

PAPER – 7 : DIRECT TAXES

Question No.1 is compulsory.

Answer any **five** questions from the remaining **six** questions.

Question 1

1. (A) "Samode Oil Refineries Ltd.", the assessee, has started commercial production of mineral oil from 1st June, 2009 of three wells in a licensed block. The company, for the purpose of claiming deduction under section 80-IB(9), contends that each well is a separate industrial undertaking entitled to deduction. Examine critically in the context of the provisions, the correctness of the contention. (5 Marks)
- (B) "Bhardwaj Textiles Ltd." had availed a term loan of Rs.400 lacs from a nationalized bank for acquiring the fixed assets. However, due to financial difficulties, it could not meet its obligation for the last three years and decided to avail the benefit of "One Time Settlement Scheme" announced by the bank to reduce its NPA. The bank as per scheme allowed waiver of principal of Rs.5 lacs and of outstanding interest of Rs.20.30 lacs in total of Rs.25.30 lacs. The company directly credited the amount so waived to the general reserve. The Assessing Officer contends that the entire amount so waived by the bank is chargeable to tax as business income under section 28(iv) or under section 41(1) of the Act. Assessee company seeks your opinion. (5 Marks)
- (C) Krishan Kanhiya HUF, running Kanha Departmental Stores consists of Karta, his wife, two sons and daughter. Both the sons who are having professional/technical qualifications as a Chartered Accountant and as an Automobile Engineer started in partnership, a garage for the repairing of motor cars, with a clear understanding that the technical side of the business be looked after by the Engineer while the general administration and finance part be taken care by the Chartered Accountant. They had taken an interest-free loan of Rs.5,00,000 from the HUF for starting the venture. The business of garage resulted in a net profit of Rs. 15,00,000 for the year ended 31-03-2010. The Assessing Officer proposes to assess the income from the business of motor garage in the hands of HUF. What do you say about the validity of the proposition of the Assessing Officer? (5 Marks)
- (D) Examine the taxability of the following assets held on valuation date in the context of provisions in Wealth-tax Act, 1957:
 - (i) A house property owned by Pankaj was transferred without consideration to Miss Geeta on 11-1-2009. Subsequently, Miss Geeta got married to his son on 18-4-2009. The value of house on 31-3-2010 is Rs.75 lacs.
 - (ii) Right to live in a house for life.
 - (iii) The cash in hand on 31.3.2010 with the cashier of ABC Pvt. Ltd. was Rs. 2,00,000. The balance as per cash book on that day was Rs.1,50,000.

(5 Marks)

The Suggested Answers for Paper 7: - Direct Taxes are based on the provisions applicable for A.Y. 2010-11, which is the assessment year relevant for November, 2010 examination.

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Answer

- (A) Sub-section (9) of section 80-IB provides for deduction in respect of profits and gains derived from, *inter alia*, commercial production or refining of mineral oil.

Sub-section (9) has been amended by the Finance (No.2) Act, 2009 by inserting an Explanation so as to clarify that for the purposes of claiming deduction under sub-section (9), all blocks licensed under a single contract, which has been awarded under the New Exploration Licensing Policy announced by the Government of India or has been awarded in pursuance of any law for the time being in force or has been awarded by the Central or a State Government in any other manner, shall be treated as single "undertaking".

In view of the above amendment, the assessee's contention is not correct. Each well in a block cannot be regarded as separate industrial undertaking. The entire block has to be treated as a single industrial undertaking.

- (B) The amount waived by the nationalized bank in respect of outstanding principal and interest is not assessable as business income applying the provisions of section 28(iv) [*Mahindra and Mahindra v. CIT 261 ITR 501 (Bom)*]. Section 28(iv) seeks to bring to charge the value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession. The Bombay High Court pointed out that what was sought to be taxed was a benefit or perquisite, that is, something received in kind. Waiver of term loan taken for acquiring fixed assets and interest on such term loan, cannot be said to be a benefit or perquisite, since what was waived was not in kind.

Section 41(1) has no application because there was no cessation of trading liability. The assessee had availed term loan for acquiring fixed assets which was not a trading liability but a capital liability. Section 41(1) can, *inter alia*, apply only where there is cessation of trading liability and not where there is cessation of capital liability. Therefore, the decision of the Bombay High Court in *Solid Containers Ltd. v. DCIT (2009) 308 ITR 416* will not apply to this case.

As regards the interest portion, the assessee could not have availed any deduction, in view of the provisions of section 43B. Section 41(1) is attracted only when an allowance or deduction is made in the previous year in respect of such expenditure and subsequently, any amount in respect of such expenditure is received in any later year. In this case, since interest was never allowed as deduction, section 41(1) is not attracted.

Therefore, the contention of the Assessing Officer is not correct.

- (C) The Delhi High Court, in *CIT v. Charan Dass Khanna & Sons (1980) 123 ITR 194*, observed that if the investment made in the business plays a minor role and it is primarily the personal efforts, specialized skill and enterprise of the individual coparceners which resulted in setting up of a new business and earning of goods profits, then it may not essentially be said that the income belongs to the HUF.

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In the case on hand, the good profits were earned primarily because of the specialized skills acquired by both the partners in their respective fields and used in the business of motor garage. The initial capital taken from the HUF as interest free loan, of course, has its role but it is nevertheless a minor one. Therefore, the income from the business set up by the brothers is assessable in their individual hands and not as the income of the family.

The Supreme Court has also supported this view in the case of *K.S. Subbiah Pillai v. CIT (1999) 237 ITR 11*. In that case, it was held that where the remuneration and commission earned by the Karta were on account of the personal qualifications and exertions and not on account of the investment of the family funds, such income cannot be treated as income of the HUF.

The proposition of the Assessing Officer to tax the profits of the business of motor garage earned by the two sons in the hands of the HUF is, thus, not valid.

