

STUDY NOTE -14

INCOME TAX - SOME ISSUES

This Study Note includes

- Merger and Amalgamation
- Demerger
- Slump Sale
- Cost of Acquisition at the hands of Shareholder after demerger
- Expenditure in respect of Amalgamation
- Amalgamation / Merger and Indirect Taxes
- Income Tax Exemptions to developer and SEZ Unit
- Transfer Pricing
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14.1 MERGER AND AMALGAMATION

Business Reorganisation has been made tax neutral under Income Tax Act. It has been recognised that business organisation can be by way of amalgamation, de-merger or slump sale. Provisions have been made for each type of reorganisation. Effect of reorganisation on shareholder of the companies has also been clarified. These changes are summarised here.

Amalgamation takes effect on the date mentioned in the scheme, even if sanction of Court is obtained later.

Amalgamation and Income Tax - Section 2(1B) of Income Tax Act defines 'amalgamation' as merger of one or more companies with another company or merger of two or more companies to form one company in such a manner that all property and liabilities of amalgamating company or companies become property of amalgamated company. At least 90% share holders of amalgamating company should become members of amalgamated company. 'Amalgamating company' means company which is merging and 'amalgamated company' means the company with which it merges or the company which is formed after merger. However, acquisition of property of one company by another is not 'amalgamation'.

The amalgamation is not considered as transfer and hence there is no liability of capital gains tax, if amalgamated company is Indian company. [section 47(vi) of Income Tax Act]. Transfer of assets by one company to another in scheme of amalgamation is not regarded as distribution of profits within the meaning of section 2(22)(a) of Income Tax Act. Amalgamation involves merger and not liquidation and hence section 2(22)(c) of Income Tax Act is also excluded.

After amalgamation, profits of amalgamating company and amalgamated company are of course, calculated together. As per proviso to section 32 of Income Tax Act, total depreciation allowable to amalgamating company and the amalgamated company cannot exceed the normal depreciation allowable under the Act if the amalgamation had not taken place.



In respect of unabsorbed losses (accumulated losses) of amalgamating company, these are permitted to be carried forward in hands of amalgamated company only if conditions of section 72A of Income Tax Act are prescribed.

Expenditure for obtaining technical know-how, expenditure on license to operate telecommunication services or expenditure on prospecting is tax deductible in hands of the amalgamated company. [section 35AB(3), 35ABB(7) and 35E(7A) of Income Tax Act].

Expenditure incurred on amalgamation is deductible in five years in equal instalments @ 20% per year. [section 35DD(1) of Income Tax Act].

14.1.1 Amalgamation of sick company

Amalgamation is often resorted to take over a sick company. The amalgamating company may be a sick company and may have accumulated losses. Such accumulated losses are allowed to be carried forward in the hands of amalgamated company (i.e. the company in which the sick company is amalgamated), subject to following conditions - (a) The provision applies only to 'industrial undertaking or a ship'. 'Industrial undertaking' is one engaged in manufacturing or processing of goods, or manufacture of computer software or business of generation or distribution of power or mining or construction of ships, aircrafts or rail system. Thus, it does not apply to non-manufacturing sector like trading, telecom, service sector, finance and investment companies or dotcom companies (b) Minimum 75% of book value of fixed assets of amalgamated company should be retained by the amalgamated company for at least five years. (c) Amalgamated company should carry on business of amalgamating company for at least five years. (d) It should make efforts to ensure revival of the business of amalgamating company, as per conditions prescribed in rule 9C. [section 72A of Income Tax Act]. After five years, the business of amalgamating company need not be carried by amalgamated company.

As per rule 9C of IT Act, the amalgamated company shall achieve level of production of at least 50% of the installed capacity of the undertaking which was amalgamated (i.e. of amalgamating company) within 4 years from date of amalgamation and continue to maintain the minimum level till end of 5 years from date of amalgamation. A CA certificate regarding production should be submitted along with return of income. If the production level is not achieved, the amalgamated company has to apply to Central Government to relax the condition regarding achieving 50% production capacity. Government may relax the condition having regard to genuine efforts made to attain the production level and circumstances why required production level could not be achieved.

Since provisions of SICA override provisions of other Acts, amalgamation in case of sick company can be ordered by BIFR, without intervention of Court.

Aspect of stamp duty and sales tax - Amalgamation will attract stamp duty, if State law so provides. However, there is no 'sale' and sales tax should not be attracted. In *Castrol India Ltd. v. State of Tamilnadu* (1999) 114 STC 468 (Mad), it was held that stock transfer between transferor company and the transferee company in amalgamation from transfer date cannot be considered as a sale and therefore cannot be subjected to sales tax.

14.2 DE-MERGER

In de-merger, a unit or division of a company is transferred to another company. In slump sale (also called as hive off or spinning off), one unit / division is sold to a buyer as a going concern with assets and liabilities.

An amalgamation has reference to company as a whole whereas a de-merger has reference to an undertaking of the company. The amalgamating company will lose its identity in amalgamation whereas the de-merged company may continue to exist after de-merger.

In 'De-merger', a company transfers one or more of its undertakings, unit, division or business activity to another company, called 'resultant company'. The transfer is of assets and liabilities pertaining to that undertaking at book value, as a going concern. The resulting company issues shares to shareholders of de-merging company on a proportionate basis. [section 2(19AA) of Income Tax Act]. The company which is transferring its undertaking, unit, business activity or division is termed as 'de-merged company'. [section 2(19AAA) of Income Tax Act]

De-mergers are tax neutral and do not attract any additional liability to tax. There has to be transfer of business as a going concern and not only of specific assets. This is because, if only specific assets are transferred, it is a sale of assets and not a business reorganisation. After de-merger, the accumulated losses and unabsorbed depreciation is allowed to be carried forward in resulting company, if there are directly relatable to undertaking proposed to be transferred. When it is not possible to relate the accumulated losses to the undertaking being de-merged, the accumulated losses and depreciation will be apportioned between the de-merged company and the resulting company, in proportion of assets coming to share of each as a result of de-merger. [section 72A(4) of Income Tax Act]

When assets are transferred, WDV of block of assets of demerged company shall be reduced by WDV of assets transferred to the resulting company pursuant to the demerger. Correspondingly, assets of the resultant company will be the WDV of the transferred assets as appearing in books of account of the demerged company immediately before de-merger. - Explanations 2A and 2B to section 43(6) of Income Tax Act, added w.e.f. 1-4-2000, i.e. AY 200-2001 onwards.

