

UNIT-3: PROFITS AND GAINS OF BUSINESS OR PROFESSION

Question 1

State with reasons, whether the following statements are true or false, with regard to the provisions of the Income-tax Act, 1961:

- (a) Payment made in respect of a business expenditure incurred on 16th February, 2007 for Rs.25,000 through a cheque duly crossed as "& Co." is hit by the provisions of section 40A(3). (2 Marks)(May 2007)
- (b) (i) It is a condition precedent to write off in the books of account, the amount due from debtor to claim deduction for bad debt.
(ii) Failure to deduct tax at source in accordance with the provisions of Chapter XVII-B, inter alia, from the amounts payable to a resident as rent or royalty, will result in disallowance while computing the business income. (2 Marks) (Nov 2007)
- (c) Rural branches of the co-operative banks are not allowed to claim provision for bad and doubtful debts. (2 Marks)(Nov 2008)
- (d) Depreciation is allowed only when it is claimed. (2 Marks)(Nov 2008)
- (e) The benefit of weighted deduction of 125% under section 35(2AB) of the Income-tax Act, 1961 has now been extended to contribution made to a company, for scientific research approved under section 35(1)(iia) to an assessee. (2 Marks) (Nov 2009)
- (f) Where the payment is made in cash by way of adjustment against the amount of any liability incurred by the payee for any goods supplied or services rendered by the assessee to such payer, in excess of Rs.20,000 in a day, no disallowance gets attracted under section 40A(3) of the Income-tax Act, 1961, read with Rule 6DD of the Income-tax Rules, 1962. (2 Marks) (Nov 2009)

Taxation

Answer

(a) True

In order to escape the disallowance specified in section 40A(3), payment in respect of the business expenditure ought to have been made through an account payee cheque. Payment through a cheque crossed as "& Co." will attract disallowance under section 40A(3).

(b) (i) True

It is mandatory to write off the amount due from a debtor as not receivable, in order to claim the same as bad debt under section 36(1)(vii).

(ii) True

Section 40(a)(ia) provides that failure to deduct tax at source from rent or royalty payable to a resident, in accordance with the provisions of Chapter XVII-B, will result in disallowance of such expenditure.

(c) False

Sub-clause (a) of section 36(1)(viia) allows the co-operative banks to claim deduction for provision for bad and doubtful debts in respect of advances made by rural branches of such banks. However, the deduction should not exceed 10% of the aggregate average advances made by the rural branches of such banks computed in the prescribed manner.

(d) False

According to the Explanation 5 to section 32(1), depreciation is mandatory. Therefore, depreciation has to be provided mandatorily while calculating business income, whether or not the assessee has claimed the deduction in respect of depreciation in computing his total income.

(e) False

Under section 35(2AB), weighted deduction of 150% is available in respect of only in-house research. The benefit of weighted deduction of 125% under section 35(1) has been extended to contribution made to companies for scientific research. Under section 35(1)(iia), an assessee is entitled to claim weighted deduction of 125% of the amount contributed to a company for scientific research.

(f) True

As per clause (d) of the Rule 6DD, no disallowance gets attracted under section 40A(3) of the Income-tax Act, 1961, where the payment is made by way of adjustment against the amount of any liability incurred by the payee for any goods supplied or services rendered by the assessee to such payee.

Profits and Gains of Business or Profession

Alternate Answer

Since the question mentions that the payment is made in cash by way of adjustment, it is possible to take a view that the net amount after adjustment was made in cash and since such net payment exceeds Rs.20,000 in a day, disallowance under section 40A(3) would be attracted. If such a view is adopted, the statement would be false.

Question 2

Swadeshi Ltd., which follows mercantile system of accounting, obtained licence on 1.6.2005 from the Department of telecommunication for a period of 10 years. The total licence fee payable is Rs.18,00,000. The relevant details are:

Year ended 31 st March	Licence fee payable for the year Rs.	Payments made	
		Date	Amount Rs.
2006	10,00,000	30.03.06	3,70,000
		15.05.06	6,30,000
2007	8,00,000	28.02.07	5,40,000

Balance of Rs.2,60,000 is pending as on 31.3.2007.

