

PAPER – 7 : DIRECT TAX LAWS

Q. No. 1 and Q. No. 7 are compulsory and
Attempt any four out of rest of the questions.

Question 1

- (a) The net profit of Siddharth Electricals Ltd. for the year ended on 31.3.08 arrived at Rs. 47 lacs after Debit/Credit of the following: (14 Marks)

- (i) Development charges of Rs. 75,000 paid to Government on a piece of industrial land purchased in the preceding year.
- (ii) Amount of Rs. 5 lacs being the cost of stocks lost in fire.
- (iii) Expenditure of Rs. 50,000 incurred on development and perfecting the designs used in manufacturing.
- (iv) Amount of Rs. 1 lac paid for obtaining an expert opinion for setting up a factory.
- (v) Expenditure of Rs. 1,25,000 incurred on replacement of wooden trolleys by stainless steel trolleys.
- (vi) Expenditure of Rs. 3.50 lacs incurred on developing and making of gardens and lawns in factory compound.
- (vii) Commodity Transaction tax of Rs. 5,000 paid on the future derivative transactions, income from which stands credited in P&L account.
- (viii) Dividend of Rs. 1,25,000 on Mutual Fund units.
- (ix) Interest of Rs. 12,500 received on an income-tax refund.
- (x) Rent of Rs. 3 lacs for letting out part of the office building.

Compute the income and the amount of tax payable for Asst. year 2008-09 keeping into consideration the following further information:

- (1) Amount of Rs. 40,000 recovered from a debtor whose amount was claimed as bad debts in Asst. year 05-06.
- (2) Short-term capital gain of Rs. 2 lacs on the sale of listed shares was credited in the investments.
- (3) Long-term Capital gains of Rs. 10 lacs on sale of piece of land credited in the block of building was earned on 18.9.07. The entire sales consideration was invested in the bonds as specified in Section 54EC on 28.3.2008.
- (4) Payment of labour charges bill of Rs. 25,000 which was credited in the books on 12.3.07 was made in Cash on 6.8.07 Rs. 15,000 and on 6.9.07 Rs. 10,000.

- (b) Atul Housing Finance Co. Ltd. provides you the following particulars from its accounts for the year ended on 31.3.2008 and seeks your opinion as to availability of deduction under Section 36(1) (viii) and the amount thereof: (6 Marks)

Profits from the business computed as per part D of Chapter IV of the Act but before claiming deduction u/s 36(i) (viii) Rs. 560 lacs

-Paid-up share Capital	Rs. 500 lacs
-General Reserve	Rs. 100 lacs
-Balance in reserve created u/s 36(i) (viii) on 31.3.2007	Rs. 1,100 lacs

Answers

- (a) Computation of total income of Siddharth Electricals Ltd for the A.Y. 2009-2010.

	Amount (Rs.)
Income from House Property	
Rental income from letting of part of office building under section 23(1)(b)	3,00,000
Less: Deduction under section 24(a) for repairs @ 30%	90,000
	2,10,000
INCOME FROM BUSINESS	
Net profit as per P & L Account	47,00,000
Add: Expenses charged but which are not allowable or to be considered separately	
-Development charges paid on land are capital in nature	75,000
- Loss of stocks of Rs.5 lakhs in fire is an allowable loss as revenue expenditure	Nil
Expenditure on developing & perfecting designs is revenue expenditure	Nil
Payment for an expert opinion for setting up a new factory is a capital expenditure	1,00,000
Expenditure on replacement of trolleys is a revenue expenditure	Nil
Expenditure on developing and making gardens & lawns in factory area is a revenue expenditure	Nil
Commodity transaction tax for which income is credited in P & L Account is disallowed	5,000
	48,80,000

Less: Income/items credited in P & L Account to be considered under other heads

- Dividend on Mutual Funds units	1,25,000	
- Interest on Income-tax refund	12,500	
- Rent of office building	<u>3,00,000</u>	<u>4,37,500</u>
		44,42,500

Add: Allowable bad debts when realized as per section 41(4)

40,000
44,82,500

Less: Depreciation on building to the extent of gains of land wrongly credited to block on 18.9.07 being 10% of Rs.10 lakhs

1,00,000
43,82,500

Income under Capital Gains

Short-term Capital Gains of listed shares	2,00,000	
Long-term Capital Gains on sale of land	10,00,000	
Less: Deduction u/s 54EC not available as bonds were purchased after 6 months	<u>Nil</u>	12,00,000
Income from other sources		
Dividend on Mutual Funds	1,25,000	
Less: Dividend income exempt u/s 10(35)(a)	<u>1,25,000</u>	Nil
Interest on Income-tax refund		<u>12,500</u>
Total Income		<u>58,05,000</u>

Computation of tax on total Income

Tax on Total Income excluding capital gains (Rs.58,05,000 – 12,00,000)@30%	13,81,500
Add: Tax on LTCG on sale of land @ 20% on Rs.10 lakhs as per section 112	2,00,000
Tax on STCG on sale of listed shares @ 10% on Rs. 2 lakhs as per section 111A	<u>20,000</u>
	16,01,500
Add: Education cess @ 2%	32,030
Add: Secondary and Higher Education Cess@1%	<u>16,015</u>
Total tax	<u>16,49,545</u>

Notes :

- (i) Development charges paid on land to Government is capital expenditure and, therefore, not deductible under section 37(1). [Jaswant Trading Co vs CIT (1995) 212 ITR 293(Raj)]
- (ii) Loss of Stock of Rs 5 Lacs in fire is an allowable loss and, therefore allowed as a revenue expenditure.
- (iii) Expenditure on developing and perfecting design is revenue expenditure and, therefore allowed as a deductible expenses. [CIT vs Praya Tools Ltd (1986) 157 ITR 282]
- (iv) Payment for an expert opinion for setting up a new factory is capital expenditure. [CIT Vs SLM Maneklal Industries Ltd (1977) 107 ITR 133.]