- (D) (i) The house property owned by Mr. Pankaj was transferred, without consideration, on 11.1.2009 to Ms. Geeta, who subsequently got married to Mr. Pankaj's son on 18.4.2009. The asset in question was transferred to Ms. Geeta prior to her marriage with the son of the transferor and therefore she cannot be treated as the son's wife on the date when it was transferred. Therefore, the property so transferred to her by Mr. Pankaj cannot be clubbed with the net wealth of Mr. Pankaj by invoking provisions of section 4(1)(a).
- (ii) As per section 7(1), the value of any asset, other than cash, for the purposes of this Act shall be its value as on the valuation date determined in the manner laid down in Schedule III. Accordingly, the value of life-interest as on the valuation date shall be determined in the manner laid down in Rule 17 of Part-F of Schedule III.

Note – For better understanding of students, a simple example has been given to explain the meaning of life interest -

Mr. X owns a residential house and as per his "Will", the house will be enjoyed by his younger brother Mr.A, and after the death of Mr.A, the property will devolve absolutely on his nephew Mr.Y. In this case, Mr.A has a life interest after the death of Mr.X and he cannot alienate the property.

So long as Mr.X is alive, the property will be assessed in his hands. After his death, the property will be assessable in the hands of Mr.A. Since Mr.A is not the absolute owner but has only life interest, hence Rule 17 would be applied for determining the value.

- (iii) The cash recorded in the books of account of a company on the valuation date does not constitute an asset under section 2(ea) of the Wealth-tax Act, 1957. However, cash held in excess of what has been recorded in the books shall be treated as an asset. Accordingly, the cash balance of Rs.50,000 shall be treated as an asset on the valuation date 31.3.2010.

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Question 2

The profit and loss account for the year ended 31-3-2010 of Jolly Ltd., a company engaged in different types of business activities, continuously incurring losses, disclosed a net loss of Rs.1,50,000 arrived at after debiting/crediting the following:

- (i) Profit of Rs.3,13,000 from a hedging contract entered into for meeting out the loss in foreign currency payments towards an imported machinery of Rs.60 lacs installed and put to use on 1-1-2010.*
- (ii) Amount in U.K. Pounds 1,660 equivalent to Rs.1,11,200 paid to a travel agent, resident of U.K. as commission for the booking of international tourists to India in one of the hotels of the company, on which the tax at source was neither deducted nor paid.*
- (iii) Amount of Rs.25,000 debited in commission account represents payment to a party as secret commission duly approved by the board.*
- (iv) Amount of Rs.4,23,000 recovered from the C&F agents towards the excess freight charges collected upto financial year 2008-09 by them from the customers of the company which was neither remitted to the company nor refunded back to customers.*
- (v) Amount of Rs.5,00,000 of unpaid interest for the year 2008-2009 waived by SBI after considering the financial health of the company.*
- (vi) Interest on the amount of advance of Rs.3,00,000 given to the subsidiary company at 10% p.a. was not charged on the ground that the financial position of the subsidiary was not satisfactory.*
- (vii) Rs.50,000 representing the value of furniture found missing on physical verification and debited to General Expenses.*
- (viii) Amount of salary of Rs.1,50,000 paid to the Managing Director for which the approval of the Central Government was received on 18-4-2010.*
- (ix) Amount of Rs.3,30,000 received from the holding company in reimbursement of loss sustained in a particular transaction.*
- (x) Expenses of Rs.26,00,000 incurred on the dismantling of building and machinery and transportation to the new site for refitting because of shifting of the location of one of its unit.*
- (xi) Provision of Rs.75,000 of interest on the unpaid purchase price of an asset which was put to use in August, 2009.*

Compute income under the head "Profits and gains of business or profession" of Jolly Ltd. for the assessment year 2010-2011 indicating brief reasons for treatment given to each of the items.

(16 Marks)

FINAL (OLD) EXAMINATION : NOVEMBER, 2010

Answer

**Computation of income under the head "Profits and gains of business or profession"
of Jolly Ltd. for the A.Y.2010-11**

Particulars	Rs.	Rs.
Net profit as per profit and loss account		(1,50,000)
Add: <u>Amounts debited to profit and loss account but not allowable as deduction or income to be considered while computing business income</u>		
Normal depreciation on the value of asset due to hedging profit (7.5% of Rs.3,13,000) [See Note 1]	23,475	
Additional depreciation@10% of Rs.3,13,000 [See Note 1]	31,300	
Secret Commission [See Note 3]	25,000	
Interest on advance to subsidiary (10% of Rs.3,00,000) not charged [See Note 6]	30,000	
Value of missing furniture wrongly debited to General Expenses [See Note 7]	50,000	
Expenditure on the shifting of location [See Note 10]	<u>26,00,000</u>	<u>27,59,775</u>
		26,09,775
Less: <u>Amounts credited to profit and loss account but not to be considered as income</u>		
Profit from hedging contract [See Note 1]	3,13,000	
Interest waived on loan by SBI [See Note 5]	5,00,000	
Reimbursement of loss by the holding company [See Note 9]	<u>3,30,000</u>	
		<u>11,43,000</u>
		14,66,775
Less: Depreciation on furniture (10% of Rs.50,000)		<u>5,000</u>
		<u>14,61,775</u>

Notes:

- The profit from hedging contract entered into for meeting out the loss in foreign currency payments towards an imported machinery is to be deducted from the cost of machinery. Since the transaction is on capital account, the hedging profit cannot be regarded as business income. As it has been credited to the profit and loss account, the same has to be reduced to compute business income.

Due to reduction in the cost of plant and machinery on account of hedging profit of Rs.3,13,000, the excess normal and additional depreciation debited to profit and loss account have to be added back to the profits. It is presumed that the imported machinery is eligible for additional depreciation under section 32(1)(ia). Since the machinery is put to use for less than 180 days during the year, only 50% of the

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normal depreciation of 15% and additional depreciation of 20% would have been provided. Therefore, only 50% of the normal depreciation (i.e., 7.5%) and additional depreciation (i.e., 10%) on Rs.3,13,000 have to be added back.

2. The commission paid to a non-resident outside India is not chargeable to tax in India in the hands of the non-resident and hence, there is no requirement of deducting tax at source. Hence, the commission paid is an allowable expenditure.