If the company is de-merged, aggregate depreciation for current year will be apportioned between two entities i.e. de-merged company and resulting company in the ratio of number of days for which assets were used by them. [fourth proviso to section 32(1)(ii)]. Transfer of patent right and copyrights also has been made tax neutral [section 35A(7) of Income Tax Act].

Expenditure for obtaining know how, expenditure on license to operate telecommunication services or expenditure on prospecting of certain minerals is tax deductible in hands of the resulting company. [section 35AB(3), 35ABB(7) and 35E(7A) of Income Tax Act].

There is no capital gain at the hands of de-merged company, if the resulting company is an Indian Company. [section 47(vib) of Income Tax Act]. Any transfer in de-merger of shares held in Indian company by de-merged foreign company to resultant foreign company is also exempt, subject to certain conditions. [section 47(vic)].



Expenditure incurred on de-merger is deductible in five years in equal installments @ 20% per year. [section 35DD(1) of Income Tax Act].

One lacuna in present provision of de-merger is that it pre-supposes that only a company with positive net worth can spin off its undertaking. The undertaking proposed to be spin off should also have positive net worth, as both asset and liability of an undertaking has to be transferred and shares have to be issued to existing shareholders. Thus, a loss making unit cannot be spun off under the present provisions.

Aspect of stamp duty and sales tax - De-merger should attract stamp duty, if State law so provides. However, there is no 'sale' and sales tax should not be attracted.

14.3 SLUMP SALE

'Slump sale' is a sale where an undertaking, unit or division or a business activity is transferred from one person to another for a lumpsum consideration without values being assigned to the individual assets and liabilities transferred. One of division or undertaking as a whole is sold. [section 2(42C) of Income Tax Act].

To constitute a slump sale, it is necessary that the sale is for a lump sum consideration and no values are assigned to the individual assets and liabilities, whereas, in demerger, the resulting company issues, in consideration of de-merger, its shares to the shareholders of the demerged company on a proportionate basis. In case of amalgamation, the properties and liabilities of the amalgamating company / de-merged company are transferred at the values appearing in the books of account immediately before the merger / de-merger to the amalgamated company / resulting company.

Slump sale provisions really apply to all assesseees and are not limited to companies, while provisions of amalgamation apply only to a company.

In such a sale, the gains arising from such sales will be taxed under the head 'capital gains'. The 'capital gain' will be 'long term capital gain' if the capital assets were originally held for more than 36 month. It will be 'short term capital gain', if the asset was originally held for less than 36 months. It will be deemed as income in the year in which transfer took place.

For calculating cost of acquisition of the undertaking or division transferred, 'net worth' of the undertaking or division being transferred shall be deemed as 'cost of acquisition and cost of improvement'. 'Net worth' means aggregate value of total assets of the undertaking as reduced by the value of liabilities of the undertaking or division as appearing in books of account. Any change in value of assets due to re-valuation of assets will be ignored. The 'total assets' will be Written Down Value (WDV) of block of assets. A Chartered Accountant's certificate regarding 'net worth' of transferred undertaking or division will have to be submitted to ITO. [section 50B of Income tax Act].

Aspect of stamp duty and sales tax - Hive off or spinning off or slump sale should attract stamp duty, if State law so provides. However, in the sale of an undertaking as a going concern for a lumpsum price, there is no 'sale' and sales tax should not be attracted. In *Coromandal*

Fertilizers Ltd. v. State of AP (1999) 112 STC 1 (AP HC FB), it was held that such a sale at the end of entire business is not 'in the course of business'. Going out of business is not a step incidental to or connected with manufacturing or business activity. Selling business is not a 'business' and hence the person is not a 'dealer'.

Agreement for hive off / slump sale - Agreement for hive off / slump sale should cover following aspects -

- Assignment of business and consideration to be paid
- Further assurances in respect of other documentation, assets, liabilities etc
- Representations and warranties to be given by seller with regard to authority to sanction sale, validity of assignment, employees terms and conditions, labour matters, status of tax and other liabilities etc.
- Representation and warranties given by buyer regarding authority to sanction buying, validity of assignment etc.
- Assignment of trade marks, patents
- Indemnity clause.
- Provisions in respect of amendments to agreement
- Arbitration clause.

14.4 COST OF ACQUISITION AT THE HANDS OF SHAREHOLDER AFTER DE-MERGER

A shareholder of de-merged company gets some shares of resulting company (i.e. new company to which some part of business is transferred) after de-merger. Such transfer is not treated as dividend distributed by the de-merged company. [section 2(22)(v) of Income Tax Act]. Issue of shares of resulting company to shareholders of de-merged company will not attract any capital gains. [section 47(vid) of Income Tax Act].

The shareholder will have shares of the original i.e. company which has de-merged. If he sales such shares, capital gain may arise. In such cases, the cost of acquisition of original shares will be bifurcated between the resulting company and the original (de-merged) company in proportion to net book value of assets transferred in de-merger to the net worth of original company before de-merger. [sections 49(2C) and 45(2D) of Income Tax Act]. e.g. assume that net worth of original i.e. de-merged company was Rs one hundred lakhs and net book value of assets transferred to resulting company was Rs 25 lakhs. If the cost of acquisition of original shares at the hands of shareholder was Rs 1,000, cost of acquisition of resulting company will be Rs 250 and cost of acquisition of original shares will be Rs 750. Thus, total cost of acquisition of original shares is bifurcated between resulting company and original company in ratio of book value of assets transferred to the net worth of original company.