There is also a similar decision in relation to expenses for expert opinion for setting up a new factory. CIT Dig Vijay cement Co Ltd (1986) 159 ITR 253 (Guj), (1986)54 ITR (Guj) 274.

- (v) Expenditure on replacement of trolley is revenue expenditure and is hence, deductible under section 37(1) [CIT VS Satyadev Chemical Ltd (1997) 226 ITR 95]. There is also a similar decision in relation to expenses under reference in the case of [Standard Mills Co. Ltd. Vs CIT (1990) 181 ITR 233(Bom)]
- (vi) Expenditure on developing and making gardens & lawns in factory area is revenue expenditure. Steel Tubes of India Ltd vs CIT (1996) 130 CTR 547 . Since such expenditure on developing and making gardens & lawns in factory area is a revenue expenditure as the plantation or garden necessary to avoid pollution of environment and create congenial atmosphere. Moreover, similar decision has been passed by in the case of Hindusthan Electro Graphites Ltd vs CIT (1996) 218 ITR 688(MP)
- (vii) Commodity transaction tax is a disallowed expenses and , therefore, not allowed as a deductible expense.
- (viii) Any income by way of, income received in respect of units of a Mutual Fund specified under 10(23D) is a an exempted income under section 10(35)(a). Hence, it has been exempted while computing the Total Income.
- (ix) Interest received on income –tax refund is an income under the head Income from other Sources. Hence, it has been deducted while computing income under the Profit and Gains of Business and Profession.
- (x) Rent of Rs.3 lakh is an income under the head Income form House Property and, therefore it has been deducted while computing income Profit and Gains of Business and Profession. Accordingly, it has been taken into consideration while computing income from under the head Income form House Property.
- (xi) As per section 41(4), if a deduction has been allowed in respect of a bad debt under section 36, and subsequently the amount recovered in respect of such debt is more than the amount due after the allowance had been made, the excess shall be

deemed to be the profits and gains of business or profession and will be chargeable as income of the previous year in which it is recovered, Accordingly, amount of Rs.40,000 recovered from debtor whose amount was claimed as bad debt in Assessment Year 2005-06 to be the profits and gains of business or profession and will be chargeable as income of the previous year 2007 -2008 in which it is recovered.

- (xii) Section 111A provides for a concessional rate of tax (i.e. 10%) on the short-term capital gains on transfer of an equity share in a company such transaction should be chargeable to securities transaction tax. Therefore, short-term capital gain of Rs.2 lakh on sale of listed shares is taxable under section 111A at the rate of 10%.
- (xiii) Section 54EC provides that, the capital gain arising from transfer of a long-term capital asset shall be exempt from tax if such capital gain is invested in a long-term specified asset as defined under this section within 6 months after the date of such transfer. Since, the long-term gain has been not been invested within 6 months after the date of such transfer, exemption under section 54EC has been denied.
- (xiv) Section 40A(3) lays down that, if an expenditure has been allowed as deduction in any previous year on due basis, and payment exceeding Rs.20,000 has been made in the subsequent year otherwise than by account payee cheque or account payee bank draft, then the payment so made shall be deemed to be the income of the subsequent year in which such payment has been made. Since the payments did not exceed Rs. 20000, it will have no impact on the A.Y. 2008-2009. The payment of labour charges bill in cash during the year will not be having any impact on the income of current year.
- (b) According to section 36(1)(viii), a special deduction is allowed to specified entities engaged in eligible business. The section provides that in order to avail such deduction a special reserve is required to be created and maintained by a specified entity. The quantum of deduction, however, should not exceed 20% of the profits derived from eligible business computed under the head "Profits and gains of business or profession" carried to such reserve account.

The eligible business for different entities specified are given in the table below –

Specified entity	Eligible business
1. Financial Corporation specified in section 4A of the Companies Act, 1956	Business of providing long-term finance for -
Financial corporation which is a public sector company	(i) Industrial or agricultural development or development of infrastructure facility in India; or
Banking company	(ii) construction or purchase of houses in India for residential purposes.
Co-operative bank (other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank)	

- | | | |
|----|--|---|
| 2. | A housing finance company | Business of providing long-term finance for the construction or purchase of houses in India for residential purposes. |
| 3. | Any other financial corporation including a public company | Business of providing long-term finance for development of infrastructure facility in India. |

However, where the aggregate amount carried to such reserve account exceeds twice the amount of paid up share capital and general reserve, no deduction shall be allowed in respect of such excess.

Atul Housing Finance Co. Ltd. is according to it a specified entity as per Explanation (a)(vi) being engaged in carrying on the eligible business as specified in Explanation (e) and accordingly entitle to claim the deduction.