Note - The CBDT Circular No.23 dated 23.7.1969 and Circular No.786 dated 7.2.2000 clarified that where the non-resident agent operates outside the country, no part of his income arises in India. Hence, no tax is deductible at source. These two circulars have since been withdrawn by the CBDT Circular No. 7/2009 dated 22.10.2009. However, inspite of withdrawal of circulars, it is possible to take a view that the income by way of commission is not taxable in the India in the hands of the non-resident, assuming that the non-resident agent does not have any permanent establishment in India. Therefore, there is no requirement to deduct tax at source. Hence, the commission is allowable as deduction while computing business income. Since it has already been debited to profit and loss account, no further adjustment is required.

3. Assuming that secret commission has been paid for a purpose which is an offence or which is prohibited by law, the same is not allowable as deduction as per Explanation to section 37(1), even though it has been approved by the Board. Hence, the same has to be added back for computing business income.
4. The amount of excess freight collected by the assessee-company in the usual course of business can be said to be held in trust on behalf of the customers if it is kept separately with an intention either to repay or to adjust in future transactions. However, once the amount is credited to the profit and loss account and mixed with the assessee's own funds, it cannot be claimed as held in trust. As it is informed that the assessee-company has credited such amount to the profit and loss account, the assessee's own conduct conclusively establishes its intention of treating the said amount as its own money. Therefore, the assessee-company is chargeable to tax in respect of this trading receipt, which assumes the character of income on being credited to the profit and loss account [*CIT v. Karam Chand Thapar (1996) 222 ITR 112 (SC)*].

In this case, since the amount of Rs.4,23,000 is credited to profit and loss account, no adjustment is required.

5. Interest to financial institution is allowed as deduction only in the year of payment as per section 43B. Hence, interest of Rs.5,00,000 which was not paid would not have been allowed as deduction while computing net income of previous year 2008-09. Section 41(1) is attracted only when an allowance or deduction is made in the previous year in respect of loss, expenditure or trading liability and subsequently any amount or benefit in respect of such expenditure, etc. is received in any later year.

In this case, the interest was never allowed as deduction. Hence, it is not taxable in A.Y. 2010-11.

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6. This issue is based on the Calcutta High Court ruling in *CIT v. Hindustan Motors Ltd. (1993) 202 ITR 839*, where it was held that accrual of interest takes place normally on a day to day basis and even where there is no due date fixed for payment of interest, the interest certainly accrues on the last day of the previous year. Forgoing of interest after its accrual will not enable an assessee to claim that the same should not be included in total income for the relevant year. In the present case, assuming that interest was forgone after its accrual, interest accrued will be taxable.
7. The write off related to capital asset and thus, the loss is a capital loss. It cannot be claimed as deduction. Further, the value cannot be reduced from the block of assets to arrive at the written down value of the block, as the assets were neither discarded, demolished nor destroyed during the previous year. Therefore, Rs.50,000 has to be added back to the block. Depreciation@10% on Rs.50,000 has to be provided.
8. The salary paid to the Managing Director is incurred wholly and exclusively for business purposes, for which the approval of the Central Government is obtained, even though after the end of the year. It is possible to take a view that such remuneration is allowable as deduction during the current previous year, since there is no specific provision under the Income-tax Act, 1961 for disallowance of such expenditure, especially since the approval of the Central Government is obtained, even though after the end of the year.
9. This issue is based on the High Court ruling *CIT v. Handicrafts & Handloom Exports Corporation [1983] 140 ITR 0532*, where it was held that such receipt from a holding company is not to be treated as a revenue receipt in the hands of the subsidiary (in this case, Jolly Ltd.). In the given case, the subsidiary company incurred losses and parent company, having regard to its relation with the assessee company, had agreed to reimburse the subsidiary company to the extent of loss.

Loss reimbursed by the holding company cannot be held taxable as a revenue receipt in hands of Jolly Ltd.
10. The Supreme Court has, in *CIT v. Sitalpur Sugar Works Ltd. [1963] 049 ITR 0160*, held that the expenditure on dismantling the building and machinery, transporting to a new site and refitting on account of shifting the location is not incurred in earning profits but only for putting up its factory, that is, its capital, in better shape so that it might produce larger profits, when worked. It is a permanent improvement. Thus, it is a capital expenditure. Since the same has been debited to profit and loss account, it has to be added back.
11. The interest paid on unpaid amount of purchase price of a business asset which is already put to use is an allowable expense. Since the same has been already debited to profit and loss account, no further adjustment is required.

Note – This problem has been solved on the basis of certain assumptions/views as mentioned under the respective adjustments. Alternate assumptions/views are possible, and accordingly, the income computed under the head “Profits and gains of business or profession” would undergo a change.

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Question 3

- (A) **"Mingle Engineering Ltd"**, a Korean non-resident company, had entered into an agreement for designing, fabricating, hook-up and commissioning of a platform in the Bombay High with **"Crude Oil India Ltd"**, an Indian company. The agreement entered into was in two parts, one for the value to be charged for fabrication of structure in Korea for Rs.20 crores (having element of profit in it of Rs.2 crores) and other for the installation and commissioning of the structure in Bombay High for Rs.15 crores (having element of profit in it of Rs.1.5 crores). The Korean company will also be setting up an office in India for the activity of installation and commissioning of the platform which is likely to be completed in 9 months.

On these facts, you are required to answer/work out:-

- (a) Whether the office of Mingle Engineering Ltd. to be opened in India be considered as its "permanent establishment"/ "business connection"?
- (b) The amount of profits, if any, of the non-resident company subject to tax in India.
- (c) The income subject to tax in India, when the arm's length price of the fabrication of structure is determined at Rs.19 crores. (8 Marks)
- (B) Mr. Harsh, aged 66 years, running business as a proprietor furnishes the particulars of his income for the year ended 31-3-2010 as under:
- (a) Net Profit of Rs.3,35,500 from the wholesale business of textiles and fabrics arrived at after charge of following expenses in the Profit & Loss Account:
- (i) Personal travelling expenses of Rs.12,750.
- (ii) Purchase of furniture items for shop on 13-6-2009 of Rs.25,000 but charged in shop expenses.
- (b) He owns a house of two storeys constructed with financial assistance of HDFC out of which ground floor is used by him for self use and first floor was on rent for Rs.8,500 p.m. from April, 2009. The municipal tax paid for the whole house was of Rs.2,500 and interest paid on housing loan taken for the construction was Rs. 52,000. Both the floors of the house are identical.
- (c) He had deposited insurance premium on the life of self of Rs.12,500, wife Rs.13,500, son and daughter of Rs.28,000, made investment of Rs.50,000 in the bonds issued by NABARD and paid Rs.22,500 by credit card for mediclaim insurance of the family.