If the shareholder sales the shares of resulting company, the period for which original shares were held will also be considered to determine whether the gain is a short term gain or a long term gain. [section 2(42A)(g) of Income Tax Act].

In *CIT v. Grace Collis* (2001) 3 SCC 430 = 2001 AIR SCW 1008 = 248 ITR 323 = 115 Taxman 326 (SC 3 member bench), it was held that in amalgamation, rights of shareholders of the transferor company in that company get extinguished upon amalgamation. Therefore, there is a 'transfer' of shares by member of their shares in amalgamating company (i.e. the company which is being amalgamated). Consequently, cost of acquisition of shares of amalgamated company is deemed to be the cost of acquisition of their shares in amalgamating company. It has to be determined as per (earlier) section 49(2). If member sales shares in amalgamated company, capital gains will arise.

14.5 EXPENDITURE IN RESPECT OF AMALGAMATION

In *CIT v. Akme Electronics* (2004) 137 Taxman 263 (Guj HC DB), it was held that legal expenses incurred by transferor company in respect of its amalgamation with another company is allowable as revenue expenditure. Amalgamation is resorted to for smooth and efficient conduct of business of company. Hence, the legal expenditure is for purpose of business of assessee even if later its business will come to an end.

In *CIT v. Bombay Dyeing & Mfg Co. Ltd.* (1996) 219 ITR 521 = 85 Taxman 396 (SC), it was held that expenditure incurred in connection with amalgamation is revenue expenditure.

14.6 AMALGAMATION/MERGER AND INDIRECT TAXES

Various factors are required to be considered when a company is being merged / amalgamated with another company. Points to be kept in mind by the amalgamating company are as follows -

General points applicable to all taxes – (1) Inform all tax authorities as soon as scheme is approved by members. This is only advance information and only a precautionary step. (2) Inform tax authorities with copy of High Order approving amalgamation. (3) Wherever show cause notices, adjudication, assessments or appeals are pending with Adjudicating authority or appellate Authority, submit application for change of name of assessee / appellant / respondent as the case may be. (4) Wherever registration has been obtained (e.g. under Central Excise, Sales Tax, Service Tax etc.), apply for amendment to registration certificates. Submit fresh list of directors. Inform new authorised signatories, if there is any change. (4) Detailed stock taking should be done on 'transfer date' as specified in scheme of amalgamation. Preferably, this date should be close of accounting year. This will be useful for assessments, preparing final accounts etc.

Income Tax – (1) Though there is no provision for cancellation of Permanent Account Number (PAN), Income tax Officer (ITO) should be informed that identity of old company is extinguished and old PAN is no more valid. (2) Income Tax Officer should also be informed that from the 'appointed date', the amalgamating company ceases to exist and no income tax return will be filed for subsequent period. (3) The amalgamating company, i.e. 'X' company will henceforth use the PAN of amalgamated company i.e. of 'Y'.



Central Excise - The following actions will be required – (1) When approval of High Court is obtained, application should be made to Assistant / Deputy Commissioner of Central Excise in charge of the division, for amending the Registration certificate. Fresh details should be given in prescribed form A-1. (2) If the bonds are executed, these should be got amended with new name or new bonds should be executed and old bonds should be got cancelled. (3) If LUT (Letter of Undertaking) was submitted for clearance of goods without payment of duty, fresh LUT for export may be submitted. (4) As per Rule 8 of Cenvat Credit Rules, if a factory is transferred on account of amalgamation, the manufacturer can transfer unutilised Cenvat credit to the amalgamated factory. The transfer of credit is subject to following conditions - * There should be specific provision for transfer of liabilities of such factory * The transfer is allowed only if stock of inputs as such or in process, or the capital goods are also transferred along with the factory to the new ownership and the inputs or capital goods on which credit has been availed of are duly accounted for to the satisfaction of Commissioner. Thus, transfer is possible only with permission of Commissioner of CE. In most of the cases, permission of High Court is obtained much later than the 'effective date' as specified in the scheme. However, till the permission of High Court is obtained, the two units work independently. Hence, approval of Commissioner can be obtained only as on date of application to him and not 'effective date' as mentioned in the scheme. Application giving all details of stock, Cenvat credit etc. should be submitted to Assistant / Deputy Commissioner.

In *Kwality Zipper v. CCE* 2002(145) ELT 296 (CEGAT), it was held that even if amalgamation is sanctioned by High Court from a later date, the clubbing provisions to decide SSI exemption limit will be effective from the transfer date as specified in the scheme. In this case, transfer date was 1-4-1999 while order of Court sanctioning amalgamation was made on 14-12-1999. However, it was held that clubbing provisions will apply w.e.f. 1-4-1999. It was also held that assessee should inform department as soon as Board resolution is passed.

Customs – (1) The company may be holding DEPB Pass Book, Advance License, EPCG licenses etc. These should be got amended by changing name of the company. (2) Pending applications for duty drawback should be amended to incorporate new name. (3) Outstanding export obligations under earlier licenses should be got transferred in name of new amalgamated company. (4) Wherever bonds were executed with customs authorities, these should be got amended with new name or new bonds should be executed and old bonds should be got cancelled.

Central Sales Tax – (1) CST Registration certificate shall be got amended to incorporate new name. (2) Security given while obtaining CST registration should be amended / modified / replaced (3) Sale of business is not 'sale of goods'. Hence, scheme should not provide for sale of individual assets.

14.7 INCOME TAX EXEMPTIONS TO DEVELOPER AND SEZ UNIT

As per section 10A(1A) of Income Tax Act, units in SEZ set up upto 31-3-2005 will be exempt from income tax for first five years from year of commencement of manufacture. For subsequent two years, income tax exemption will be 50% of their export income.

In respect of units set up in SEZ on or after 1-4-2005, income tax exemption will be available as per provisions of section 10AA of Income tax Act (inserted w.e.f. 10-2-2006). It will be 100% for five years and 50% for next five years.