The Amount of deduction will be :-

- | | | |
|---|--|------------|
| - | Total paid up share capital and general reserve | 600 lakhs |
| - | Maximum amount of deduction can be twice of capital and reserve | 12 lakhs |
| - | Balance in reserve on 1.4.07 as per section 36(1)(viii) | 1200 lakhs |
| - | 20% of profits for the year
(20% of 560 lakhs) | 112 lakhs |
| - | Maximum deduction available is restricted to the maximum limit of reserve under section 36(1)(viii)(Rs.1200 lakhs – Rs.1100 lakhs) | 100 lakhs |

The deduction available to the company for A.Y. 2008-09 is therefore Rs.100 lakhs.

Question 2

- (a) Whether the following be treated as transfer of capital asset for the purpose of tax under capital gain: (4 Marks)
- (i) Transfer of house property in a transaction of reverse mortgage.
 - (ii) Conversion of foreign currency bonds into shares.
- (b) State in brief about the chargeability of the following to Fringe Benefit Tax in A.Y.2008-09: (3 Marks)
- (i) Expenses on foreign travel by the partners of a firm for the purposes of its business.
 - (ii) Distribution of free samples and expenses on display of a newly launched product.
 - (iii) Contribution by the employer to an approved superannuation fund for employees.
- (c) Examine the correctness of the following statements: (5 Marks)

- (i) Section 2(14) of the Act excludes all items of movable property which are held for personal use of the assessee or any member of his family.
- (ii) The Appellate Tribunal is empowered to grant indefinite stay for the demand disputed in appeals before it.
- (d) What meaning has been assigned to "Venture Capital Undertaking" in section 10(23FB) of the Act? (4 Marks)

Answer

- (a) (i) Clause (xvi) of section 47 has been inserted to provide that any transfer of a capital asset in a transaction of reverse mortgage under a scheme made and notified by the Central Government would not amount to a transfer for the purpose of capital gains. Moreover, section 10(43) exempts any amount received by an individual as a loan, either in lump sum or in instalment, in a transaction of reverse mortgage referred to in clause Clause (xvi) of section 47, since, it is intended to secure a stream of cash flow against the mortgage of residential house and not to alienate the property. However, capital gains tax liability would be attracted only at the stage of alienation of the mortgaged property by the bank/housing finance company for the purposes of recovering the loan.
- (ii) In order to encourage the flow of foreign exchange to India, the Government, in 1992, had allowed established Indian companies to issue foreign currency convertible bonds (FCCB), with special tax scheme for non-resident investors. The Government has now allowed established Indian companies to issue foreign currency exchangeable bond (FCEB). These are bonds expressed in foreign currency and the principal and interest in respect of such bonds is payable in foreign currency. The Central Government, has vide Notification No.G.S.R.89(E) dated 15.2.2008, introduced the "Issue of Foreign Currency Exchangeable Bonds Scheme, 2008" for facilitating the issue of FCEBs by Indian companies. The difference between FCCB and FCEB is that while FCCBs can only be converted into shares of the issuing company, FCEBs can also be converted into or exchanged for the shares of a group company. Therefore, in order to provide an equitable treatment to FCEBs, clause (xa) has been inserted in section 47 to provide that the conversion of FCEBs into shares or debentures of any company shall not be treated as a 'transfer'.
- (b) (i) Section 115WB(2)(Q) lays down that expenses incurred on tour and travel (including foreign travel) are to be considered as fringe benefits. Further, section 115WC(1)(e) provides that 5% of the expenses incurred on tour and travel including foreign travel would be considered as the value of fringe benefit.
- (ii) As per proviso to section 115WB(2)(D)(vii) and section 115WB(2)(D)(v), distribution of samples of the new product and display of product are not be considered as fringe benefit.
- (iii) As per proviso to section 115WC(1)(b), contribution by an employer to an approved superannuation fund under section 115WB(1)(c) upto Rs.1 lakh per employee is not to be regarded for the value of fringe benefit.

- (c) (i) Sub-clause (ii) of section 2(14) provides that all movable property including wearing apparel and furniture held for the personal use by the assessee or any member of his family dependent on him are not capital assets as per section 2(14). However, the following movable property held for the personal use by the assessee or any member of his family dependent on him are capital assets -

- (a) jewellery
- (b) archaeological collections
- (c) drawings
- (d) paintings
- (e) sculptures, or
- (f) any work of art

Hence, the statement "Section 2(14) of the Act excludes all items of movable property which are held for personal use of the assessee or any member of his family" is incorrect.

- (ii) Section 254(2A) provides that where an order of stay has been passed and the appeal has not been disposed of within the specified period of 180 days from the date of such order, the Appellate Tribunal may extend the period of stay or pass an order of stay for a further period or periods, as it thinks fit, on an application made in this behalf by the assessee and on being satisfied that the delay in disposing of the appeal is not attributable to the assessee.

However, the aggregate period of stay, including the original stay granted and the extension allowed, cannot exceed 365 days. If such appeal is not disposed of within the period originally allowed or the extended period or periods, the order of stay shall stand vacated after the expiry of such period or periods.

Therefore, the Appellate Tribunal cannot grant stay for indefinite period. Hence, the statement is incorrect.

- (d) Section 10(23FB) defines a venture capital undertaking to mean such domestic company whose shares are not listed in a recognised stock exchange in India and which is engaged in –

- (i) the business of -
 - (A) nanotechnology;
 - (B) information technology relating to hardware and software development;
 - (C) seed research and development;
 - (D) bio-technology;
 - (E) research and development of new chemical entities in the pharmaceutical sector;
 - (F) production of bio-fuels,

- (G) building and operating composite hotel-cum-convention centre with seating capacity of more than three thousand; or
- (H) developing or operating and maintaining or developing, operating and maintaining any infrastructure facility as defined in the Explanation to clause (i) of sub-section (4) of section 80-IA i.e.
 - (1) a road including toll road, a bridge or a rail system;
 - (2) a highway project including housing or other activities being an integral part of the highway project;
 - (3) a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system;
 - (4) a port, airport, inland waterway, inland port or navigational channel in the sea.
- (ii) dairy or poultry industry.