Compute taxable income and the amount of tax payable by Mr. Harsh on such income for the Assessment Year 2010-2011. (8 Marks)

Answer

- (A) The facts given in the problem are similar to the facts of the case decided by the Apex Court in *CIT v. Hyundai Heavy Industries Co. Ltd.* [2007] 291 ITR 482. The answer to the various parts of the question is accordingly based upon the ruling of the Apex Court in this case and the provisions as contained in sections 9, 92B, 92C and 92F of the Income-tax Act, 1961.

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- (a) The Korean Company, for the purpose of commissioning of the platform in Bombay High, shall be having an office in India for a period of around 9 months. The business of the enterprise shall be wholly or partly carried on in India through the office to be set up by the non-resident company. As per section 92F(iia), maintaining of an office by the non-resident in India for the conduct of its business, shall be treated as a 'permanent establishment'. Therefore, the office of Mingle Engineering Ltd. to be opened in India can be considered as its permanent establishment in India. It is possible to draw an inference that as per section 9(1), a business connection is also established.
- (b) The total income of a person who is a non-resident includes only income which accrues or arises or is deemed to accrue or arise to him in India during the previous year. The income which accrues or arises outside India is not includible in the total income of a non-resident assessee.

Accordingly, only the profits attributable to the permanent establishment of the Korean non-resident company i.e., Rs.1.5 crores relating to the second part of the agreement for carrying out the activity of installation and commissioning of the platform in Bombay High (which is being conducted/supervised from the office in India) would be taxable in India, since it accrues or arises in India.

The profit of Rs.2 crores relating to the fabrication work of the platform shall not be taxable in India because the completed structure is to be supplied from Korea. Such profits are not attributable to the permanent establishment, because the work of fabrication was completed in Korea prior to coming into existence of the permanent establishment in India.

Note – It is presumed that the permanent establishment was constituted in India after fabrication but before installation. It was on this basis that the Apex Court held that the profit on supplies of fabricated platforms could not be attributed to the permanent establishment in India as the installation of PE emerged only after the fabrication contract was concluded.

- (c) Assuming that the arm's length price (ALP) of Rs.19 crores has been determined by taking the arithmetical mean of more than one price determined by the most appropriate method, since the variation between the ALP and the transfer price (TP) is within 5% of the TP, the TP shall be deemed to be the arm's length price and no adjustment is required to be made.

In this case, the TP is Rs.20 crores and 5% of the TP is Rs.1 crore. Since the variation between the ALP of Rs.19 crores and the TP of Rs.20 crores is within 5% of TP (i.e., Rs.1 crore), no adjustment is required and the TP of Rs.20 crores shall be deemed to be the ALP.

The income subject to tax in India would, therefore, continue to be only Rs.1.50 crores.

Note - The solution given above is based on certain assumptions/views as given under (a), (b) and (c) above. Alternate assumptions/views are possible for answering this question.

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(B) Computation of total income of Mr. Harsh for the A.Y.2010-11

Particulars	Rs.	Rs.
<u>Income from house property</u>		
Self-occupied portion (50%)		
Annual Value under section 23(2)	Nil	
Less: Deduction under section 24(b)		
Interest on housing loan [Rs.52,000 × 50%]	<u>26,000</u>	(26,000)
Let-out portion (50%)		
Income of rented out portion being rent of Rs.8,500 p.m. received for 12 months (Rent received has been taken as the GAV in the absence of other information).		
Gross Annual Value under section 23(1) (8,500 × 12)	1,02,000	
Less: 50% of municipal taxes paid allowable in respect of rented out portion (i.e., 50% of 2,500)	<u>1,250</u>	
Net Annual Value (NAV)	1,00,750	
Less: Deduction under section 24		
30% of NAV under section 24(a)	30,225	
Interest on housing loan under section 24(b)	<u>26,000</u>	<u>44,525</u>
		18,525
<u>Profits and gains of business or profession</u>		
Net profit as per profit and loss account of wholesale business of textiles and fabrics	3,35,500	
Add: Expenses charged in profit and loss account either not allowable or to be considered separately -		
Personal travelling expenses of proprietor	12,750	
Purchase of furniture items wrongly debited to shop expenses	<u>25,000</u>	
	3,73,250	
Less: Depreciation on furniture @ 10% on Rs.25,000	<u>2,500</u>	
		<u>3,70,750</u>
Gross Total Income		3,89,275
Less: Deduction under Chapter VI-A		
Under section 80C [Life insurance premium]		
Self	12,500	
Wife	13,500	

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Son and daughter	28,000
Bonds issued by NABARD	<u>50,000</u>
	<u>1,04,000</u>
Maximum allowable upto Rs.1 lakh	1,00,000

Under section 80D [Medical insurance premium]

Mediclaime insurance of Rs.22,500, restricted to Rs.20,000 being maximum allowable for a Senior Citizen	20,000	<u>1,20,000</u>
Total Income		<u>2,69,275</u>
Total Income (rounded off)		2,69,280

Tax on total income of Rs.2,69,280 [10% of Rs.2,69,280, being the excess of Rs.2,69,280 over the basic exemption limit of Rs.2,40,000]	2,928
Education cess @ 2%	59
Secondary and higher education cess @ 1%	<u>29</u>
Total tax payable	<u>3,016</u>

