

PROFITS AND GAINS OF BUSINESS OR PROFESSION

Some Key Points : Recent Amendments

Section 28(vii)

Where any sum is received or receivable, in cash or kind, on account of any capital asset, (other than land or goodwill or financial instrument) towards demolition, destruction, discard or transfer is taxable under section 28(vii), if the whole of such expenditure towards the capital asset was allowed earlier as a deduction under section 35AD of the Act.

Enhanced deduction for in-house research [Section 35(2AB)]

In the case of a company engaged in the business of bio-technology or in any business of manufacture or production of any article or thing, not being an article or thing specified in the Eleventh Schedule, expenditure (other than capital expenditure in the nature of cost of land or building) towards scientific research which is approved by the prescribed authority, **200% of the expenditure so incurred is eligible for deduction.**

Investment Linked Deduction [Section 35AD]

The Finance (No.2) Act, 2009 has inserted section 35AD to provide impetus to certain specified businesses and the capital expenditure incurred thereof are deductible against income from such business. The unabsorbed portion of capital expenditure relating to the specified business is eligible for carry forward and set off under section 73A of the Act.

The term 'specified business' means any one or more of the following business, namely:–

- (i) Setting up and operating a cold chain facility;
- (ii) Setting up and operating a warehousing facility for storage of agricultural produce;
- (iii) Laying and operating a cross-country natural gas or crude or petroleum oil pipeline network for distribution, including storage facilities being an integral part of such network.
- (iv) Building and operating a new hotel of two star or above category as classified by the Central Government.
- (v) Building and operating, anywhere in India, a new hospital with at least 100 beds for patients.

- (vi) Developing and building a housing project under a scheme for slum redevelopment or rehabilitation framed by the Central Government or State Government, as the case may be, and notified by the Board in this behalf in accordance with the guidelines, as may be prescribed.

Expanded coverage of eligible business under section 36(1)(viii)

The Special reserve created and maintained by specific entities of an amount not exceeding 20% of the eligible business is deductible under section 36(1)(viii). The entities eligible for such deduction are (i) financial corporations specified in section 4A of the Companies Act, 1956; (ii) financial corporations which are public sector companies; (iii) banking companies; (iv) co-operative banks other than those eligible for section 80-P deduction; (v) housing finance companies; and (vi) any other financial corporation including public companies.

In respect of entities referred to in (i) to (iv) above the 'eligible business' would mean the business of providing long term finance for –

- (A) Industrial or agricultural development;
- (B) Development of infrastructural facility in India; and
- (C) Development of housing in India.

Extended time for remitting the tax deducted at source [Section 40(a)(ia)]

The Finance Act, 2010 has amended section 40(a)(ia) with retrospective effect from 01.04.2010 (assessment year 2010-11 onwards) by extending the time limit for remitting the tax deducted at source.

In view of the change, the tax deducted at source if remitted before the 'due date' specified in section 139(1), such expenditure on which tax was deducted, would be eligible for deduction.

Where such remittance is made beyond the 'due date' specified in section 139(1) then such expenditure is deductible in computing the income of the previous year in which such tax payment was made.

Written down value for LLP on conversion of a company [Explanation 2C to Section 43(6)]

When a private company or unlisted company is converted into LLP and the conditions of section 47(xiiib) are satisfied, the actual cost of the block of assets in the case of LLP shall be the WDV of the block of assets as in the case of company on the date of its conversion into LLP. In other words, the WDV of the predecessor viz. company will be adopted as the WDV of the successor viz the LLP.

Amendment to nullify Doom Dooma India Ltd's case

The Apex Court, in *CIT v. Doom Dooma India Ltd* (222 CTR 105) had held that the

language employed in section 43(6)(b) regarding depreciation 'actually allowed', where any income is partially agricultural and partially chargeable to tax under the head "Profits and gains of business", the depreciation deducted in arriving at the taxable income alone can be taken into account for computing the WDV in the subsequent year. It was held that the interpretation is not in accordance with the legislative intent. Accordingly, Explanation 7 to section 43(6) was inserted by the Finance (No.2) Act, 2009 w.e.f. 01.04.2010.

As per the Explanation 7 to section 43(6), where the income of an assessee is in part from agriculture and partly chargeable under the head 'Profits and gains of business or profession', for computing the WDV of the asset acquired before the previous year, the total amount of depreciation shall be computed as if the entire income is derived from the business of the assessee under the head 'Profits and gains of business or profession' and the depreciation so computed shall be deemed to be the depreciation actually allowed.

Expanded application of presumptive income [Section of 44AD]

The Finance (No.2) Act, 2009 has substituted section 44AD w.e.f. 01.04.2011. The extended presumptive income determination scheme replaces the erstwhile section 44AD meant for civil construction contractors and section 44AF meant for retail traders.

As per the newly substituted provision, in the case of an eligible assessee engaged in eligible business, a sum equal to 8% of the total turnover or gross receipt or a sum higher than the aforesaid sum claimed to have been earned by the eligible assessee, shall be deemed to be Profits and Gains of business, which is chargeable to tax under the head 'Profits and gains of business or profession'.