Therefore, exemption under this clause would be available only if the venture capital company/venture capital fund invests in the businesses or industries specified above. In such cases, tax would be payable by the investor under section 115U. If the venture capital company/venture capital fund invests in other businesses or industries, then it would not be eligible for exemption under this clause

Question 3

- (a) Explain in brief about the treatment to be given in each of the following cases under the IT. Act, for A.Y. 08-09: (10 Marks)
 - (i) Pankaj a salaried employee received from his employer medical allowance of Rs.12,000 and reimbursement of Rs. 16,000 on account of medical facilities.
 - (ii) A farmer resident of Jaipur sold his rural agricultural land situated in Nepal and received Indian Rupees 2 lacs over the cost of acquisition of this land.
 - (iii) Radhe received on 11.9.07 gifts each of Rs. 21,000 from his two friends Shiva "and Krishna and of Rs. 51,000 from his sister living in UK.
 - (iv) A loss of Rs. 85,000 was sustained by Simran in the activity of owning and maintaining camels for races.
 - (v) Interest of Rs. 20,000 on bank FDRs received by minor son of Rajesh. These FDRs were made by the minor son out of his earnings from stage acting.
- (b) Who can be treated as an agent of a non-resident foreign collaborator for the purpose of proceedings and/or any other matters under the Income Tax Act? (6 Marks)

Answers

- (a) (i) The medical allowance of Rs. 12,000/-received by Pankaj from his employer shall be chargeable to tax under the head income from salary as per section 17(1).

However, according to proviso (v) of section 17(2)(vi), reimbursement of Rs. 16,000/- on account of medical facilities an amount of Rs.15,000/- will be exempt and balance of Rs.1000/- will be chargeable value of perquisite.

- (ii) According to Sub-clause (iii) of Section 2(14) Rural agricultural land in India i.e. agricultural land in India which is not situated in any specified area are not capital assets. Since, herein the rural agricultural land is situated in Nepal i.e. outside India shall be treated as capital asset and Rs 200000 capital gain arising out of such transfer would be taxable as capital gain under section 45(1)
- (iii) Section 56(2)(vi) provides that where any sum of money is received without consideration by an individual or a Hindu undivided family from any person or persons and the aggregate value of all such sums received during the previous year exceeds Rs.50,000/-, the whole of the aggregate value of such sum shall be included in the total income of such individual or Hindu undivided family under the head "Income from other sources". However, as per proviso (a) to section 56(2)(vi) lays down that any sum received from any relative would be exempted. Explanation to section 56(2)(vi) defines the term "relative". Sister of the individual is included in the said definition. Therefore, gifts received by Radhe on 11.9.2007 from his two friends of Rs 21000 each shall not be included in the total income of Radhe since, the aggregate value of all such sums received during the previous year does not exceed Rs.50,000. Further, the gift from sister living in UK would be exempted as per as per proviso (a) to section 56(1)(vi).
- (iv) Sec 74A(3) lays down the provisions for set-off and carry forward of loss from the activity of owning and maintaining race horses. According to provisions of section 74A(3), the losses incurred by an assessee from the activity of owning and maintaining race horses cannot be set-off against the income from any other source other than the activity of owning and maintaining race horses. Therefore, set-off and carry forward of loss from the activity of owning and maintaining camels is not covered under the section 74A(3) since the scope of this section is confined to the activity of owning and maintaining race horses only. The loss from the activity of owning and maintaining camels for races may be governed by section 72 provided such activity amounts to business. Accordingly, the loss from the activity of owning and maintaining of camels for races can be set-off against any income (other than income from salary) of current year and unadjusted amount shall be carried forward for set off against any business income for a maximum period of 8 assessment years immediately succeeding the assessment year in which the loss was incurred.
- (v) Section 64(1A) provides the provisions for clubbing of minor's income. The section provides that all income accruing or arising to a minor is to be included in the income of his parent, whose total income (excluding the income includible under this section) is greater. However, proviso (a) to section 64(1A) and proviso (b) to section 64(1A) provide that the income derived by the minor from manual work and that from any activity involving his skill, talent or specialised knowledge or experience will not be included in the income of his parent.

Since, interest of Rs. 20,000 on bank FDRs received by minor son of Rajesh does not arise to minor on account of his manual work as per proviso (a) to section 64(1A) nor by activity involving his skill, talent or specialized knowledge or experience as per proviso (b) to section 64(1A) and, therefore such interest should be included in income of Mr. Rajesh or Mrs Rajesh whose income higher.

- (b) Section 2(7) also defines the term 'assessee' to include a representative assessee within its scope. The Assessing Officer is statutorily empowered to issue notice under section 163 to any person to deem him as the agent of the non-resident foreign collaborator.

The term 'agent' should, for this purpose, be taken to include:

- (i) any person in India who is employed by or on behalf of the non-resident; or
- (ii) any person in India who has any business connection with the non-resident within the meaning of section 9(1)(i); or
- (iii) any person in India from or through whom the non-resident is in receipt of any income, whether directly or indirectly; or
- (iv) any person in India who is the trustee of the non-resident; or
- (v) any person in India who, whether resident or non-resident, has acquired by means of a transfer, a capital asset in India.