Question 4

- (A) Explain the duty of an Assessing Officer under section 220(6) as summarized by the following statement: "The Assessing Officer while acting under section 220(6) should not act as a mere tax-gatherer but as a quasi-judicial authority." (4 Marks)
- (B) Can the aggregate of the deductions under the various provisions of the Income-tax Act, 1961 exceed the profits and gains of the undertaking or unit or enterprise or eligible business, as the case may be? Explain briefly the amendment effected in section 80A of the Act in this regard to prevent abuse of tax incentives. (4 Marks)
- (C) In the proceedings initiated under section 153A, the assessment order passed in respect of Mr. Simbu pertaining to a particular assessment year was annulled by the Income-tax Appellate Tribunal in its order passed on 28.1.2010. The same was received on 28.2.2010 by the jurisdictional Commissioner of Income-tax. Does the Department have any power to complete the assessment subsequent to such annulment? If yes, within what time limit? (4 Marks)
- (D) What will be the consequences when Mr. Raghav made payment of Rs.75,000 in cash to a travel agent for his travel to Saudi Arabia to be undertaken for business purposes by quoting intentionally the wrong PAN? Would your answer be different if such cash payment was made for his travel to Nepal, instead of Saudi Arabia? (4 Marks)

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Answer

- (A) As per section 220(6), where an assessee has presented an appeal under section 246A, the Assessing Officer may, in his discretion and subject to such conditions as he may think fit to impose in the circumstances of the case, treat the assessee as not being in default in respect of the amount in dispute in the appeal, even though the time for payment has expired, as long as such appeal remains undisposed of.

Being a quasi-judicial authority, the powers should be exercised judicially, keeping in mind that –

- (a) The power under section 220(6) is coupled with a duty to take into consideration all relevant grounds. It should not be exercised arbitrarily or, capriciously or should not be based on matters extraneous or irrelevant.
 - (b) The Assessing Officer should apply his mind to the relevant factors such as the assessment history of the assessee, his conduct and co-operation to the Department, the points raised in appeal, chances of recovery in case the appeal is dismissed, the hardship to the assessee by insistence on immediate payment, etc.
 - (c) He must remember that he is not the final arbiter of the dispute involved, but only the first amongst the statutory authorities. [*Rajan Nair (N) v ITO (1987) 165 ITR 650 (Ker.)*].
- (B) The profit-linked deductions in Chapter VIA are susceptible to sizable manipulation by the taxpayers who have, in the past, resorted to claiming deduction under more than one section in respect of the same profits by taking advantage of the overlap of provisions of the different sections.

In order to prevent such manipulation by tax payers, section 80A has been amended to provide that -

- (1) the profits and gains allowed as deduction under section 10A or section 10AA or section 10B or section 10BA or under any provision of Chapter VIA under the heading "C.-Deductions in respect of certain incomes" in any assessment year, shall not be allowed as deduction under any other provision of the Act for such assessment year.
 - (2) the deduction, referred to in (1) above, shall not exceed the profits and gains of the undertaking or unit or enterprise or eligible business, as the case may be.
 - (3) No deduction under any of the provisions referred to in (1) above, shall be allowed if the deduction has not been claimed in the return of income.
- (C) As per section 153A(2), if any proceedings initiated under section 153A or any order of assessment or reassessment made under section 153A(1) has been annulled in any appeal or other legal proceeding, the abated assessment or reassessment relating to any assessment year shall stand revived with effect from the date of receipt of the order of such annulment by the Commissioner. If the order of annulment is set aside, such revival shall cease to have effect [Sub-section (2) of section 153].

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The time limit for completion of such assessment or reassessment shall be one year from the end of the month in which the abated assessment revives or within the period already specified in section 153 or in sub-section (1) of section 153B, whichever is later.

Explanation 1 to section 153 provides for exclusion of certain periods as specified therein in computing the period of limitation for the purposes of section 153. If after exclusion of such time period, the period of limitation available to the Assessing Officer is less than 60 days, such remaining period shall be extended to 60 days and the period of limitation shall be deemed to be extended accordingly.

The period commencing from the date of annulment of a proceeding or order of assessment or reassessment referred to in sub-section (2) of section 153A till the date of the receipt of the order setting aside the order of such annulment by the Commissioner, shall be excluded in computing the period of limitation for the purposes of section 153B.

- (D) If a person who is required to quote his permanent account number in any document referred to in section 139A(5)(c), quotes a number which is false, and which he either knows or believes to be false or does not believe to be true, the Assessing Officer may direct that such a person shall pay by way of penalty a sum of Rs.10,000 under section 272B(2).

In the given case, if Mr. Raghav travels to Saudi Arabia and pays his travel agent cash in excess of Rs.25,000, such a transaction is covered by section 139A(5)(c) and therefore, Mr. Raghav has to quote his PAN. Mr. Raghav has to be given an opportunity of being heard in the matter. If Mr. Raghav is not able to prove that there was a reasonable cause for the said failure, penalty under section 272B(2) would be imposable.

Also, the above expenditure would be disallowed in computing the business income of Mr. Raghav under section 40A(3) of the Income-tax Act, 1961, since the cash payment exceeds Rs.20,000.

Travel to a foreign country does not include, for the purpose of section 139(5)(c), travel to neighbouring countries. Therefore, in case Mr. Raghav travels to Nepal instead of Saudi Arabia, payment to the travel agent in excess of Rs.25,000 would not be covered under section 139(5)(c), and therefore, penalty under section 272B(2) would not be attracted.

Question 5

- (A) *Siddharth Hospitals Pvt. Ltd., the assessee, has recently been accorded recognition by several insurance companies to admit and treat patients on cashless hospitalization basis. Payment to the assessee hospital will be made by Third Party Administrators (TPA) who will process the claims of the patients admitted and make the payments to the various hospitals including the assessee. All TPAs are corporate entities. The assessee wants to know whether the TPAs are bound to deduct tax at source under section 194J or under section 194C.* (4 Marks)
- (B) *Richie Rich Real Estates, a partnership firm engaged in real estate business, sold a land for Rs.50 lacs. The buyer was a stranger to the assessee firm. The valuation adopted by the stamp valuation authority was Rs.60 lacs. The Assessing Officer wants to adopt the*

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value of Rs.60 lacs for computing the profit arising from the sale of land, by invoking the provisions of section 50C. Is the same justified? (4 Marks)