Developer of SEZ can claim exemption u/s 80-IA (for SEZ notified upto 31-3-2005) or 80-IAB of Income tax Act (for SEZ notified on or after 1-4-2005).

Dividend distribution tax payable u/s 115-O of Income tax Act is also exempt.

In case of trading, income tax benefits are available only in case of re-exports [see *explanation* to rule 76].

14.7.1 Income tax Exemptions to new units in SEZ

Section 10AA of Income-tax Act makes provision for exemption to units newly established in SEZ on or after 1-4-2005. The conditions are as follows -

- **Assessee should be 'entrepreneur' (i.e. person who has been granted approval by Development Commissioner) as per section 2(j) of SEZ Act.**
- **The unit should manufacture or produce article or things during financial year 2005-06 or any subsequent year [Definition of 'manufacture' is very wide, as discussed earlier.**
- **Assessee should export his goods or services by any mode - physical or otherwise.**
- **Unit should not be formed by splitting up or reconstruction of existing business.**
- **It should not be formed by transfer to a new business, machinery used earlier for any purpose.**
- **Taxpayer should maintain proper accounts which should be audited. He should submit audit report in form 56F along with his return of income.**
- **Second hand capital goods can be imported if these satisfy requirement of section 10AA(4) read with explanation I to section 80-IA of Income Tax Act.**

In case of trading, income tax benefits are available only in case of re-exports [see *explanation* to rule 76].

Deduction allowable - If these conditions are satisfied, deduction is available in respect of profits derived from exports or articles or things or services (including computer software). Profit is calculated as (profit of business of undertaking x Export Turnover) / total turnover of business of undertaking.

Profit and gains derived from site development of computer software (including services for development of software) will be deemed to be profits from export of computer software. However, 'export turnover' will not include freight, telecommunication charges, outward insurance and expenses incurred in foreign exchange in providing technical services outside India.

100% deduction will be available for first five consecutive assessment years. Deduction will be 50% for next 5 years.

SEZ Re-investment allowance reserve - For eleventh to fifteenth assessment year, deduction of 50% of profit will be available, if an equivalent amount is debited to P&L account and credited to SEZ Re-investment Allowance Reserve Account. This Special Reserve should be utilised for purpose of acquiring new plant and machinery within three years. Till then, the amount can be utilised for business purposes. Details of purchases of machinery should be submitted in form 56FF with return of income.

Amalgamation or demerger - Deduction is available if undertaking is transferred to another company under a scheme of amalgamation or demerger. However, deduction will not be admissible to the amalgamating company or the demerged company for the previous year in which amalgamation or demerger takes place.

No deduction of unabsorbed depreciation etc. - If deduction is claimed u/s 10AA of Income-tax Act unabsorbed depreciation allowances or unabsorbed capital expenditure on scientific research or family planning (pertaining to assessment year 2005-06 or earlier years) will not be allowed to be carried forward and set off. Losses u/s 72(1), 74(1) or 74(3) of Income-tax Act will not be allowed to be carried forward.

Depreciation compulsory - Depreciation will be allowed on WDV in respect of each assessment year.

14.7.2 Income tax Exemptions to developer of SEZ

Exemption to developer of SEZ will be available under section 80-IAB of Income-tax Act in respect of developers of SEZ notified on or after 1-4-2005. The accounts should have been audited and return of income for assessment year 2006-07 should be filed on or before due date. Otherwise, deduction under this section will not be available.

Deduction will be for 10 consecutive assessment years. The taxpayer can claim deduction for any 10 consecutive assessment years out of 15 consecutive years, beginning from the year in which SEZ has been notified by Central Government.

If taxpayer transfers the operations/maintenance of zone to another developer (or there is amalgamation with another company), the transferee will be eligible for deduction for remaining period.

If deduction is claimed u/s 80-IAB of Income-tax Act, deduction to the extent of such profits and gains will not be allowed under sections 80HH to 80RRB of Income-tax Act.

14.7.3 Exemption to capital gains from transfer of capital assets

Capital gains arising from transfer of capital assets in case of shifting from urban area to SEZ are exempt as per section 54GA of Income Tax Act. Capital asset may be plant, machinery, land or building or any right in land or building.

Amount of exemption will be equal to - (a) Amount of capital gains in shifting or (b) Cost and expenses incurred in shifting etc., whichever is lower.



If capital gains are not utilised for purchase or construction of new assets, the amount should be deposited in a public sector bank in accordance with Capital Gains Accounts Scheme. The provisions are similar to sections 54 and 54B.

14.7.4 Exemption from dividend distribution tax

Section 111-O(6) of Income Tax Act provides that dividend distribution tax will not apply in respect of total income of SEZ developer or SEZ unit or any amount declared, distributed or paid as dividend by the enterprise or SEZ developer, either in the hands of developer or enterprise or person receiving the dividend.

The dividend referred to in section 115-O will not be included in total income of assessee, being a Developer or entrepreneur [explanation to section 10(34) of Income Tax Act].

14.8 TRANSFER PRICING

Concept of transfer pricing is mainly for taxation of international transaction. Sections 92 to 92F of Income Tax Act provide a statutory framework for computation of reasonable, fair and equitable profit and tax in India so that the profits chargeable to tax in India do not get diverted elsewhere by altering the prices charged and paid in intra-group transactions. Any income arising from an international transaction shall be computed having regard to arm's length price.

International transaction is subjected to the arm's length price only in case of transaction between two entities called associate enterprises.

Enterprise - Enterprise means a person who engages or has been engaged or proposed to engage in the following activities - (a) any activity relating to the production, storage, supply, distribution, acquisition or control of articles or goods (b) know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights (c) any activity relating to the provision of services of any kind (d) carrying out any work in pursuance of a contract (e.g., construction contract) (e) investment activity (f) activity relating to provision of loan (g) business of acquiring, holding, underwriting or dealing with shares, debenture or other securities of any body corporate [SEC. 92F(iii)]

A person would be an enterprise if it carries on the specified activity/business directly or through one or more of its units or divisions or subsidiaries.