However, a broker in India who in respect of any transaction does not deal directly with or on behalf of a non-resident principal but deals with or through a non-resident broker should not be deemed to be an agent under section 163(1) in respect of the income attributable to those transactions provided both the following conditions are fulfilled:

- (a) the transactions must be carried on in the ordinary course of business through the first mentioned broker; and
- (b) the non-resident broker must be one who carries on such transactions in the ordinary course of his business and not as a principal.

Question 4

- (a) Explain the meaning of "eligible expense" for the purpose of claiming benefit of Section 35D. (6 Marks)
- (b) Can a trust created for charitable purposes in Feb. 07 having filed application for registration as per section 12A on 11.4.08 claim benefits of Sections 11 and 12 from Asst. Year 07-08 ? (4 Marks)
- (c) Explain the purposes for which the Central Government as per Section 90 of the LT. Act can enter into an agreement with any foreign country. (6 Marks)

Answer

(a) Section 35(1) refers the provisions regarding amortization of preliminary expenses. Section 35(2) lays down the following expenditure are eligible for amortisation:

- (i) Expenditure in connection with - (a) the preparation of feasibility report (b) the preparation of project report; (c) conducting market survey or any other survey necessary for the business of the assessee; (d) engineering services relating to the assessee's business; (e) legal charges for drafting any agreement between the assessee and any other person for any purpose relating to the setting up to conduct the business of assessee.
- (ii) Where the assessee is a company, in addition to the above, expenditure incurred - (f) by way of legal charges for drafting the Memorandum and Articles of Association of the company; (g) on printing the Memorandum and Articles of Association; (h) by way of fees for registering the company under the Companies Act; (i) in connection with the issue, for public subscription, of the shares in or debentures of the company, being underwriting commission, brokerage and charges for drafting, printing and advertisement of the prospectus; and
- (iii) Such other items of expenditure (not being expenditure qualifying for any allowance or deduction under any other provision of the Act) as may be prescribed by the Board for the purpose of amortisation. However, the Board, so far, has not prescribed any specific item of expense as qualifying for amortisation under this clause.

In the case of expenditure specified in items (a) to (d) above, the work in connection with the preparation of the feasibility report or the project report or the conducting of market survey or any other survey or the engineering services referred to must be carried out by the assessee himself or by a concern which is for the time being approved in this behalf by the Board.

- (b) Clause (aa) of section 12A(1) read with subsection (2) of section 12A, provides that where an application for registration has been made on or after 1st day of June, 2007 the provision of sections 11 and 12 shall apply in relation to the income of such trust or institution from the assessment year immediately following the financial year in which such application is made. In the given case the trust had filed the application for registration on 11.04.2008 i.e. in the financial year 08-09 which is a previous year for assessment year 09-10 and because of the amended provisions, the benefit of sections 11 and 12 shall be available to the trust only from assessment year 09-10 as it would not be available in respect of any earlier assessment year. Therefore, the claim of the trust to get it from the A.Y. 07-08 is incorrect and wrong.
- (c) Section 90(1) empowers the Central Government to enter into an agreement with any foreign country for any of the following purposes :
 - (a) granting of relief in respect of
 - (i) income on which income tax has been paid both in India and in the other country; or

- (ii) income-tax chargeable under this Act and under the corresponding law in force in that country to promote mutual economic relations, trade and investment.
- (b) the avoidance of double taxation of income under the Income-tax Act and under the corresponding law in force in the other country;
- (c) exchange of information for the prevention of evasion or avoidance of income tax chargeable under this Act or under the corresponding law in force in that country or investigation of cases of such evasion or avoidance; and
- (d) recovery of income tax under the Income-tax Act, 1961 of India and under the corresponding law in force in the other country.

This section also empowers the Central Government to make such provisions as may be necessary for implementing the agreement. These provisions shall be made by notification in the Official Gazette.

Under section 90 of the Income-tax Act, the Government of India can enter into agreements with governments of other countries for granting of relief in respect of income on which tax is payable, avoidance of double taxation of income under the laws of India as well as the laws of the other country, for exchange of information for prevention of tax evasion or avoidance and for the recovery of income-tax.

The position of law is that the double taxation avoidance treaties entered into by the Government of India override the domestic law. This has been clarified by the CBDT vide circular no.333 dated April 2, 1982, which provides that a specific provision of the DTAA will prevail over the general provisions of the Income-tax Act.

Question 5

- (a) Specify all those instances which are generally incorporated in Article 5(2) in all DTA agreements to signify the presence of a permanent establishment. (4 Marks)
- (b) Is CIT (Appeals) empowered to consider an appeal filed by an assessee challenging the order of assessment in respect of which the proceedings before the Settlement Commission abates? (4 Marks)
- (c) An interest free loan of Rs. 50 lacs was given by HSP Ltd. to its sister concern SH Ltd. (which sells its entire production to HSP Ltd.) for procurement of raw material available at a discount on cash payment. A.O. proposes to disallow the interest paid on loans by HSP Ltd. to the extent of interest foregone by advancing loan to SH Ltd. Is the action of A.O. in doing so correct? (4 Marks)
- (d) Can A.O. complete the assessment of an income from international transactions in disregard of the order passed by the Transfer Pricing Officer by accepting the contention of the assessee? (4 Marks)

Answer

- (a) In order to determine the taxability of business income of foreign enterprises operating in India, it is important to determine the existence of a Permanent