- (C) The assessee, Pandey Co-operative Housing Society, is a registered co-operative housing society, formed with the objective of maintaining the property owned by it, to effect repairs and maintenance of the common property of the members, and to confer to the members, the usual rights and privileges. For the assessment year 2010-2011, the assessee has received Rs.3 lacs as transfer fees from the transferor members and like amount from the transferees, who at the time of transfer, were not members of the society. Discuss the exigibility to tax the aforesaid receipts in the hands of the assessee. (4 Marks)
- (D) There is a private specific trust in which the shares of the beneficiaries are certain. Mr. L and Mr. M are the trustees. The beneficiaries are all minors and there are several items of assets as envisaged by section 2(ea). Mr. B, the father of the minor children also has taxable net wealth. What is the best possible manner in which the Assessing Officer should complete the assessment of the trust, so as to maximize the tax revenue? (4 Marks)

Answer

- (A) This issue has been clarified by the CBDT Circular No.8/2009 dated 24.11.2009. As per provisions of section 194J(1), any person, not being an individual or a Hindu Undivided Family, who is responsible for paying to a resident any sum, *inter alia*, by way of fees for professional services, shall, at the time of credit of such sum to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct an amount equal to ten per cent of such sum as income-tax on income comprised therein. Further, as per Explanation (a) to section 194J "professional services" includes services rendered by a person in the course of carrying on medical profession.

The services rendered by hospitals to various patients are primarily medical services and, therefore, the provisions of section 194J are applicable on payments made by TPAs to hospitals etc. Further, for invoking provisions of section 194J, there is no stipulation that the professional services have to be necessarily rendered to the person who makes payment to hospital. Therefore, TPAs who are making payment on behalf of insurance companies to hospitals for settlement of medical/insurance claims etc. under various schemes including Cashless Schemes are liable to deduct tax at source under section 194J on all such payments to hospitals etc.

In view of the above, all such transactions between TPAs and hospitals would fall within the ambit of provisions of section 194J.

- (B) Section 50C(1) enjoins that where the consideration received or accruing as a result of the transfer by an assessee of a capital asset, being land or building or both, is less than the value adopted or assessed or assessable by the "stamp valuation authority" for the purpose of payment of stamp duty in respect of such transfer, the value so adopted or assessed or assessable shall for the purposes of section 48, be deemed to be the full value of the consideration received or accruing as a result of such transfer.

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In *CIT v. Thiruvengadam Investments Private Limited* (2010) 320 ITR 345 (Mad.), the issue under consideration was whether the provisions of section 50C are applicable where the property is held as a business asset.

The High Court pointed out that it was not in dispute that the assessee was engaged in real estate business. As the property in the hands of the assessee was treated as a business asset and not as a capital asset, there is no question of invoking the provisions of section 50C. Section 50C pertains to determining the full value of consideration of a capital asset.

Therefore, in the given case, section 50C cannot be invoked and since the sale was to an outsider, the sale value of Rs.50 lakh has to be taken for computing the profits from sale of land.

Hence, the Assessing Officer is not justified in invoking the provisions of section 50C in this case.

- (C) Transfer fees received by a co-operative housing society, whether from outgoing or from incoming members, is not liable to tax on the ground of principle of mutuality where the predominant activity of such co-operative society is maintenance of property of the society. It was so held by the Bombay High Court in *Sind Co-op Housing Society v. ITO* (2009) 317 ITR 47.

Further, section 28(iii), which provides that income derived by a trade, professional or similar association from specific services performed for its members shall be treated as business income, can have no application since the co-operative housing society is not a trade or professional association.

Therefore, Rs.3 lakhs received as transfer fees by Pandey Co-operative Housing Society from its transferor members and its transferees, is not chargeable to tax.

- (D) As regards the applicability of wealth-tax in case of a private specific trust, the two possible views in this regard are as follows -

The first view is that since an individual is an assessable entity as per section 3 of the Wealth-tax Act, 1957, and as per the General Clauses Act, "individual" includes "individuals" as well, the trustees of a trust (Mr. L and Mr. M, in this case) may be charged to wealth-tax, of course, with reference to only those assets which fall within the definition of section 2(ea) of the Wealth-tax Act, 1957.

It is also possible to take a view that since the minor children have beneficial interest, the value of their interest in the assets of the trust, determined in the manner laid down in Schedule III, are to be included in the net wealth of the father, Mr.B, as per section 4(1)(a)(ii).

Question 6

- (A) *Examine the correctness or otherwise of the following cases/matters/issues in the context of provisions contained in the Income-tax Act, 1961 relevant/applicable for the assessment year 2010-2011:*

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- (a) PNF Ltd. made an entry on 11-06-2009 in its books of account relating to liability against the purchase of material from M/s. Roma Services. The Assessing Officer gathered that M/s. Roma Services had failed to file its return of income and also reported to have lost the books of account for the year ended 31-03-2010. The Assessing Officer having suspicion in mind on these two grounds, got conducted an inquiry and noted that the whole transaction of the purchases shown by PNF Ltd. was not genuine but bogus and the entry made in the books of account as a liability was also a paper entry. The Assessing Officer, therefore, treated the liability shown by PNF Ltd. as income chargeable to tax under section 68 of the Act. PNF Ltd., however, contends that section 68 can be invoked only in respect of cash credits and not otherwise.
- (b) Nargis, working as Regional Area Sales Manager of Pincer Marketing Ltd., was paid salary and a commission based as a percentage on the volume of sales effected by her. Nargis claimed the expenses incurred by her for earning the commission in the return of income, which were disallowed by the Assessing Officer.
- (c) B. Ltd., the holding company of A. Ltd., had entered into an agreement by which the textile unit belonging to it was transferred to A. Ltd. The agreement also stipulates for the protection of service conditions and continuity of service of the workmen employed in the textile unit so transferred to/taken over by A. Ltd. B. Ltd. delivered the possession of the properties to A. Ltd. and also transferred all the employees working in the textile unit with the benefit of continuity of service and protection of service conditions. A. Ltd. claimed deduction for the amount of gratuity payment in respect of the workers of erstwhile textile unit of B. Ltd., who had retired during the relevant previous year. The Assessing Officer disallowed this claim of A. Ltd. on the ground that the liability towards gratuity payment to the employees of erstwhile company for the period prior to the takeover of the unit is not a revenue expenditure but is a capital expenditure. (9 Marks)
- (B) The Finance (No.2) Act, 2009, for facilitating expeditious resolution of disputes relating to international transactions involving transfer pricing and foreign companies, has provided for "alternate dispute resolution mechanism". In this context, you are required to answer the following:
- (i) What meanings have been assigned to "dispute resolution panel" and the "eligible assessee" under this mechanism?
- (ii) When can a grievance for resolution be filed by an assessee?
- (iii) What evidences are being considered by the panel to redress the grievance of the assessee? (7 Marks)