Associate Enterprise - - The provisions regarding taxation of international transactions [sections 92 to 92F] apply in case the two enterprises are associated enterprises.

An enterprise would be regarded as an associated enterprise of another enterprise, if (a) it participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or (b) in respect of it one or more persons who

participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise [Section 92A(1)].

Deemed associate enterprise - Section 92A(2) provides that two enterprises shall be deemed to be associated enterprises if for the purpose of section 92A(1), the two enterprises satisfy, at any time during the previous year, any of the conditions as specified in section 92A(2)].

Deemed International Transaction - Section 92B(2) provides that transactions between an enterprise and another person is deemed as transactions entered into between two associated enterprises if (a) there is a prior agreement in relation to the relevant transaction between such other person and the associated enterprise; **or** (b) the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

Transaction - The transaction includes an arrangement, understanding or action in concert, whether or not such arrangement, understanding or action is formal or in writing; or is intended to be enforceable by legal proceeding [section 92F]. Thus it is inclusive definition.

14.8.1 Computation of the arm's length price

If there is transaction between two entities called associate enterprises, arm's length price will be computed for income tax purposes.

Arm's length price is the price applied (or proposed to be applied) when two unrelated persons enter into a transaction in uncontrolled conditions [section 92F]

Persons are said to be unrelated if they are not associated or deemed to be associated enterprise according to section 92A.

Method of computing arm's length price - Arm's length price can be computed by one of the following methods [section 92C]

- a. Comparable uncontrolled price method
- b. Resale price method
- c. Cost *plus* method
- d. Profit split method
- e. Transactional net margin method
- f. Such other method as may be prescribed by the Board.

Comparable uncontrolled price method - Under this method, the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, (*i.e.*, a transaction between enterprises other than associated enterprises whether resident or non-resident) or a number of such transactions, is identified. The price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or



between the enterprises entering into such transactions, which could materially affect the price in the open market. The adjusted price arrived at is taken to be an arm's length price.

Resale price method - Under this method, the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified. The resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions. The price is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services. The price is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market. The adjusted price arrived at is taken to be an arm's length price.

Cost plus method - Under this method, the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined. The amount of a normal gross profit mark-up to such costs arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined. The normal gross profit mark-up is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market. The cost is increased by the adjusted profit. The sum so arrived at is taken to be an arm's length price.

Profit Split Method - This method is used in transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction. In this method, the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined. Then relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data. The profit thus apportioned to the assessee is taken into account to arrive at an arm's length price.

Transactional Net Margin - In this method, the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base. The net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base. The net profit margin arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount

of net profit margin in the open market. The net profit margin realised by the enterprise is established. The net profit margin thus established is then taken into account to arrive at an arm's length price.

14.8.2 Selecting Most appropriate method

The arm's length price shall be determined having regard to the most appropriate method. The most appropriate method shall be the method which is best suited to the facts and circumstances of each particular transaction, and which provides the most reliable measure of an arm's length price in relation to an international transaction [section 92C]

14.8.3 Determination of arm's length price by Assessing Officer

The Assessing Officer may determine the arm's length price, in a proceeding for assessment of income, if the Assessing Officer is of the 'opinion' that the arm's length price charged or paid in an international transaction has not been determined in accordance with section 92C(1) or 92C(2) or assessee has not kept the prescribed information and document relating to an international transaction; or information or data used for consulting the arm's length price is not reliable or correct; or assessee has failed to furnish, within the time specified any information or document which was required to be furnished by the Assessing Officer [Sec. 92C(3)]

14.8.4 Report from Chartered Accountant

The report from an accountant which is required to be furnished under section 92E by Every person who has entered into an international transaction during the previous year shall submit report in Form No. 3CEB and be duly verified It shall be furnished before the due date of submission of return of income [section 92E]

14.9 PRACTICAL EXAMPLES

A company engaged in pharmaceutical business commenced business in May 2007. incurred following expenditure relating to scientific research– (a) Capital expenditure of Rs 3 lakhs in April 2007 (b) The company had incurred revenue expenditure on raw material and salaries, of Rs two lakhs in 2003-04, Rs one lakh in 2004-05, Rs three lakhs in 2005-06, Rs two lakhs in 2006-07 and Rs four lakhs in 2007-08 on scientific research. (c) The machinery was sold in February 2008 for Rs five lakhs. Compute (i) deduction allowable in AY 2008-09 and (ii) Capital gains on sale of asset

Ans - Deduction allowable u/s 35 of Income Tax Act is as follows –

Revenue expenditure in three previous years (1+3+2)	Rs 6 lakhs
Capital expenditure in current year – 150% of Rs 3 lakhs	Rs 4.50 lakhs
Revenue expenditure in current year – 150% of Rs 4 lakhs	Rs 6 lakhs.
Total	Rs 16.50 lakhs



Short term capital gains on sale of machinery –Sale proceeds – Rs 5 lakhs. Less – Amount deemed as income u/s 41(3) of Income Tax Act – Rs 4.50 lakhs.

Hence, amount of short term capital gains is Rs 50,000.

Mr. X , resident in India, completed 65 years of age on 31-3-2008. His income for the financial year 2007-08 is as under:

- (a) Pension-Rs 84,000**
- (b) Income from Post Office Monthly Income Scheme-Rs. 48,000**
- (c) Interest from company fixed deposits-Rs. 60,000**
- (d) Rent from house property owned by him Rs. 2,000 per month NSCs purchased during 2006-07 Rs. 20,000**

Calculate the tax liability of Mr. X for the Assessment Year 2008-09.