Establishment ('PE'). Article 5(1) of the DTAA provides that for the purpose of this convention the term 'Permanent Establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on. According to Article 5(2), various instances of PE, include

- (a) a place of management,
 - (b) a branch,
 - (c) an office,
 - (d) a factory,
 - (e) a workshop,
 - (f) a sales outlet,
 - (g) a warehouse,
 - (h) a mine, an oil or gas well, a quarry or other place of extraction of natural resources (but not exploration).
- (b) Section 251(1) (aa) which empowers CIT(A) certain powers in case of an appeal filed by an assessee challenging the order of assessment in respect of which the proceedings before the Settlement Commission stands abated under Section 245H. He may , confirm, reduce, enhance or annul the assessment after taking into consideration the following -
- (1) all the material and other information produced by the assessee before the Settlement Commission;
 - (2) the results of the inquiry held by the Settlement Commission;
 - (3) the evidence recorded by the Settlement Commission in the course of the proceeding before it; and
 - (4) such other material as may be brought on his record.
- (c) The facts narrated in the problem were before the Apex Court in the case of S.A. Builders Ltd. v. CIT(Appeals) (2007) 288 ITR 1(SC) in which the honorable Court had held that to allow deduction under section 36(1)(iii) on interest paid on amounts borrowed and advanced to sister concern, the authorities should examine the purpose for which the money was advanced and what the sister-concern did with the money. The borrowed amount is not utilized by the assessee in its own business but had been advanced as interest free loan to its sister concern is not relevant. What is relevant is whether the amount was advanced as a measure of commercial expediency and not from the point of view whether the amount was advanced for earning profits. The expression "Commercial expediency" is of wide import and includes such expenditure which a prudent businessman incurs for the purpose of business. Once it is established that there was a nexus between the expenditure and purpose of the business(which need not necessarily be the business of the assessee itself) the revenue cannot justifiably claim to put itself in the arm- chair of the

businessman and assume the role to decide how much is reasonable expenditure having regard to the circumstances of the case. No businessman can be compelled to maximize his profits. In the given problem the sister-concern sells its entire production to HSP Ltd. and to procure raw material at a cheaper rate is a purpose of commercial expediency and therefore the action proposed by the Assessing Officer to disallow the interest paid by HSP Ltd. on the borrowed funds to the extent of interest foregone by advancing loan to SH Ltd is in correct.

- (d) Section 92CA(1) provides for a procedure for reference to a Transfer Pricing Officer (TPO) of any issue relating to computation of arm's length price in an international transaction. The procedure is as under -
- (1) The option to make reference to TPO is given to the Assessing Officer. He may make this reference if he considers it necessary or expedient to do so. This option is not available to the assessee.
 - (2) The Assessing Officer has to take the approval of the CIT before making such a reference.
 - (3) Any Joint /Deputy/Assistant Commissioner of Income Tax, authorised by CBDT, can be appointed as TPO.
 - (4) According to section 92A(2) when such reference is made, TPO can call upon the assessee to produce evidence in support of the computation of arm's length price made by him.
 - (5) Sec 92A(3) provides that, the TPO has to pass an order determining the arm's length price after considering the evidence, documents, etc. produced by the assessee and after considering the material gathered by him. He has to send a copy of his order to Assessing Officer as well as the assessee.
 - (6) Sec 92A(4) provides that the order of the Transfer Pricing Officer determining the arm's length price of an international transaction is now binding on the Assessing Officer and the Assessing Officer shall proceed to compute the total income in conformity with the arm's length price determined by the Transfer Pricing Officer

Therefore, the Assessing Officer cannot complete the assessment in disregard of the order of Transfer Pricing Officer and on the basis of contention raised by the assessee.

Question 6

- (a) Samode Food Processing Cooperative Society engaged in processing without the aid of power of the agricultural produce of its members, in carrying out activities of marketing of agricultural produce, in agency business and others, furnishes the following particulars of its income for the year ended on 31.3.2008 :

(8 Marks)

-Income from processing of the produce of members	:	Rs. 50,000
-Income from marketing activities		Rs 30,000

-Income from letting of building used as godowns	Rs. 96,000
-Dividend from another Cooperative Society	Rs. 45,000
-Collective disposal of Labour of its members	Rs. 25,000
-Income from agency business	Rs. 75,000
-Interest on deposits from another Cooperative Society	Rs. 15,000

Compute the income chargeable to tax for A.Y. 2008-09.

- (b) "Section 145A of the Act is not in agreement with the principal laid down by AS-2 of the Institute of Chartered Accountants of India." Explain the controversy. (5 Marks)
- (c) When can a non-resident or a Foreign company be treated as having a permanent establishment in India? (3 Marks)

Answers

- (a) Name Of Assessee : Samode Food Processing
Cooperative Society

Previous Year ended on : 31.03.2008

Assessment Year : 2008-2009

Computation of Income

Particulars	Amount (Rs.)
Income from letting of godowns	96,000
Business Income derived from the following	
Processing of Agricultural Produce	50,000
Marketing activity	30,000
Agency work	75,000
Collective disposal of labour	<u>25,000</u>
Dividend from other Co-op. Society	45,000
Interest on deposit from other Co-op. Society	<u>15,000</u>
Gross Total Income	3,36,000
Less: Deductions in respect of various income Available under section 80P	
Processing of agricultural produce of its members without the aid of power [Section 80P(2)(a)(v)]	50,000