The following are of the features of the scheme -

- (a) The gross receipt should not exceed Rs.60 lakhs in the previous year in which such presumptive income determination is opted for by the assessee.
- (b) The provisions of Chapter XVII-C relating to advance payment of tax will not apply.
- (c) All expenses and deductions allowable under sections 30 to 38 shall be deemed to have been already given to effect to and no further deduction under those sections shall be allowed.
- (d) In the case of firm, deduction under section 40(b) is allowable subject to the conditions contained therein.
- (e) 'eligible assessee' means an individual or HUF or a partnership firm (other than LLP) and who have not claimed deduction under sections 10A, 10AA, 10B, 10BA or deduction under any provisions of Chapter VI-A under the heading "C – Deductions in respect of certain incomes", in the relevant assessment year.

- (f) 'eligible business' means any business except the business of plying, hiring or leasing goods carriages referred to in section 44AE of the Act.
- (g) Section 44AD covers manufacturers, jobworkers, processing industry and wholesalers. It does not cover any notified profession.

Enhanced presumptive income in respect of plying, hiring or leasing of goods carriages [Section 44AE]

The Finance (No.2) Act, 2009 has substituted sub-section (2) to section 44AE and has enhanced the presumptive income from plying, hiring or leasing of goods carriages.

Income from heavy goods vehicles, shall be an amount equal to Rs.5,000 for every month or part of a month during which the vehicle is owned by the assessee in the previous year or an amount claimed to have been actually earned from such vehicle – whichever is higher.

Income from other than heavy goods vehicles, shall be an amount equal to Rs.4,500 for every month or part of a month during which the vehicle is owned by the assessee in the previous year or an amount claimed to have been actually earned from such vehicle – whichever is higher.

Section 44BB and section 44DA are mutually exclusive

The Finance Act, 2010 has clarified that the provisions of section 44BB will not apply to cases where the provisions of section 44DA would apply. Thus, income by way of royalties in the case of non-resident (not being a company) would be governed by section 44DA from the assessment year 2011-12 onwards.

Question 1

Discuss the allowability of the following expenditure while computing income under the head "Profits and gains of business or profession" with the help of decided case laws –

- (a) *Expenses incurred on partly-convertible debenture; and*
- (b) *Expenditure incurred on MS Office software.*

Answer

- (a) The Madras High Court has, in *CIT v. South India Corporation (Agencies) Ltd. (2007) 290 ITR 217*, held that expenditure incurred on partly-convertible debentures is revenue expenditure eligible for deduction while computing business income. The High Court observed that the issue of shares is a future event, which may or may not happen. Since, at present, it is an expenditure incurred on the issue of debentures only, it is revenue expenditure eligible for deduction under section 37(1).
- (b) The Delhi High Court has, in *CIT v. GE Capital Services Ltd. (2008) 300 ITR 420*, held that only customized software can have an enduring value. The High Court observed that

MS Office software is not a customized software. Due to technological changes and the need to upgrade the software on a regular basis, it could not be said that the software is of an enduring nature. Therefore, the expenditure incurred on MS Office software is allowable business expenditure.

Question 2

XYZ Ltd. commenced operations of the business of laying and operating a cross-country natural gas pipeline network for distribution on 1st April, 2010. The company incurred capital expenditure of Rs.32 lakh during the period January to March, 2010 exclusively for the above business, and capitalized the same in its books of account as on 1st April, 2010.

Further, during the financial year 2010-11, it incurred capital expenditure of Rs.95 lakh (out of which Rs.60 lakh was for acquisition of land) exclusively for the above business. Compute the deduction under section 35AD for the A.Y.2011-12, assuming that XYZ Ltd. has fulfilled all the conditions specified in section 35AD.

Answer

The amount of deduction allowable under section 35AD for A.Y.2011-12 would be –

Particulars	Rs.
Capital expenditure incurred during the P.Y.2010-11 (excluding the expenditure incurred on acquisition of land) = Rs.95 lakh – Rs.60 lakh	35 lakh
Capital expenditure incurred prior to 1.4.2010 (i.e., prior to commencement of business) and capitalized in the books of account as on 1.4.2010	<u>32 lakh</u>
Total deduction under section 35AD for A.Y.2011-12	<u>67 lakh</u>

Question 3

Mr. A, a civil contractor and builder, paid a compensation of Rs.5 lakh to the tenants for vacating the premises. This was in pursuance of an agreement for development of the property. Mr. A claimed the expenditure as revenue expenditure. Discuss the correctness of the claim of Mr.A. Would the tax treatment of such compensation be different if Mr.A was not a civil contractor?

Answer

The Bombay High Court has, in *CIT v. Shriram Builcons Ltd. (2008) 306 ITR 328*, held that any compensation paid to tenants for vacating the premises in the course of business of the assessee, who was a civil contractor and builder, pursuant to an agreement for development of property, was revenue expenditure. However, if the assessee was not a civil contractor, then he would be subject to capital gains tax and the compensation so paid would be allowed as cost of improvement.

