuer and the Assessing Officer is of the opinion that such value returned is less than the fair market value;
  - In any other case, if the fair market value, in the opinion of Assessing Officer, exceeds the value of the asset (as disclosed in the return), by 33-1/3% or Rs.50,000; or
  - having regard to the nature of the asset and other relevant circumstances, the Assessing Officer is of the opinion that it is necessary to make a reference.