Marketing of agricultural produce [Section 80P(2)(a)(iii)]	30,000	
Agency work (Section 80P(2)(C))	50,000	
Collective disposal of labour [Section 80P(2)(a)(vi)]	25,000	
Dividend from other Co-operative Society [Section 80P(2)(d)]	45,000	
Interest from other Co-operative Society [Section 80P(2)(d)]	15,000	
Letting of godowns [Section 80P(2)(e)]	<u>96,000</u>	<u>3,11,000</u>
Total Income		25,000

(b) As per section 145A of the Income-tax Act, the valuation of purchase and sale of goods and inventory for the purposes of determining the income chargeable under the head "Profits and gains of business or profession" has to be-

- (a) in accordance with the method of accounting regularly employed by the assessee; and
- (b) further adjusted to include the amount of any tax, duty, cess or fee, by whatever name called, actually paid or incurred by the assessee to bring the goods to the place of its location and condition as on the date of valuation.

The intention of section 145A is to ensure that the sale of goods and purchase of goods are grossed up by including the excise duty, tax, cess, etc., Inventory should also be grossed up in the same manner. However, the CENVAT credit, if any available towards such duty paid should not be taken into account.

Therefore, Section 145A is aimed at requiring assessee to follow the inclusive method whereby more profit is shown. However, it is significant to note that if a higher value of closing stock is shown in a particular year, the same will be the opening stock in the next year. Therefore, the increase in profits in one year would be compensated by a reduction in profits in the subsequent year. In short, the effect of adopting the inclusive method under section 145A would be to prepone the booking of profits to the preceding year.

AS-2 as prescribed by the ICAI requires that the cost of inventories should comprise all costs of purchase, cost of conversion and other costs in bringing them to their present location and condition. AS-2 on "Valuation of Inventories" requires adoption of Exclusive method.

Therefore, both AS-2 and section 145A state about two methods for accounting of tax, duty etc. while preparing accounts viz the exclusive method and the inclusive method respectively. Under the inclusive method, the amounts are grossed up whereas under the exclusive method, the figures are shown net.

The controversy between the two is that the intention of section 145A is to ensure that the sales, purchases and inventory of the goods are grossed up by including the excise duty, tax, cess etc whereas AS-2 prescribed by the ICAI recognises exclusive method.

- (c) A non-resident or a foreign company is said to have a Permanent Establishment in India has been clarified as per Circular No.5/2004 dated 28.9.2004 issued by CBDT. Therefore, a non-resident or a foreign company is said to have a Permanent Establishment in India, if the said non-resident or foreign company carries on business in India through a branch, sales office etc. or through an agent (other than an independent agent) who habitually exercises an authority to conclude contracts or regularly delivers goods or merchandise or habitually secures orders on behalf of the non-resident principal. In such a case, the profits of the non-resident or foreign company attributable to the business activities carried out in India by the Permanent Establishment becomes taxable in India.

Question 7

- (a) Mr. Duggal, a Chartered Accountant and citizen of India after serving 16 years in U.K. returned back on 12.4.2007 for permanent settlement in Delhi started professional practice, furnishes value of his all Assets and Liabilities held on 31.3.08 and request you to compute his net wealth for A.Y. 08-09 : (10 Marks)

Rs.

- | | |
|---|---------|
| (i) Car used for professional work | 15 lacs |
| (ii) Car used for personal purposes | 5 lacs |
| (iii) Laptop used for personal purposes | 1 lac |
| (iv) Desktop/Scanner/Printer used in Office for professional work | 2 lacs |
| (v) Bank Term Deposits | 10 lacs |
| (vi) Shares of listed and unlisted various companies | 5 lacs |
| (vii) Loan against the car used for professional work | 5 lacs |
| (viii) Urban land purchased in the name of handicapped son (Minor) | 3 lacs |
| (ix) Jewellery valuing now Rs.5 lacs purchased out of money from NRE account on 1.12.2006 | |
| (x) House property valuing now Rs.40 lacs purchased on 11.10.2003 from the funds in NRE account was given on rent to a corporate house on 1.7.2007 | |
| (xi) Amount of Rs.. 2,00,000 was withdrawn from bank on 27.3.08 for a deal of a house which could not be materialized and therefore the cash was deposited back in bank on 2.4.2008 | |
| (xii) Jewellery worth Rs. 2 lacs was gifted on 22.3. 2008 to wife on the occasion of 25 th marriage anniversary . | |
- (b) The recognition of the heirloom jewellery granted to a former ruler by the Central Government in March, 1957 was withdrawn by the Board on 11.8.2007 with retrospective effect from 1.4.1970. The fair market value of this jewellery on 11.8.2007 was Rs. 100

lacs and on 31.3.2008 was Rs. 110 lacs. Explain the implications of it on the Wealth Tax Liability of the former ruler. (4 Marks)

- (c) What meaning has been assigned to "Net Wealth" under the Wealth Tax Act, 1957? (2 Marks)

Answers

- (a) Name of the Assessee : Mr. Duggal
Valuation Date : 31.03.2008
Assessment Year : 2008-09