Question 4

- (a) *A Ltd. paid IDBI a lump sum prepayment premium of Rs.1.2 lakh on 7.4.2010 for restructuring its debts and reducing its rate of interest. It claimed the entire sum as business expenditure for the P.Y.2010-11. The Assessing Officer, however, held that the prepayment premium should be amortised over a period of 10 years (being the tenure of the restructured loan), and thus, allowed only 10% of the pre-payment premium in the P.Y.2010-11. Discuss, with reasons, whether the contention of A Ltd. is correct or that of the Assessing Officer.*
- (b) *Explain the tax treatment for depreciation on emergency spares (of plant and machinery) acquired during the year which, even though kept ready for use, have not actually been used during the relevant previous year.*

Answer

- (a) This issue came up before the Delhi High Court in *CIT v. Gujarat Guardian Ltd (2009) 177 Taxman 434*. The Court observed that the assessee company's claim for deduction has to be allowed in one lump sum keeping in view the provisions of section 43B(d), which provide that any sum payable by the assessee as interest on any loan or borrowing from any financial institution shall be allowed to the assessee in the year in which the same is paid, irrespective of the periods, in which the liability to pay such sum is incurred by the assessee according to the method of accounting regularly followed by the assessee. The High Court concurred with the Tribunal's view supporting the assessee that in terms of section 36(1)(iii) read with section 2(28A), the deduction for pre-payment premium was allowable. Since there was no dispute that prepayment premium paid was nothing but interest and that it was paid to a public financial institution i.e. IDBI, the Court held that, in terms of section 43B(d), the assessee's claim for deduction has to be allowed in the year in which the payment has actually been made.

Therefore, applying the ratio of the above case, the contention of A Ltd. is correct and not that of the Assessing Officer.

Note – Section 36(1)(iii) provides for deduction of interest paid in respect of capital borrowed for the purposes of business or profession. Section 2(28A) defines interest to include, *inter alia*, any other charge in respect of the moneys borrowed or debt incurred. Section 43B provides for certain deductions to be allowed only on actual payment. From a combined reading of these three sections, it can be inferred that –

- (i) *pre-payment premium represents interest as per section 2(28A);*
 - (ii) *such interest is deductible as business expenditure as per section 36(1)(iii);*
 - (iii) *such interest is deductible in one lump-sum on actual payment as per section 43B(d).*
- (b) This issue was dealt with by the Delhi High Court in *CIT v. Insilco Ltd (2009) 179 Taxman 55*. The Court observed that the expression “used for the purposes of business”

appearing in section 32 also takes into account emergency spares, which, even though ready for use, yet are not consumed or used during the relevant period. This is because these spares are specific to a fixed asset, namely plant and machinery, and form an integral part of the fixed asset. These spares will, in all probability, be useless once the asset is discarded and will also have to be disposed of. In this sense, the concept of passive use which applies to standby machinery will also apply to emergency spares. Therefore, once the spares are considered as emergency spares required for plant and machinery, the assessee would be entitled to capitalize the entire cost of such spares and claim depreciation thereon.

Note – One of the conditions for claim of depreciation is that the asset must be “used for the purpose of business or profession”. In the past, courts have held that, in certain circumstances, an asset can be said to be in use even when it is “kept ready for use”. For example, depreciation can be claimed by a transport company on spare engines kept in store in case of need, though they have not actually been used by the company. Hence, in such cases, the term “use” embraces both active use and passive use for business purposes.

Question 5

The business profit of T Ltd., a tea growing and manufacturing company, is Rs.120 lakh (before deduction under section 33AB) for the assessment year 2011-12. It deposits Rs.50 lakh with NABARD for claiming deduction under section 33AB. It wants to claim set-off of brought forward business loss of Rs.40 lakh. Find out the taxable income of T Ltd. for the assessment year 2011-12.

Answer

An assessee, engaged in growing and manufacturing tea in India, is entitled to a deduction under section 33AB, in respect of the amount deposited by the assessee to an account maintained with NABARD as per scheme approved by Tea Board, to the extent of lower of the following two amounts –

- (i) Amount deposited to the account maintained with NABARD within 6 months from the end of the previous year or before the due date for filing the return of income, whichever is earlier;
- (ii) 40% of profits of such business computed under the head “Profits and Gains of Business or Profession” before making any deduction under this section.

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

Direct Tax Laws

Computation of taxable income of T Ltd. for the A.Y.2011-12			
Particulars	Rs. in lakh	Rs. in lakh	
Profit before deduction under section 33AB		120.00	
Less: Deduction under section 33AB for deposit to the account with NABARD being lower of the following amounts:			
Amount deposited with NABARD	50		
40% of business profit i.e., 40% of Rs.120 lacs	<u>48</u>	<u>48.00</u>	
		72.00	
Less: 60% of Rs.72 lakh, being agricultural income as per Rule 8		<u>43.20</u>	
		28.80	
Less: Set off brought forward loss under section 72		<u>28.80</u>	
Taxable business income		<u>Nil</u>	
Total Income		Nil	

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

Question 6

Ishwar is a commission agent receiving commission from his principal. He collected certain amount as deposit towards sales tax and showed the amount so received under the head "Contingency deposit" in the Balance Sheet. He did not deposit the amount to the Government. The Assessing Officer invoked section 43B and added back the said amount to the business income of Ishwar. Examine the correctness of the action of the Assessing Officer.