Compute the amount of deduction available to the assessee under section 35ABB for the assessment years 2006-07 and 2007-08. Can any deduction be claimed under section 32 also?
(6 Marks)(May 2007)

The provisions of the Income-tax Act, 1961 relevant for A.Y.2010-11 should be taken into consideration while solving the question. Accordingly, the facts given above may be taken as relating to the F.Y. 2009-10. It may be taken that the licence fee payable for the year ended 31.3.2009 is Rs.10 lakh and for the year ended 31.3.2010 is Rs.8 lakh. The dates of actual payment may be taken as 31.3.2009, 15.5.2009 and 28.02.2010. The question requires computation of the amount of deduction available to the assessee under section 35ABB for the A.Y.2009-10 and 2010-11.

Answer

As per section 35ABB, any amount actually paid for obtaining licence to operate telecommunication services, shall be allowed as deduction in equal installments during the number of years for which the licence is in force. Therefore, the year of actual payment is relevant and not the previous year in which the liability for the expenditure was incurred according to the method of accounting regularly employed by the assessee.

Taxation

- Rs. 3,70,000 paid on 30.03.2009 [P.Y.2008-09]
Unexpired period of licence 10 years
Hence Rs.37,000 [i.e. Rs.3,70,000/10] can be claimed under section 35ABB for period of 10 years commencing from A.Y.2009-10.
- Rs.11,70,000 paid during year ended 31.03.10 [P.Y.2009-10]
Unexpired period of licence 9 years
Hence, Rs.1,30,000 [i.e. Rs.11,70,000/9] can be claimed under section 35ABB for a period of 9 years commencing from A.Y.2010-11.
- Amount of deduction u/s 35ABB

Assessment year	Amount (Rs.)
2009-10	37,000
2010-11	37,000 + 1,30,000 = 1,67,000

- Where deduction under section 35ABB is claimed and allowed, deduction under section 32(1) cannot be allowed for the same previous year or any subsequent previous year

Question 3

A newly qualified Chartered Accountant Mr. Dhaval, commenced practice and has acquired the following assets in his office during F.Y. 2006-07 at the cost shown against each item. Calculate the amount of depreciation that can be claimed from his professional income for A.Y. 2007-08:

Sl. No.	Description	Date of acquisition	Date when put to use	Amount Rs.
1.	Computer	27 Sept., 06	2 Oct., 06	35,000
2.	Computer software	2 Oct., 06	4 Oct., 06	8,500
3.	Computer printer	2 Oct., 06	3 Oct., 06	12,500
4.	Books (of which books being annual publications are of Rs.12,000)	1 Apr., 06	1 Apr., 06	13,000
5.	Office furniture (Acquired from practising C.A.)	1 Apr., 06	1 Apr., 06	3,00,000
6.	Laptop	26 Sep., 06	4 Oct., 06	43,000
7.	Fire extinguisher	1 Apr., 06	No instance arose to use during F.Y. 2006-07	2,500

Profits and Gains of Business or Profession

8. Purchased practising CA's office in April '06 who had run it for 4 years, for Rs.5 lacs which includes Rs.2 lacs for goodwill and Rs.3 lacs for cost of furniture (included in 5 above)

Note: Depreciation is to be provided at the applicable rates. (8 Marks)(May 2007)

The provisions of the Income-tax Act, 1961 relevant for Assessment Year 2010-11 should be taken into consideration while solving the question. Accordingly, the facts given above may be taken as relating to financial year 2009-10.