Computation of Net Wealth

Particulars	Amount (Rs.)
(i) Cars used for professional work is an asset	15,00,000
(ii) Car used for personal purpose is an asset	5,00,000
(iii) Laptop used for personal purposes are not assets	
(iv) Desktop/Scanner/Printer used in office for professional work are not assets	Nil
(v) Bank term Deposits is not an asset	Nil
(vi) Shares of various listed and unlisted Companies is not asset	Nil
(vii) Urban land purchased in the name of handicapped son is not a deemed asset as per section 4(1)(a)(ii)	Nil
(viii) Jewellery purchased from NRE account, on 1.12.2007 is exempted	Nil
(ix) House purchased from NRE account prior to one year of return and also was on rent for less than 300 days (i.e. 274 days) is an asset	40,00,000
(x) Amount withdrawn from bank and held in the form of Cash on valuation date in excess of Rs.50,000 is an asset.	15,0000
(xi) Value of jewellery gifted to wife includible under section 4(1)(a)(ii) as deemed wealth.	<u>2,00,000</u>
Gross Wealth	63,50000
Less: Debts incurred in relation to assets	<u>5,00,000</u>
(xii) Loan against cars used for professional work is deductible	
Net Wealth	58,50000

Reasons for inclusion or exclusion of the various items are furnished below :

- (i) Car used for professional work is an asset as per section 2(ea)(ii) and , therefore included in the net wealth.
- (ii) Car used for personal purpose is an asset as per section 2(ea)(ii) and , therefore included in the net wealth.
- (iii) Laptop used for personal purposes are not assets as per section 2(ea). Hence, excluded from net wealth.
- (iv) Desktop/Scanner/Printer used in office for professional work are not assets according to section 2(ea)
- (v) Bank term Deposits are not assets according to section 2(ea). Therefore, not included in the net wealth.
- (vi) Shares of various listed and unlisted Companies are not assets, and therefore, excluded.
- (vii) According to section 4(1)(a)(ii) net wealth of an individual shall include assets held by his/ her minor child, other than, minor suffering from any disability of any nature specified in section 80U. Therefore, urban land purchased in the name of handicapped son is not to be included in the hands of the individual.
- (viii) Clause (v)section of 5 seeks to provide wealth tax exemption in respect of value of assets brought into India and who must be person of Indian origin or Indian citizen and who must have returned to India from a foreign country for settling down permanently will be exempted for seven assessment years . Moreover, assets acquired by him out of such moneys within one year immediately preceding the date of his return and at any time thereafter will qualify for exemption. Explanation to this clause clarifies that the moneys standing to the credit of a person (to whom this clause is applicable in a non-resident external) account in any Bank in accordance with the Foreign Exchange Regulation Act, 1973 and rules made thereunder on the date of his return shall be deemed to be moneys brought by him into India on that date. Hence, Jewellery purchased from NRE Account on 1.12.2007 is exempted.
- (ix) Clause (v)section of 5 seeks to provide wealth tax exemption in respect of assets acquired by him out of such moneys within one year immediately preceding the date of his return and at any time thereafter will qualify for exemption. Explanation to this clause clarifies that the moneys standing to the credit of a person (to whom this clause is applicable in a non-resident external) account in any Bank in accordance with the Foreign Exchange Regulation Act, 1973 and rules made thereunder on the date of his return shall be deemed to be moneys brought by him into India on that date. Further according to section 2(ea)(i) any residential property that has been let out for a minimum period of 300 days in the previous year is not an asset. Since , House purchased from NRE account is prior to one year of return and also was on rent for less than 300 days (i.e. 274 days) and, therefore, included in the net wealth.

- (x) Cash in hand, in excess of Rs 50000, of individuals constitute an asset. Therefore, Rs 150000, being cash in hand in excess of Rs50000 , is to be included in net wealth.
 - (xi) According to section 4(1)(a)(ii) net wealth of an individual shall include assets held by spouse of such individual to whom such assets have transferred by the individual, otherwise than for inadequate consideration. Therefore, jewellery worth of Rs200000 gifted to wife would be included in the net wealth of Mr.Duggal by the deeming provisions.
 - (xii) Cars used for professional work is an asset and therefore debts incurred in relation to it is a deductible in computing the net wealth.
- (b) The jewellery held by a former ruler when recognized by the Central Government is exempt under section 5(iv) but Board has been empowered to withdraw such recognition with retrospective effect from 9.9.1972 only and in such case the wealth tax shall be payable by such former ruler for all the assessment years falling between 9.9.1972 to the date of withdrawal of recognition. The fair market value of the jewellery on the date of the withdrawal of the recognition shall be deemed to be the fair market value of such jewellery on each successive valuation date relevant to the assessment years. However, in such a case, the aggregate amount of wealth tax payable in respect of the jewellery for all the assessment years (in respect of which tax becomes payable consequent on withdrawal of the recognition) shall not exceed 50% of its fair market value on the valuation date relevant for the assessment year in which recognition was withdrawn. Therefore, the former ruler shall be liable to pay tax on the jewellery from the assessment year 1973-74 to 2007-2008 on Rs 100 lacs in respect of each valuation dates inspite that the recognition was withdrawn from 1.4.1970. The maximum liability to tax will be 50% of Rs.110 lakhs i.e. Rs.55 lakhs for the assessment years 1973-74 to 2007-2008. Moreover , wealth tax liability for the assessment year 2008-2009 would be 1% on 110 lacs i.e . 1.1 lacs
- (c) The expression 'net wealth' according to the section 2 (m) means the amount by which the aggregate value, computed in accordance with the provisions of this Act, of all the assets wherever located, belonging to the assessee on the valuation date, [including assets required to be included under section 4], in his net wealth as on that date under this Act, is in excess of the aggregate value of all the debts owed by the assessee, on the valuation date which have been incurred in relation to the said assets.