Answer

The facts of the case are similar to that in *Ishwardas Sons v. CIT (2007) 295 ITR 473 (Ker)*. The issue is whether sales tax collected and kept as a contingency deposit can be considered as a trading receipt. The assessee collected certain amount as deposit towards sales tax and showed the amount so collected under the head "contingency deposit" account in the balance sheet. He did not deposit the amount to the Government. The Kerala High Court observed that the amount of sales tax collected formed part of the trading receipts of the assessee. The mere fact that the assessee created a head of account "Contingency Deposit" would not alter the nature of receipt. The High Court held that the sales tax collected by the assessee and shown under the head "Contingency Deposit" had to be considered as a trading receipt and included in the total income of the assessee. The disallowance under section 43B would be

attracted for non-payment of sales tax collected irrespective of the nomenclature used and the accounting head under which it is categorized.

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

Question 7

Sea Port Shipping Line, a non-resident foreign company operating its ships on the Indian Ports during the previous year ended on 31.3.2011, had collected freight of Rs.100 lacs, demurrages of Rs.20 lacs and handling charges of Rs.10 lacs inclusive of an amount of Rs.40 lacs collected in US dollars for the cargo booked for JNPT (Mumbai) from Antwerp. The expenses of operating its fleet during the year for the Indian Ports were Rs.110 lacs. The company denies its liability to tax in India. Examine.

Answer

The provisions of section 44B would apply in this case. This section provides that in the case of an assessee, being a non-resident, engaged in the business of operation of ships, a sum equal to 7½% of the aggregate of the following amounts would be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession"

- (i) The amount paid or payable, whether within India or outside, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods shipped at any port in India.
- (ii) The amount received or deemed to be received in India by the assessee himself or by any other person on behalf of or on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.

The above amounts will include demurrage charges and handling charges.

These provisions for computation of the income from the shipping business in case of non-residents would apply notwithstanding anything to the contrary contained in the provisions of sections 28 to 43A of the Income-tax Act.

Therefore, in this case, M/s. Sea Port Shipping Line is required to pay tax in India on the basis of presumptive tax scheme as per the provisions of section 44B. The assessee shall not be entitled to set off any of the expenses incurred for earning of such income. Therefore, the Shipping Line is required to pay tax @ 7½% on the total receipts of Rs.130 lacs i.e., Rs.9.75 lacs.

Question 8

Examine critically in the context of provisions contained in Income-tax Act, 1961 as to the correctness of the action or the treatment given in each of the following cases:

- (a) *Singhal Sons Mines, for acquiring rights for extracting minerals, had taken a mine on*

Direct Tax Laws

lease basis w.e.f. 01.09.10 for a period of 15 years from Mr. Naresh against an amount of Rs.30 lacs payable in three equal instalments on 31.08.10, 31.08.11 and 31.08.12. Amount of Rs.10 lacs paid on 31.08.10 was charged as an expense in the mining account.

- (b) *XYZ is engaged in the business of sale of Zinc Concentrate in India and in U.K. markets. The company valued its closing stock on 31.03.11 on the basis of the price prevailing in London Metallic Exchange instead of price in the domestic market, as the price in London Metallic Exchange was lesser than the Indian rate.*

Answer

- (a) The assessee had acquired the mining rights after entering into the lease agreement against the payment of lease money in 3 installments. The assessee firm had charged the payment of Rs.10 lacs made on 31.8.2010 in the previous year as revenue expenditure. The Apex Court, in the case of *Enterprising Enterprises v. DCIT (2007) 293 ITR 437*, on identical facts, had held that the payment of royalty or rent for the mining lease falls under revenue expenditure where it is paid on a year to year basis, but where the lease money is paid either one time or in installments then the same would be a capital expenditure. Accordingly, the amount of Rs.10 lacs charged by the assessee in the mining account will not be allowed as revenue expenditure but shall be treated as capital expenditure.
- (b) The Supreme Court, in the case of *Hindustan Zinc Limited v. CIT (2007) 295 ITR 453*, observed that it was generally accepted as a rule of commercial practice and accountancy that the closing stock has to be valued on the basis of cost or market price, whichever is lower, and there should be no writing down in the value of goods except when there was an actual or anticipated loss. In that case, the assessee was engaged only in domestic business activities and no export had taken place during the relevant previous year. Accordingly, the Supreme Court held that writing down the value of Zinc Concentrate by adopting the price of London Metallic Exchange as its net realizable value is incorrect as the same does not correspond with the term "actual or anticipated loss" in any manner, because prices in the domestic market were higher.

Therefore, in the case on hand, the action of the assessee to value the closing stock on the basis of the prices prevailing in the London Metallic Exchange is not correct, assuming that in this case also, the assessee was engaged only in domestic business activities and no export had taken place during the relevant previous year. Hence, the assessee is required to adopt the net realizable value of the goods held in the closing stock, being the market price prevailing in the domestic market, when the same is less than the cost price, for valuation of its closing stock.

Question 9

- (a) *Meghna Film Distributors have acquired the rights of exhibition of a feature film 'Nasha' in the territory of Rajasthan from the producers under an agreement executed on*

11.06.10 against a consideration of Rs.300 lacs. It thereafter executed a sub-agreement with a distributor to whom the rights of exhibition of the film in some of the areas of Rajasthan were assigned against an amount of Rs.100 lacs. The film was released for exhibition on commercial basis on 25.12.10. Collection from the exhibition of film of "Meghna Film Distributors" for 25.12.2010 to 10.01.2011 was Rs.50 lacs and thereafter up to 31.03.2011 was Rs.190 lacs.