Answer

Computation of depreciation allowable for A.Y.2010-11

	Asset	Rate	Depreciation
Block 1	Furniture	10%	30,000
Block 2	Plant (Computer, computer software, laptop & books)	60%	37,050
Block 3	Plant (Books)	100%	12,000
Block 4	Plant (Fire Extinguisher and Printer)	15%	2,250
Total depreciation allowable			81,300

Notes -

1. Computation of depreciation

Block of Assets	Rs.
Block 1: Furniture – rate 10%	
Put to use for more than 180 days [Rs.3,00,000@10%]	30,000
Block 2: Plant – rate 60%	
(a) Computer (put to use for more than 180 days) [35,000 @ 60%]	21,000
(b) Laptop (put to use for less than 180 days) [43,000 @ 30%]	12,900
(c) Computer Software (put to use for less than 180 days) [8,500 @ 30%]	2,550
(d) Books (other than annual publications) (Put to use for more than 180 days) [1,000 @ 60%]	600
	37,050
Block 3: Plant – Rate 100%	
Books (being annual publications) put to use for more than 180 days	12,000

Taxation

[12,000 @100%]

Block 4: Plant – Rate 15%

Computer printer (Put to use for 180 days) [12,500 @15%] 1,875

Fire extinguisher [2,500 @ 15%] 375

2,250

2. Where an asset is acquired by the assessee during the previous year and is put to use for the purposes of business or profession for a period of less than 180 days, the deduction on account of depreciation would be restricted to 50% of the prescribed rate. In this case, since Mr. Dhaval commenced his practice in the P.Y. 2009-10 and acquired the assets during the same year, the restriction of depreciation to 50% of the prescribed rate would apply to those assets which have been put to use for less than 180 days in that year, namely, laptop and computer software.
3. Goodwill is not an intangible asset entitled to depreciation.
4. In case of fire extinguishers, it is sufficient if they are kept ready for use. Actual use is not essential.

Question 4

X Ltd. follows mercantile system of accounting. After negotiations with the bank, interest of Rs.4 lakhs (including interest of Rs.1.2 lakhs pertaining to year ended 31.03.2007) has been converted into loan. Can the interest of Rs.1.2 lakhs so capitalized be claimed as business expenditure? (2 Marks)(Nov 2007)

Answer

Explanation 3D to section 43B provides that if any interest payable by the assessee is converted into a loan, the interest so converted and not “actually paid” shall not be deemed as actual payment, and hence would not be allowed as deduction. Therefore, the interest of Rs.1.2 lakhs converted into loan cannot be claimed as business expenditure.

Question 5

Vivitha Bio-medicals Ltd. is engaged in the business of manufacture of bio-medical items. The following expenses were incurred in respect of activities connected with scientific research:

Year ended	Item	Amount (Rs.)
31.03.2004	Land	10,00,000
(Incurred after 1.9.2003)	Building	25,00,000
31.03.2005	Plant and machinery	5,00,000
31.03.2006	Raw materials	2,20,000
31.03.2007	Raw materials and salaries	1,80,000

Profits and Gains of Business or Profession

The business was commenced on 01-09-2006.

In view of availability of better model of plant and machinery, the existing plant and machinery were sold for Rs. 8,00,000 on 1.03.2007.

Discuss the implications of the above for the assessment year 2007-08 along with brief computation of deduction permissible under section 35 assuming that necessary conditions have been fulfilled. You are informed that the assessee's line of business is eligible for claiming deduction under Section 35 at 150% on eligible items. (7 Marks (Nov 2007))

The provisions of the Income-tax Act, 1961 relevant for Assessment Year 2010-11 should be taken into consideration while solving the question. Accordingly, the facts given above may be taken as relating to financial year 2009-10. The question would be as follows:

Vivitha Bio-medicals Ltd. is engaged in the business of manufacture of bio-medical items. The following expenses were incurred in respect of activities connected with scientific research:

Year ended	Item	Amount (Rs.)
31.03.2007	Land	10,00,000
(Incurred after 1.9.2006)	Building	25,00,000
31.03.2008	Plant and machinery	5,00,000
31.03.2009	Raw materials	2,20,000
31.03.2010	Raw materials and salaries	1,80,000

The business was commenced on 01-09-2007.

In view of availability of better model of plant and machinery, the existing plant and machinery were sold for Rs. 8,00,000 on 1.03.2010.