Computation of gross total income of Mr. X for the assessment year 2008-09

Particulars	Rs	Rs
(A)Income from Salaries (pension)		84,000
Rent(annual value)	24,000	
Less: Deduction u / s 24(a)-30% of Rs. 24,000	7,200	
(B) Income from house property		16,800
(C) Income from other sources (interest income)		1,08,000
Gross total income (A) +(B)+(C)		2,08,800
Less: deduction under Chapter VI-A (NSC-section 80C)		20,000
Total Income		1,88,800

Tax on total income of Rs. 1,88,800

On first Rs. 1,85,000-	Nil
On balance Rs. 3,800 (@ 20%)-	Rs. 760
Tax on total income is	Rs. 760

Notes:

1. The Finance Act, 2005 prescribes a basic exemption limit of Rs. 1,85,000 for a senior citizen. A senior citizen is a resident individual who is 65 years or more of age *at any time during the previous year*. In view of this, Mr. X who turns 65 on the last day of the previous year is eligible for basic exemption of Rs. 1,85,000.
2. Standard deduction under section 16(i) is not available with effect from Assessment Year 2006-07. So, entire pension will be taxable.
3. **Section 80L deduction is not available with effect from Assessment Year 2006-07. So, entire interest from Post Office MIS is taxable.**

Mr. A who is resident in India wins a lottery of Rs. 10,00,000 during the financial year 2007-08. He is a daily wage-earner who earns on an average Rs. 2,000 per month. He won the prize in December 2007 and received it in the same month after deduction of TDS of 33.66%. He invested Rs. 6,00,000 in Post Office MIS in joint name with his wife. With the balance amount, he started a small business in January, 2008. His income from business for 3 months (January, 2008 to March, 2008) is Rs. 24,000. His Post Office MIS income is Rs. 12,000 (for 3 months). Calculate his tax liability for the assessment year 2008-09

This case is directly covered by section 115 BB. According to the said section, where the total income of an assessee includes winnings from lotteries, the income tax payable shall be the aggregate of :

(i) income tax on lottery calculated at the rate of 30%; and

(ii) the income-tax which the assessee would have been chargeable had his total income been reduced by the amount of income by way of winnings from lottery.

His income other than by way of lottery for assessment year 2006-07 is as under:

Salary for 9 months	18,000
Interest from Post Office MIS	12,000
Income from business	24,000
Income from business	24,000
GROSS TOTAL INCOME (other than lottery)	54,000
<i>Less; Chapter VIA deductions</i>	Nil
TOTAL INCOME (other than lottery)	54,000



Tax on total income other than lottery is Nil since it is below the basic exemption limit of Rs. 1,00,000. On lottery, the TDS deducted is his tax liability. He does not have to shell out anything more than the TDS from his pocket. However, by virtue of section 115BB, he cannot utilize the balance Rs. 46,000 out of his basic exemption limit against the lottery income and cannot claim any refund of TDS deducted from lottery winnings. Section 115BB is harsh.

Mrs. X is a qualified cost accountant. She is a salaried employee in a firm of cost accountants in which Mr. X (her husband) is a partner. Mr. X's share in the firm is 20%. Mrs. X draws a salary of Rs. 8,000 per month from the firm. Mr. X's income by way of sitting fees from the various boards of the companies in which he is an independent director is Rs. 1,50,000. Will Mrs. X's income be clubbed with that of Mr. X under section 64 of the Income-Tax Act.

Section 64(1)(ii) provides for clubbing of income arising to spouse of individual by way of salary from a concern in which such individual has a substantial interest (20% or more interest) if the individual's total income before including the salary is greater than the spouse's total income. However, the proviso to section 64(1)(ii) provides that such the provisions of section 64(1)(ii) will not apply to any income earned by spouse if the spouse possesses technical qualifications and the income is solely attributable to the application of his or her technical knowledge or professional knowledge or experience. Therefore, the case appears to fall squarely within the aforesaid proviso and the clubbing provisions of section 64(1)(ii) cannot be invoked to club the salary income of Mrs. X in Mr. X's hands. However, if Mrs. X is a dummy employee, then section 64(1)(ii) will be applicable as the proviso not only envisages the spouse possessing qualifications but also application of such qualifications to derive the income.

A company withdraws Rs. 2,00,000 in cash from its current account maintained with a particular branch of State Bank of India situated at New Delhi on 31-1-2007. What will be the tax payable on cash withdrawal under Banking Cash Transaction Tax? Would your answers be different if the company withdrew Rs. 1,00,000 each from its current accounts maintained with two different branches of the said bank located in New Delhi?

Ans - Banking Cash Transaction Tax will be charged and collected by the bank at the rate of 0.1% of Rs. 2,00,000-i.e. Rs. 200 if cash withdrawal from an account with a scheduled bank in a single day exceeds Rs. 1,00,000. The bank will not deduct this from withdrawal amount. It will pay full Rs. 2,00,000 and debit Rs. 200 to the current account. The total debit to the current account would be Rs. 2,00,200. There is no provision in the Income-Tax Act, 1961 to disallow cash withdrawals. The tax of Rs. 200 is deductible expense in computing profits and gains from business or profession. If Rs. 1,00,000 each is drawn from two different accounts, BCTT is not attracted.

Mr. Z had acquired house property in 1989-90 for Rs 5,00,000. He sold the property in 2007-08 for Rs 20,00,000. Cost inflation index was 172 in 1989-90 and 551 in 2004-05. Compute long term capital gain.

Indexed cost of acquisition is $5,00,000 \times 551 / 172$ i.e. 16,20,588. Hence, long term capital gain is $= 20,00,000 - 16,20,588$ i.e. 3,79,412 .



Mr. A ,an individual, aged 50, has made the following payments during the financial year 2007-08:

- (a) Prepayment of entire outstanding housing loan balance of Rs. 80,000 as on 1-4-2007. The loan was taken from HDFC Ltd. 10 years ago. He repaid this amount out of the maturity proceeds of his life insurance policy (Rs. 1,90,000) which he received on 1-4-2007.
- (b) He contributed Rs. 15,000 to recognized provident fund (by way of deduction from salary).
- (c) He purchased National Savings Certificates Rs. 5,000 in the name of his wife.
- (d) He paid his health insurance premium of Rs. 10,000 through his credit card on 31-3-2008. He paid the credit card company the amount on 25-4-2008.