It asks you to clarify as to how these transactions will be reflected in the Income-tax return for A.Y. 2011-12. Would your answer be different if the film was released for exhibition on 11.01.2011?

- (b) What meaning has been assigned to "Speculative transaction"? Narrate those transactions which shall not be treated as speculative transactions under the Income-tax Act, 1961.

Answer

- (a) Meghna Film Distributors is engaged in the business of exhibition of feature films after taking the rights from the producers. The profits and gains of such business are to be computed as per the provisions given in Rule 9B of the Income-tax Rules.

Accordingly, the profits shall be worked out after deducting the amount paid towards cost of acquisition of film by the film distributor to the producer from the amount recovered by giving the rights of exhibition of film to sub-distributors and the receipts from exhibition of the feature films on commercial basis by the distributor himself where the film was released for exhibition on commercial basis before 90 days from the end of the financial year. If the film is not so released at least 90 days before the end of such previous year, the cost of acquisition shall be allowed to the extent of the amount realized by the film distributor and the balance shall be carried forward to the next following previous year and allowed as deduction in that year.

In the present problem, the agreement was executed on 11.06.2010 and the film also stands released for exhibition on commercial basis before 90 days from the end of the financial year i.e., on 25.12.10. Accordingly, the profit of the assessee will be computed as under: -

Particulars	Rs.
Collection from exhibition of film (Rs.50 lacs + Rs.190 lacs)	240 lacs
Collection from sub-distributor	<u>100 lacs</u>
	340 lacs
Less : Cost of acquisition	
Amount paid to producer for exhibition rights of the film	<u>300 lacs</u>
Net income of film "Nasha"	<u>40 lacs</u>

Direct Tax Laws

Release of film for exhibition on commercial basis on 11.1.2011:

(i.e., less than 90 days before the end of the previous year 2010-11). In this case, the profits of the assessee will be as under :-

Particulars	Rs.
Collection from exhibition of film	190 lacs
Collection from sub-distributor	<u>100 lacs</u>
	290 lacs
Less : Cost of acquisition	
Amount paid to producer for exhibition rights of the film (Rs.300 lakh, but restricted to Rs.290 lakh)	<u>290 lacs</u>
Net income of film "Nasha"	<u>Nil</u>

The balance of Rs.10 lakh (i.e. Rs.300 lakh – Rs.290 lakh) has to be carried forward to the next following previous year and allowed as a deduction in that year i.e., P.Y.2011-12.

- (b) According to section 43(5), the expression "speculative transaction" means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips.

The following transactions shall not be deemed to be speculative transactions:

- a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchandising business to guard against loss through future price fluctuations in respect of his contracts for the actual delivery of goods manufactured by him or merchandise sold by him; or
- a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or
- a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member; or
- an eligible transaction in respect of trading in derivatives carried out in a recognized stock exchange.

Question 10

Work out the taxable income for A.Y. 2011-12 of a partnership firm engaged in retail trade from the following particulars:

- Net profit of Rs.3,65,000 arrived at after debit of interest on capital of partners of Rs.1,80,000 and salaries to working partners of Rs.4,80,000.*

Profits and Gains of Business or Profession

- (ii) *Total capital of the partners on which interest paid is debited in the profit and loss account was Rs.10,00,000.*

Answer

Computation of taxable income of the partnership firm for A.Y.2011-12

Particulars	Amount (Rs.)	Amount (Rs.)
Net Profit as per profit and loss account		3,65,000
Add : Interest on Capital		1,80,000
Salaries to Partners		<u>4,80,000</u>
		10,25,000
Less : Interest on capital allowable @ 12% on Rs.10 lakh		<u>1,20,000</u>
Book Profits		9,05,000
Less: Admissible amount of salary as a percentage of book profits or actual paid, whichever is less		
90% of Rs.3,00,000	2,70,000	
60% on the balance Rs.6,05,000	<u>3,63,000</u>	
(a) Salary as per limits prescribed in section 40(b)	<u>6,33,000</u>	
(b) Actual salary paid and authorized by the deed	<u>4,80,000</u>	
Least of the above is deductible		<u>4,80,000</u>
Taxable Income		<u>4,25,000</u>

Question 11

Intelysis Limited charged depreciation on its fixed assets at the rates prescribed in the Income-tax Rules in its accounts consistently. The Assessing Officer disallowed the same and considered depreciation computed at the rates prescribed in the Companies Act, 1956, for the purpose of computation of 'book profit' under section 115JB of the Income-tax Act for the assessment year 2011-12. Examine the correctness of the action of the Assessing Officer.

Answer

This issue was settled by the Supreme Court in *Malayala Manorama Co. Ltd. v. CIT (2008) 300 ITR 251*. The Apex Court observed that for the purpose of computation of book profit under section 115JB, the Assessing Officer's power is restricted to examining whether the books of account are certified by the authorities under the Companies Act as having been properly maintained in accordance with the Companies Act. Thereafter, he only has the

Direct Tax Laws

limited power of making additions and deductions as provided for in Explanation 1 to section 115JB. The Assessing Officer does not have the jurisdiction to go behind the net profit shown in the profit and loss account except to the extent provided in Explanation 1 to section 115JB.