Answer

- (A) (a) The provisions of section 68 are invoked where any sum is found credited in the books of an assessee maintained for any previous year for which the assessee either does not offer any explanation about the nature and source thereof or the explanation offered is not, in the opinion of the Assessing Officer, satisfactory. In

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the present case, a credit entry is appearing in the books of PNF Ltd. indicating purchases of material made from M/s Roma Services. The transaction, on the basis of inquiry conducted by the Assessing Officer, was found to be bogus and a paper entry and was therefore treated to be income chargeable to tax as per section 68. It clearly suffices that the assessee had failed to explain the credit entry to the satisfaction of the Assessing Officer.

The Madhya Pradesh High Court in the case of *V.I.S.P. (P) Ltd. v. CIT (2004) 136 Taxman 482*, on the identical facts, had held that if the liability shown in the accounts is found to be bogus and no plausible and reasonable explanation is offered by the assessee, the same can be added as the income of the assessee and be brought to tax.

Therefore, PNF Ltd. is not correct in contending that section 68 can be invoked only in respect of cash entries.

Note – (1) However, where the purported purchases have been disallowed while computing business income, then, section 68 cannot be invoked again for the credit entry.

(2) It may also be noted that in a case where the purchases are not bogus though the names of the persons from whom the purchases have been made are bogus, and the Assessing Officer has accepted the purchases, sales as also the trading result disclosed by the assessee, then, the provisions of section 68 could not be attracted on the purchases made on credit [*CIT v. Pancham Das Jain 205 CTR 444*]

- (b) The facts of this case are similar to the case decided by the Madras High Court in *CIT v. R. Rajendran (2004) 135 Taxman 95*, where it was held that since the assessee was employed as a regional sales manager and the commission paid to him is based on the volume of sales effected, such commission was obviously paid to the employee as an encouragement to effect a higher level of sales. The commission paid in addition to what the employee was getting as a fixed salary would also constitute/form part of salary. When the commission is chargeable as salary, then no deduction is allowable in respect of any expenditure incurred to earn the commission.

Therefore, in this case, the claim made by Nargis is not valid and the expenses incurred for earning commission are not allowable as deduction while computing her salary income.

- (c) The facts given in the problem are identical to the facts of the case decided by the Madras High Court in *Sree Akilandeswari Mills Pvt. Ltd. v. Dy. CIT (2005) 274 ITR 1*, where the Court has held that “the company, by virtue of the deed of transfer, had taken over the liability towards the employees of the transferor company and on the date of transfer, the liability relating to the gratuity was an ascertained liability on the basis of actuarial valuation. This also formed an integral part of the sale consideration to be discharged by making actual payment to the employee in subsequent years. The payment of gratuity, thus, was in the nature of a capital expenditure.”

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In the given problem, A. Ltd., by virtue of the deed of transfer, had taken over the possession of the textile unit of B. Ltd. with a liability of the transferor company towards the continuity of service and the protection of service conditions of the employees on the date of transfer. The gratuity liability was, thus, also an ascertained liability on the basis of actuarial valuation payable to the employees retiring after the date of transfer.

Hence, in this case, the expenditure incurred by A Ltd. towards discharge of the gratuity liability of the employees of the unit taken over from B Ltd., is a capital expenditure. Therefore, the reasoning of the Assessing Officer is correct.

Note – The Supreme Court, in *CIT v. Hoogly Mills Co. Ltd.* 287 ITR 333, held that such expenditure was a capital expenditure as it was incurred for acquiring an asset of enduring nature. However, no depreciation is allowable in respect of gratuity liability even if it is regarded as capital expenditure.

- (B) (i) The term "Dispute Resolution Panel" has been defined to mean a collegium comprising of three Commissioners of Income-tax constituted by the Board for this purpose. The term "Eligible Assessee" means any person in whose case the variation referred to in section 144C(1) in the income or loss returned arises as a consequence of the order of the Transfer Pricing Officer passed under sub-section (3) of section 92CA and any foreign company.
- (ii) The Assessing Officer shall forward a draft of the proposed order of assessment to the eligible assessee and on receipt of such order, the eligible assessee shall, within thirty days of the receipt of the draft order, file his acceptance of the variations to the Assessing Officer or file his objections, if any, to such variation, with the Dispute Resolution Panel and the Assessing Officer.
- (iii) The Dispute Resolution Panel shall, in a case where any objections are received, take into consideration (a) the draft order; (b) the objections filed by the assessee; (c) the evidence furnished by the assessee; (d) the report, if any, of the Assessing Officer, Valuation Officer or Transfer Pricing Officer or any other authority; (e) the records relating to the draft order; (f) the evidence collected by, or caused to be collected by it; and (g) the result of any enquiry made by or caused to be made by it, and issue such directions, as it thinks fit, for the guidance of the Assessing Officer to enable him to complete the assessment.