What is the amount of deduction to which Mr. A is entitled to under sections 80C and 80D for the assessment year 2008-09?

There is no stipulation in section 80C that the payments/deposits/investments mentioned therein should be made out of income chargeable to tax. Admittedly, Mr. A has made the prepayment of housing loan from income which is not chargeable to tax [i.e. LIC policy proceeds which are exempt from tax under section 10(10D)]. However, this will not disentitle him to the deduction for prepayment of housing loan which is available under clause (xviii) of section 80C(2).

The contributions towards recognized provident fund of Rs. 15,000 is deductible under clause (vi) of section 80C(2). The amount invested in NSC under section 80C(2)(ix) is not deductible under clause (ix) of section 80C(2) as these are in the name of spouse. Only Life insurance premium [80C(2)(i)], deferred annuity contribution [80C(2)(ii)], contribution to Public Provident Fund Account [80C(2)(v)] contribution to Unit Linked Insurance Plan [80C(2)(x)/(xi)] made in spouse's name are deductible under section 80C.

The total contributions are Rs. 1,00,000 which is within the overall ceiling of Rs. 1,00,000 stipulated by section 80C and hence fully deductible from gross total income.

.The Finance Act,2007 has amended section 80D w.e.f.Assessment Year 2008-09 to provide that deduction is available if premium is paid by any mode of payment other than cash. In terms of the Memorandum Explaining the provisions of the Finance Bill,2008 and CBDT's Circular No.3/2008 dated 12-3-2008, payment by credit card is "any mode of payment other than cash" and payment through it is allowable as a deduction. Para 32.3 of the said Circular reads as under:

"32.3With a view to allow deduction for *payments made through electronic mode, credit card, etc.*, the provisions of section 80D and clause (ib) of sub-section (1) of section 36 have been amended so as to provide that the payment of premium made by any mode *other than cash*, shall be eligible for deduction under these sections."

The following data regarding normal tax liability and tax liability of a company under section 115JB (i.e. MAT) is given for Assessment Years 2006-07 to 2012-13. Calculate the tax payable by

the assessee for each of the said assessment years, MAT Credit available for carry forward under section 115JAA and MAT credit utilized.

A.Y.	Normal tax Liability (Rs. Crores)	Tax liability Under section 115JB (Rs. Crores)
(1)	(2)	(3)
2006-07	100	300
2007-08	120	90
2008-09	150	110
2009-10	180	200
2010-11	200	150
2011-12	225	175
2012-13	250	200

A.Y.	Normal tax liability	Tax liability Under section 115JB	Higher of (2) and (3)	Tax actually Payable (After considering utilization Of Credit under Section 115JAA)	Add-ional Tax liability (4)-(2)	Credit under Section 115JAA utilised	Credit Available for Carry forward
(1)	(2)	(3)	(4)	(5)	(5)	(6)	(7)
2006-07	100	300	300	300	200	----	200
2007-08	120	90	120	90 (see note 1)	Nil	30	170
2008-09	150	110	150	110 (see note 1)	Nil	40	130
2009-10	180	200	200	200	20	----	150
2010-11	200	150	200	150 (see note 1)	Nil	50	100
2011-12	225	175	225	175 (see note 1)	Nil	50	20 (see note 2)
2012-13	250	200	250	230 (see note 1)	Nil	20 (see note 2)	---

Notes:

1. **Mat credit will be allowed to be utilized by way of set-off against tax liability in those years in which normal tax liability exceeds liability determined under section 115JB. The amount of set-off allowed will be the lower of the two amounts:**
 - (a) **MAT credit available; and**
 - (b) **The amount by which normal tax liability exceeds liability determined under section 115JB.**
2. **Utilisation of credit is permissible upto 5 assessment years immediately following the assessment year in which credit has arisen. If not utilised within the said period, credit will lapse. Out of the credit of Rs. 50 crores available at the end of assessment year 2011-12, Rs. 20 crores has arisen in A.Y. 2009-10 and the balance Rs. 30 crores had arisen in A.Y. 2006-07. In view of the fact that 5 years period expires, the credit of Rs. 30 crores and cannot be carried forward. To determine the amount of lapsed credit, one should adopt, the “first arisen first utilized” basis. That is credit which has arisen first is utilised first.**

The accounts of ABC Co. Ltd. have been prepared in accordance with the provisions of Companies Act. The profit and loss account laid before the annual general meeting for the previous year ending 31.3.2008 shows a net profit of Rs. 40 lakhs. The profit and loss account contains the following credits/debits:

Credits in profit and loss account –

(1)	Profit from a new industrial undertaking qualifying for deduction under section 80-IB (Net)	Rs 14,00,000
(2)	Gross Receipts of a newly established 100% export oriented undertaking qualifying for deduction under section 10B	Rs 20,00,000
(3)	Capital gains on transfer of factory building, being a depreciable asset, held for 5 years by ABC Co. Ltd.	Rs 5,00,000



Debits in profit and loss account

(1)	Expenditure relating to the newly established 100% export oriented undertaking qualifying for deduction under section 10B	Rs 15,00,000
(2)	Current year's depreciation	Rs 7,50,000
(3)	Penalty for infraction of law	Rs 50,000
(4)	Provision of sales-tax	Rs 2,25,000
(5)	Proposed dividend	Rs 1,75,000

Following additional information is available –

- (1) Brought forward depreciation (relating to A.Y. 2007-08) 8,00,000
- (2) Brought forward business loss (relating to A.Y. 2007-08) 12,00,000
- (3) Depreciation admissible under the Income-tax Act for the Financial Year 2007-08 is Rs. 15,50,000.
- (4) There is no unabsorbed loss or unabsorbed depreciation brought forward from the previous year under the Income-tax Act, 1961.
- (5) The company is carrying on scientific and industrial research and development and is eligible for deduction of 100% of its profits under section 80-IB.
- (6) The entire capital gain has been invested in specified assets under section 54EC.
- (7) Sales tax provided in the accounts has been remitted before the due date.