Where an assessee is consistently charging depreciation in its books of account at the rates prescribed in Income-tax Rules and the accounts of the assessee have been prepared and certified as per the provisions of the Companies Act, the Assessing Officer does not have any jurisdiction under section 115JB to rework the net profit of the assessee by substituting the rates of depreciation prescribed under the Companies Act.

Applying the ratio of the Supreme Court decision to this case, it may be concluded that the action of the Assessing Officer is not correct.

Note - The rates of depreciation prescribed in Schedule XIV to the Companies Act are the minimum rates at which depreciation is to be charged in the profit & loss account. The rates prescribed in the Income-tax Rules are higher than those prescribed in the Companies Act. A company is, therefore, not precluded from adopting higher rates of depreciation, if the circumstances justify. Thus, even if a company adopts the higher rates of depreciation prescribed in the Income-tax Rules, it can be said that the company has prepared the accounts in the manner provided under the Companies Act.

Question 12

'X' Ltd., transferred its fertilizer business to a new company 'Y' Ltd., by way of demerger with effect from appointed date of 1.4.2010 after satisfying the conditions of demerger. Further information given:

- (a) *WDV of the entire block of plant and machinery held by 'X' Ltd. as on 1.4.2010 is Rs. 100 crores;*
- (b) *Out of the above, WDV of block of plant and machinery of fertilizer division is 70 crores;*
- (c) *'X' Ltd. has unabsorbed depreciation of Rs.50 lakhs as at 31.3.2010;*

On the above facts:

- (i) *You are required to explain the provisions of the income-tax as to the allowability of depreciation, post-merger, in the hands of 'X' Ltd. and 'Y' Ltd. as at 31.3.2010 duly calculating the depreciation.*
- (ii) *State how the unabsorbed depreciation has to be dealt with for the assessment year 2011-12.*

Answer

- (i) In the case of a demerger, satisfying the conditions as laid down in section 2(19AA), the depreciation claim is governed by the provisions as under:
 - (1) As per the *Explanation 7A* of section 43(1), where in a scheme of demerger, if the demerged company transfers any capital asset to the resulting company, being an

Profits and Gains of Business or Profession

Indian company, the actual cost of the capital asset transferred shall be taken to be the same as it would have been if the demerged company had continued to hold the capital asset for the purpose of its own business.

- (2) The resulting company will be entitled to depreciation on the written down value of the block of assets transferred to it, which will be the written down value of the transferred assets of the demerged company immediately before the demerger [Explanation 2B to section 43(6)].
- (3) *Explanation 2A* to section 43(6) provides that the written down value of the block of assets in the hands of the demerged company shall be the written down value of the block of assets of the demerged company for the immediately preceding previous year as reduced by the written down value of the assets transferred to the resulting company pursuant to the demerger.
- (4) As per the above provisions, the calculation of depreciation on plant and machinery in the hands of 'X' Ltd. and 'Y' Ltd. is as under:

WDV of plant and machinery	'X' Ltd.	'Y' Ltd.
	Rs. in crores	
As at 1 st April, 2010	30.00	70.00
Less: Depreciation @ 15%	4.50	10.50
WDV as at 31 st March, 2011	25.50	59.50

Note – It is presumed that Y Ltd. is an Indian company

(ii) Set-off of unabsorbed depreciation:

- (i) As per section 72A(4), on demerger, the unabsorbed depreciation directly relatable to the undertakings transferred to the resulting company is allowed to be carried forward and set off in the hands of the resulting company.
- (ii) Where such unabsorbed depreciation is not directly relatable to the undertaking transferred to the resulting company, it has to be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company.
- (iii) The demerged company and the resulting company would be allowed to carry forward and set-off their respective portion of unabsorbed depreciation, as calculated above, for an unlimited period as per section 32(2).

Question 13

Specify all those public facilities which have been notified by CBDT as infrastructure facility for the purpose of section 36(1)(viii).

Answer

The CBDT, vide Notification No. SO 1153(E) dated 20.07.2006, has notified the following public facilities as infrastructure facility for the purpose of section 36(1)(viii):

- (1) Inland Container Depot and Container Freight Station notified under the Customs Act, 1962
- (2) Mass Rapid Transit system
- (3) Light Rail Transit system
- (4) Expressways
- (5) Intra-urban or semi-urban roads like ring roads or urban by-passes or flyovers
- (6) Bus and truck terminals
- (7) Subways
- (8) Road dividers
- (9) Bulk Handling Terminals which are developed or maintained or operated for development of rail system
- (10) Multilevel Computerised Car Parking.