Question 7

Answer any **four** out of the following:

- (A) If an assessee does not claim any expenditure with respect to exempt income then write down the prescribed methods that the Assessing Officer would follow to determine the amount of expenditure incurred in relation to exempt income. (4 Marks)
- (B) "Capital expenditure cannot be said to be application of income by a trust under section 11(1)(a) of the Income-tax Act, 1961." Examine the validity of this statement. (4 Marks)
- (C) Discuss the taxability of the following receipts in the hands of Mr. H under the Income-tax Act, 1961 -

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- (i) Gets Rs.1,75,000 in cash as a marriage gift from his grandfather on 13-02-2010.
 - (ii) Received 100 shares of B Ltd., the fair market value of which was Rs.1,00,000 on his birthday, 21-04-2009 from his friend Mr. J.
 - (iii) Received Rs.51,000 from his sister living in UK on 21-09-2009.
 - (iv) Wrist Watch valued at Rs.60,000 from his friend on 01-12-2009. (4 Marks)
- (D) The Director General of Income Tax after getting the information that Mr. Mogambo is in possession of unaccounted cash of Rs.50 lakhs, issued orders by invoking powers vested in him as per section 131(1A) of the Act, for its seizure. Is the order for seizure of cash issued by the Director General of Income Tax correct? If not, does the Director General of Income Tax have any other power to seize such cash? (4 Marks)
- (E) The assessment of Vasudha Polyesters Pvt. Ltd. for the assessment year 2008-09 was completed under section 143(3). On 12-3-2010, the Assessing Officer reopened the assessment in proper manner. The reason recorded was that certain expenditure which ought to have been disallowed under section 14A was not done and hence there has been escapement of income. During the course of hearing, he wants to touch upon some other aspect also, which is not covered by the reason recorded. The assessee objects to the same, contending that the same is not permissible. Examine the correctness of the assessee's contention. (4 Marks)

Answer

- (A) If the assessee claims that no expenditure has been incurred by him in relation to exempt income, the Assessing Officer shall proceed to determine the amount of expenditure incurred in relation to such exempt income in accordance with the method prescribed in Rule 8D.

Rule 8D lays down the method for determining amount of expenditure in relation to income not includible in total income.

If the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with –

- (a) the correctness of the claim of expenditure by the assessee; or
- (b) the claim made by the assessee that no expenditure has been incurred in relation to exempt income for such previous year,

he shall determine the amount of expenditure in relation to such income in the manner provided hereunder -

The expenditure in relation to income not forming part of total income shall be the aggregate of the following:

- (i) the amount of expenditure directly relating to income which does not form part of total income;
- (ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an

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amount computed in accordance with the following formula, namely :

$$A \times \frac{B}{C}$$

Where,

A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

- (iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

'Total assets' means total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

- (B) This statement is not valid, since, if the income is applied for the purchase of a capital asset for the purposes of the trust, it would still constitute application of income for charitable purpose. If an assessee invests in construction of a building so as to augment its resources for fulfilling the objectives of the institution, the same would be considered as application for charitable purpose. Similarly, repayment of loan taken for construction of a building or construction of a commercial complex so as to augment the resources of the trust would also amount to application of income for charitable purposes.

- (C) (i) **Cash of Rs.1,75,000 received from grandfather as marriage gift** : Where any sum of money is received without consideration by an individual or HUF and the aggregate value of all such sums received during the previous year exceeds Rs.50,000, the whole of the aggregate value would be included in the total income of the individual under section 56(2)(vii). However, any sum received from a relative is exempt from the applicability of this provision.

Relative includes ascendant or descendant of the individual. Since grandfather is a lineal ascendant, the amount of Rs.1,75,000 received from him is not chargeable to tax.

In any case, any sum of money received on the occasion of marriage of the individual is exempt, whether or not received from a relative.

- (ii) **Shares received from a friend on 21.04.2009** : Value of shares of B Ltd. gifted by Mr. J on 21.04.2009 is not taxable since only receipt of property without consideration on or after 1st October, 2009 is chargeable to tax under section 56(2)(vii).
- (iii) **Sum of Rs.51,000 received from sister** : Where any sum of money is received without consideration by an individual or HUF and the aggregate value of all such sums received during the previous year exceeds Rs.50,000, the whole of the

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aggregate value would be included in the total income of the individual under section 56(2)(vi). However, any sum received from a relative is exempt from the applicability of this provision. Since sister is a relative for the purpose of this clause, the amount of Rs.51,000 received from her would be exempt.

- (iv) **Wrist Watch valued at Rs.60,000 received from a friend on 1.12.2009** : With effect from 1st October, 2009, receipt of property without consideration would attract the provisions of section 56(2)(vii). However, the provisions of section 56(2)(vii) are attracted only in respect of "property" as defined in that section. Since wrist watch is not included in the said definition of "property", the receipt of the same without consideration would not attract the provisions of section 56(2)(vii).

- (D) The powers under section 131(1A) deal with power of discovery and production of evidence. They do not confer the power of seizure of cash or any asset. The Director General, for the purposes of making an enquiry or investigation relating to any income concealed or likely to be concealed by any person or class of persons within his jurisdiction, shall be competent to exercise powers conferred under section 131(1), which confine to discovery and inspection, enforcing attendance, compelling the production of books of account and other documents and issuing commissions. Thus, the power of seizure of unaccounted cash is not one of the powers conferred on the Director General under section 131(1A).

However, under section 132(1), the Director General has the power to authorize any Additional Director or Additional Commissioner or Joint Director or Joint Commissioner etc. to seize money found as a result of search [Clause (iii) of section 132(1)], if he has reason to believe that any person is in possession of any money which represents wholly or partly income which has not been disclosed [Clause (c) of section 132(1)]. Therefore, the proper course open to the Director General is to exercise his power under section 132(1) and authorize the Officers concerned to enter the premises where the cash is kept by Mr. Mogambo and seize such unaccounted cash.

- (E) The Assessing Officer may, in course of proceeding under section 147, assess or reassess any other income which has escaped assessment and which comes to his notice subsequently in the course of such proceeding.

Some Courts have ruled that the Assessing Officer should confine reassessment proceedings only to issues in respect of which the reasons have been recorded for reopening of the assessment. He cannot extend the proceedings to issues for which no reasons have been recorded. This interpretation, however, does not reflect the correct legislative intent.

In order to clarify the correct legislative intent, Explanation 3 has been inserted in section 147 by the Finance (No. 2) Act, 2009, with retrospective effect from A.Y. 1989-90, to provide that the Assessing Officer may assess or reassess the income in respect of any issue (which has escaped assessment) which comes to his notice subsequently in the course of proceedings under section 147, even though the reason for such issue does not form part of the reasons recorded under section 148(2).

Therefore, the contention of the assessee is not correct.