Compute the taxable income and the tax liability of ABC Co. Ltd. for the A.Y. 2008-09

We have to compute total income as per Income-tax Act as well as book profits. In the case of a company, where 10% of book profits exceeds tax on total income, the book profit shall be deemed to be the total income and the tax payable on such total income shall be 10% thereof plus surcharge plus education cess.

Computation of book profit of ABC Co. Ltd. under section 115JB

Details	Rs.	Rs.
Net profit as per profit and loss account		40,00,000
Add: (i) Proposed dividend	1,75,000	
(ii) Expenditure relating to section 10B unit	15,00,000	
	16,75,000	56,75,000
Less: (i) Income exempt under section 10B	20,00,000	
(ii) Brought forward depreciation [since the same is lower than unabsorbed loss]	8,00,000	
	28,00,000	
Book profit under section 115JB		28,75,000
10% of book profit		2,87,500

Computation of total income of ABC CO. Ltd. under the Income-tax Act

Details	Rs.	Rs.
Net profit as per profit and loss account		40,00,000
Add: Expenses not allowable:		
Penalty for infraction of law	50,000	
Proposed dividend	1,75,000	
Depreciation as per Companies Act	7,50,000	
Sub-total	9,75,000	
		49,75,000
Less:		
Profit eligible for deduction under section 10B [Rs. 20,00,000 - Rs. 15,00,000]	5,00,000	
Capital gains (considered separately)	5,00,000	
Depreciation allowable under the Income-tax Act	15,50,000	
Sub-total	25,50,000	
Profits and gains of business		24,25,000
Long-term capital gain on sale of depreciable asset –exempt since invested in specified assets in specified period		Nil
Gross total income		24,25,000
Less: Deduction u/s 80-IB		14,00,000
Total income		10,25,000



A. Tax on total income as per the Income-tax Act is Rs. 3,07,500 (being 30% of Rs. 10,25,000).

B. 10% of book profit of Rs. 28,75,000 is Rs. 2,87,500.

Since 10% of book profit does not exceed tax on total income, the provisions of section 115JB are not attracted. Hence, the tax payable on total income as per Income-tax Act is as follows
 Tax on total income - @30% 3,07,500 Add: Surcharge @10% 30,750 Sub-total Rs 3,38,250. Add: Education cess @2% - Rs 6,765. Add: Secondary Higher Education Cess @1%-Rs3383.00. Hence, tax on total income as per the Income-tax Act is Rs 3,48,398.

Gopal receives the following salary and perquisites from his employer during the previous year 2007-08: Basic pay: Rs. 1,20,000; profit bonus: Rs. 5,500; commission on sales @ 2 per cent of turnover (turnover of the year 2007-08 achieved by Gopal: Rs. 6,00,000); advance salary of April, May and June 2008: Rs. 30,000; employer's contribution towards recognised provident fund: Rs.16,220; interest credited on May 15, 2007 in provident fund account @ 15 per cent: Rs. 8,700; conveyance allowance: Rs. 300 (@ Rs. 100 per month from January 1, 2008 to March 31, 2008 which is fully utilised for official purposes); free services of a gardener (salary : Rs. 8,000); free services of personnel attendant (salary Rs. 9,000) and free services of watchman (salary Rs. 1,200). Apart from taking salary in advance Gopal takes an interest-free loan of Rs. 95,000 on November 1, 2007 from the employer repayable after 3 years for higher education of his daughter (SBI lending rate on April 1, 2007: 10.5 per cent). He owns a house at Calcutta. During the previous year, he earns taxable income of Rs. 1,75,000 from the house. Gopal holds 20 per cent equity shares in the employer-company.

Gopal contribute Rs. 19,500 towards recognised provident fund during the previous year and pays Rs. 8,000 in a bank as a fixed deposit for the purpose of section 80C. Compute the total income and tax payable by Gopal for the assessment year 2008-09.

Ans - Computation of taxable income and tax payable by Gopal for A.Y. 2008-09

Particulars	Rs.	Rs.
Basic pay		1,20,000
Profit bonus		5,500
Commission on sales (2% of Rs. 6,00,000)		12,000
Advance Salary		30,000
Employer's contribution in excess of 12% of salary (i.e. 16,220 – 12% of Rs. 1,32,000) (see Note 1)		380
Interest credited to PF account, being the amount in excess 12% per annum (i.e., Rs. 8,700 X 3 ÷ 15)		1,740
Conveyance allowance		300
Less: Exemption (as it is utilized for official purpose)	300	Nil
Free Gardner		8,000
Free personnel attendant		9,000

Free watchman	1,200
Interest-free loan (interest on Rs. 95,000 @ 10.5% p.a. from November 1, 2007 to March 31, 2008) (see Note 2)	4,156
Gross salary	1,91,976
Less: Deduction under section 16	-
Net salary	1,91,976
Income from house property	1,75,000
Gross total income	3,66,976
Less: Deduction under section 80C (see Note 3)	27,500
Total income	3,39,476
Tax on total income	
Income-tax	50,844
Add: Surcharge (surcharge is not applicable if total income does Not exceed Rs. 10 lakh)	-
	50,844
Add: Education cess @2%	1,017
Add: Secondary and Higher Education cess @1%	508
Tax payable	52,369
Tax payable (rounded off)	52,370

Notes -

1. As commission is based upon fixed percentage of turnover achieved by Gopal, it will be part of salary for the purpose of determining tax incidence on employer's contribution towards provident fund. For the aforesaid purposes salary would, therefore, be Rs. 1,32,000 (i.e., basic salary Rs.1,20,000 + Rs. 12,000).
2. Salary received in advance is taxable in the year of receipt. Loan taken from the employer is not taxable. However, interest on such loan is taxable.
3. Deduction under section 80C is computed as under: - Contribution towards Recognised PF - Rs 19,500 plus FD in Bank - Rs 8,000. Total deduction - Rs 27,500