Question 14

M/s. Nagdiwala Enterprises, a partnership firm constituted by a doctor and a non-doctor engaged in running a multispeciality hospital, seeks your opinion in the context of provisions of the Act as to allowability/chargeability of the following transactions for preparing its return for A.Y. 2011-12:

- (a) *Depreciation on the instruments, imported from U.K. for Rs.2 lacs cleared by customs on 22.3.2011 on payment of duty of Rs.1 lakh, installed and ready for use on 26.3.2011. Only one operation with the help of such instruments was performed till 31.3.2011.*
- (b) *The book profits calculated as per section 40(b) are Rs.3 lacs and payment of salary to working partners was Rs.1 lakh. Clause for payment of salary to working partners though appears in the deed, but the same is silent as to quantum and the manner of distribution.*
- (c) *Salary of Rs.10,000 p.m. paid to the wife of a partner for working as an anesthetist. The normal salary of an anesthetist in the town is Rs.7,500 p.m. or less.*
- (d) *Purchase of medicines in cash on 18.12.2010 for Rs.35,000.*
- (e) *Revenue expenditure of Rs.10,000 incurred for promoting family planning amongst its employees.*

- (f) *Interest of Rs.3,000 paid on an overdraft of Rs.1 lac taken for making payment of installment of advance tax of Rs.1.25 lacs.*

Answer

The allowability/chargeability of each of the transactions entered into by M/s Nagdiwala Enterprises for the purpose of computation of income for Assessment Year 2011-12 shall be as under:-

- (a) The surgical instruments used by a firm engaged in the business of running a hospital are covered under the category of Plant & Machinery, on which the rate of depreciation is 15%. The depreciation on the instruments imported from U.K. is allowable to the firm since the same were put to use during the previous year ended on 31.3.11 because of performing of one operation. However, the same were used in the previous year for less than 180 days and accordingly the allowable depreciation will be one half of the normal depreciation. The cost of instruments is Rs.3 lakh and the amount of depreciation thereon works out to Rs.22,500 [$3,00,000 \times 15\% \times 50\%$].
- (b) As per section 40(b), payment of remuneration to a working partner is allowable as deduction only if it is authorised by and in accordance with the terms of the partnership deed. CBDT Circular No.739 dated 25.3.96 clarifies that no deduction in respect of remuneration paid to partners is allowable unless the partnership deed either specifies the amount of remuneration payable to each individual working partner or lays down the manner of quantifying such remuneration. If the partnership deed contains a clause for payment of salary to working partners without specifying the manner of quantification or manner of distribution of such salary, the payment of salary to the working partners cannot be construed to be authorised by and in accordance with the partnership deed.
- (c) Section 40A(2) provides that if any expenditure in respect of which payment has been made to, *inter alia*, any relative of the partner of a firm and the Assessing Officer is of the opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the services for which the payment is made, then disallowance under this section is attracted to the extent the same is excessive or unreasonable. In this case, salary of Rs.10,000 p.m. is paid to the partner's wife, who is working as an anesthetist. The fair market value of a similar service is Rs.7500 p.m. Therefore, disallowance under section 40A(2) is attracted to the extent of Rs.2500 p.m., since to that extent, the same is excessive.
- (d) Section 40A(3) provides for 100% disallowance of an expenditure, in respect of which payment is made in a sum exceeding Rs.20,000 otherwise than by way of account payee cheque or account payee bank draft. Therefore, the entire amount of Rs.35,000 incurred for purchase of medicines in cash is disallowed under section 40A(3).

Direct Tax Laws

- (e) Section 36(1)(ix) provides for deduction in respect of expenditure incurred by companies to promote family planning amongst its employees. However, since the assessee in this case is a partnership firm, such expenses are not allowable as deduction under section 36(1)(ix).
- (f) Interest on the overdraft taken for making payment of installment of advance tax is not allowable under section 37(1) since it is not an expenditure wholly and exclusively incurred for the purpose of business as held by the Apex Court in the case of *East India Pharmaceutical Works Ltd. v. CIT* (1997) 224 ITR 627.

Question 15

Raja Ltd., made a provision on 31.3.11 of Rs.85,500 against a bill of supplier of raw material by charging the amount to profit and loss account and claimed deduction thereof while computing the income chargeable to tax for A.Y. 2011-12. The amount of Rs.40,000 not paid to the party till 31.3.11 was paid in cash on 11.6.11. The Assessing Officer issued show cause notice to the company to rectify the computation of income for the A.Y. 2011-12 on account of payment made in cash on 11.6.11.

Can the Assessing Officer do so?

Answer

Section 40A(3A) provides that where an allowance has been made in the assessment for any year in respect of any liability for any expenditure incurred by the assessee and subsequently, during any previous year, the assessee makes any payment in respect of such liability in a sum exceeding Rs.20,000 otherwise than by an account payee cheque drawn on a bank or by an account payee bank draft, the payment so made shall be deemed to be profits and gains of business or profession of the subsequent year.

Section 40A(3A) is attracted in this case since the company has made a cash payment of Rs.40,000 in respect of a liability incurred and allowed earlier. Accordingly, Rs.40,000/-, will be added in the computation of income for the A.Y.2012-13 (considering that the payment was made on 11.06.2011).

The action of the Assessing Officer to issue show cause notice to rectify the computation of income of earlier assessment year is not valid. The payment would go to increase the assessable income of the assessee for the previous year relevant to the assessment year in which such payment is made.

Question 16

“Easy Call Ltd.”, to provide telecom services in Mumbai, obtained a licence on 11.4.2008 for a period of 10 years ending on 31.3.2018 against a fee of Rs.27 lacs to be paid in 3 installments of Rs.10 lacs, 9 lacs and 8 lacs by April, 2008, April, 2009 and April, 2010 respectively.

Explain, how the payment made for licence fee shall be dealt with under the Income-tax Act, 1961 and work out the amount, if any, deductible in this respect out of income chargeable to tax for A.Y. 2011-12.