Discuss the implications of the above for the assessment year 2010-11 along with brief computation of deduction permissible under section 35 assuming that necessary conditions have been fulfilled. You are informed that the assessee's line of business is eligible for claiming deduction under section 35 at 150% on eligible items.

Answer

1. As per section 35, where a company engaged in manufacture of bio-medical items incurs any expenditure on scientific research during the current year, it is eligible for claiming weighted deduction of a sum equal to 150% of the eligible expenditure.

The eligible expenditure and quantum of deduction will be:

- (a) Current year capital or revenue expenditure incurred for scientific research (weighted deduction @ 150%).
- (b) Any expenditure incurred during earlier 3 years immediately preceding the date of commencement of business on payment of salary or purchase of materials, or capital expenditure incurred other than expenditure on acquisition of land (actual expenditure qualifies for deduction).

Taxation

The deduction available under section 35 for scientific research will, therefore, be:

	Particulars	Rs.
(a)	Land	Nil
(b)	Building	25,00,000
(c)	Revenue expenses of last 3 years	2,20,000
(d)	Capital expenditure of last 3 years: Plant and machinery	5,00,000
(e)	Current year revenue expenditure Rs.1,80,000 [150% of Rs.1,80,000 is allowable under section 35(2AB)]	2,70,000
	Deduction under section 35	<u>34,90,000</u>

2. Section 41(3) provides that where a capital asset used for scientific research is sold, without having been used for other purposes, the lower of sale proceeds or the total amount of deduction earlier allowed under section 35 will be considered as income from business of the previous year in which the sale took place.

Therefore, business profit under section 41(3) should be lower of the following:

- (1) Sale proceeds i.e. Rs. 8,00,000
- (2) Total amount of deduction earlier allowed under section 35 i.e. Rs. 5,00,000

Rs. 5,00,000 will be deemed to be business profits under section 41(3).

3. The difference between sale proceeds and business income under section 41(3) will be treated as short-term capital gain.

Sale proceeds of plant and machinery	8,00,000
Less: Business Income as per section 41(3)	<u>5,00,000</u>
Short-term capital gain	<u>3,00,000</u>

Question 6

Mr. B.A. Patel, a non-resident, operates an aircraft between London to Ahmedabad. For the Financial year ended on 31st March, 2007, he received the amounts as under:

- (i) For carrying passengers from Ahmedabad Rs. 50 lacs.
- (ii) For carrying passengers from London Rs. 75 lacs received in India.
- (iii) For carrying of goods from Ahmedabad Rs. 25 lacs.

The total expenditure incurred by Mr. B.A. Patel for the purposes of the business for the financial year 2006-07 was Rs. 1.4 crores.

Compute the income of Mr. B.A. Patel under the head "Profits and Gains from business or profession" for the financial year ended on 31st March 2007 relevant to assessment year 2007-08.
(8 Marks) (Nov 2007)

Profits and Gains of Business or Profession

The provisions of the Income-tax Act, 1961 relevant for Assessment Year 2010-11 should be taken into consideration while solving the question. Accordingly, the facts given above may be taken as relating to financial year 2009-10.

Answer

Under section 44BBA, in case of an assessee, being a non-resident, engaged in the business of operation of aircraft, a sum equal to 5% of the aggregate of the following amounts shall be deemed to be his business income:

- (a) the amount paid or payable, whether in or out of India, to the assessee on account of carriage of passengers, goods etc. from any place in India; and
- (b) the amount received or deemed to be received in India by the assessee on account of carriage of passengers, goods etc. from any place outside India.

Hence, the income of Mr. B.A. Patel chargeable to tax in India under the head "Profits and Gains of business or profession" is determined as under:

Particulars	Rs.
(i) For carrying passengers from Ahmedabad	50,00,000
(ii) For carrying passengers from London, amount received in India	75,00,000
(iii) For carrying goods from Ahmedabad	25,00,000
Total	1,50,00,000

Hence, income from business computed on presumptive basis as per section 44BBA is Rs. 7,50,000, being 5% of Rs.1,50,00,000.

Note: No deduction is allowable in respect of any expenditure incurred for the purpose of the business.

Question 7

Comment on the allowability of the following claims made by the assessee:

Mr. Achal, a hotelier, claimed expenditure on replacement of Linen and carpets in his hotel as revenue expenditure. (2 Marks)(Nov 2007)

Answer

The expenditure on replacement of linen and carpets in a hotel are in the nature of expenses incurred for the business and are allowable as revenue expenses under section 37(1).

Question 8

List six items of expenses which otherwise are deductible shall be disallowed, unless payments are actually made within the due date for furnishing the return of income under Section 139(1). When can the deduction be claimed, if paid after the said date?

(4 Marks)(May 2008)

Taxation

Answer

Section 43B provides that the following expenses shall not be allowed as deduction unless the payments are actually made within the due date for furnishing the return of income under section 139(1):

- (i) Any tax, duty, cess or fees under any law in force.
- (ii) Employer's contribution to provident fund or superannuation fund or gratuity fund or any other fund for the welfare of the employees;
- (iii) Any bonus or commission for services rendered payable to employees;
- (iv) Any interest on any loan or borrowings from any public financial institution or State financial corporation or State industrial investment corporation;
- (v) Interest on loans and advances from a scheduled bank;
- (vi) Any sum paid as an employer in lieu of earned leave at the credit of his employee.

In case the payment is made after the due date of filing of return of income, deduction can be claimed only in the year of actual payment.

Question 9

Briefly explain the term "substantial interest". State any two situations in which the same assumes importance. (4 Marks) (May 2008)

Answer

As per Explanation to section 40A(2), a person shall be deemed to have a substantial interest in a business or profession, if, -

- (1) in case where the business or profession is carried on by a company, such person is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend, whether with or without a right to participate in profits), carrying not less than 20% of the voting power.
- (2) In any other case, such person is beneficially entitled to not less than 20% of the profits of such business or profession.

Following are the situations under which the substantial interest assumes importance

- (i) Taxability of deemed dividend under section 2(22)(e);
- (ii) Disallowance of excessive or unreasonable expenditure under section 40A(2) to an individual who has a substantial interest in the business or profession of the assessee, and
- (iii) Clubbing of salary income of spouse, under section 64(1)(ii) in respect of remuneration received by the spouse from a concern in which the individual has a substantial interest.

Question 10

Can an Assessing Officer make a request for withdrawal of approval which was granted to an institution by the National Committee for carrying out any eligible project or scheme, under section 35AC of the Income-tax Act, 1961? (4 Marks)(Nov 2008)

Answer

The National Committee can withdraw the approval to an association or institution if it is satisfied that the project or the scheme (notified as an eligible project or scheme) is not being carried on in accordance with all or any of the conditions subject to which approval was granted or if the association/institution has failed to furnish to the National Committee, after the end of each financial year, a progress report within the prescribed time in the prescribed form. The National Committee should, however, give a reasonable opportunity to the concerned association or institution of showing cause against the proposed withdrawal.

A copy of the order withdrawing the approval or notification should be forwarded to the Assessing Officer having jurisdiction over the concerned association or institution. Therefore, the Assessing Officer is not empowered to make a request for withdrawal of the approval which was granted to an institution by the National Committee under section 35AC.

Question 11

Are there any restrictions on deduction allowable to the partnership firm in respect of salary and interest to its partners under section 40(b) of the Income-tax Act, 1961? (4 Marks)(Nov 2009)

Answer

In the case of a partnership firm, there are following restrictions:

- (i) The remuneration payable to its working partners and interest payable to partners should be authorized by and in accordance with the partnership deed and should fall after the date of execution of the deed.
- (ii) The payment of interest to partners is allowable up to 12% p.a simple interest if it is authorized in the partnership deed and must fall after the date of the deed.
- (iii) In the case of a firm, the remuneration should not exceed the following limits:
 - (a) On the first Rs.3 lakh of book profit Rs.1,50,000 or 90% of book profits
or in the case of loss whichever is more
 - (b) On the balance of the book profit @ 60%