Answer

The payment made for acquiring the licence to operate telecom services in Mumbai shall be subject to deduction as per the scheme in section 35ABB. As per section 35ABB, any amount actually paid for obtaining licence to operate telecommunication services shall be allowed as deduction in equal installments during the number of years for which the license is in force. If the payment is made before the commencement of business, the deduction shall be allowed beginning with the year of commencement of business. In any other case, it will be allowed commencing from the year of payment. Deduction shall be allowed up to the year in which the license shall cease to be in force.

The amount of deduction available for A.Y. 2011-12 is Rs.3 lakh as worked out below:-

(1) <i>Previous year of payment</i>	(2) <i>Unexpired period of license</i>	(3) <i>Installment paid (Rs.)</i>	(4) = (3)/(2) <i>Deduction in respect of each installment (Rs.)</i>
2008-09	10 years	10,00,000	1,00,000
2009-10	9 years	9,00,000	1,00,000
2010-11	8 years	<u>8,00,000</u>	<u>1,00,000</u>
		<u>27,00,000</u>	<u>3,00,000</u>

The deduction under section 35ABB from assessment year 2011-12 onwards till A.Y. 2018-19 will be Rs.3 lakh each year.

Note – It is assumed that the company has commenced business during the P.Y.2008-09.

Question 17

GP Ltd. was incorporated on 31.12.2009 for manufacture of tyres and tubes for motor vehicles. The manufacturing unit was set up on 30.4.2010. The company commenced its manufacturing operations on 1.5.2010. The total cost of the plant and machinery installed in the unit is Rs.100 crores. The said plant and machinery included second hand plant and machinery bought for Rs.10 crores and new plant and machinery for scientific research relating to the business of the assessee acquired at a cost of Rs.10 crores.

Compute the amount of depreciation allowable under section 32 of the Income-tax Act, 1961 in respect of the assessment year 2011-12. Furnish explanations in support of your computation.

Answer

Computation of depreciation allowable for the A.Y. 2011-12 in the hands of GP Ltd.

Particulars	Rs. in crores
Total cost of plant and machinery	100.00
Less: Used for Scientific Research (Note 1)	<u>10.00</u>

Direct Tax Laws

	<u>90.00</u>	
Normal Depreciation @ 15% on Rs.90 crores		13.50
Additional Depreciation:		
Cost of plant and machinery	100.00	
Less: Second hand plant and machinery (Note 2)	10.00	
Plant and machinery used for scientific research, the whole of the actual cost of which is allowable as deduction under section 35(2)(ia) (Note 2)	<u>10.00</u>	<u>20.00</u>
	80.00	
Additional Depreciation @ 20%		<u>16.00</u>
Depreciation allowable for A.Y.2011-12		<u>29.50</u>

Notes:

1. As per section 35(2)(iv), no depreciation shall be allowed in respect of plant and machinery purchased for scientific research relating to assessee's business, since the entire expenditure is deductible under section 35.
2. As per section 32(1)(ia), additional depreciation is allowable in the case of any new machinery or plant acquired and installed after 31.3.2005 by an assessee engaged in the business of manufacture or production of any article or thing, at the rate of 20% of the actual cost of such machinery or plant.

However, additional depreciation shall not be allowed in respect of, inter alia, –

- (i) any machinery or plant which, before its installation by the assessee, was used either within or outside India by any other person;
- (ii) any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profit and gains of business or profession" of any one previous year.

In view of the above provisions, additional depreciation cannot be claimed in respect of -

- (i) Second hand plant and machinery; and
- (ii) New plant and machinery purchased for scientific research relating to assessee's business in respect of which the whole of the capital expenditure can be claimed as deduction under section 35(1)(iv) read with section 35(2)(ia).

Question 18

Mr. Sunil carried on the business of purchase and sale of agricultural commodities like paddy, wheat, etc. He borrowed loans from Punjab State Financial Corporation and State Bank of India and has not paid interest as detailed hereunder:

	Rs.
(i) Punjab State Financial Corporation (Previous years 2007-08, 2008-09 & 2009-10)	36,00,000
(ii) State Bank of India (Previous years 2008-09 & 2009-10)	72,00,000
	1,08,00,000

Both Punjab State Financial Corporation and State Bank of India, while restructuring the loan facilities of Sunil during the financial year 2010-11, converted the above interest arrear as loan repayable in 36 equal instalments.

During the year ended 31.3.2011, Sunil paid six instalments to Punjab State Financial Corporation and five instalments to State Bank of India.

Sunil claimed the entire interest of Rs.1,08,00,000 as an expenditure while computing the income from business of purchase and sale of agricultural commodities for the financial year 2010-11.

Discuss whether his claim is valid and if not, what is the amount of interest, if any, allowable.

Answer

Section 43B allows deduction only on "payment" basis in respect of certain expenditure specified therein, irrespective of the method of accounting followed by the assessee. Such expenditure would be allowed as deduction in the previous year in which the liability to pay such sum was incurred only if the payment is made on or before the due date for filing the return of income under section 139(1). If the payment is made after the stipulated due date, deduction can be claimed only in the year of actual payment. Such specified expenditure include, *inter alia*,

- (1) interest on loan or borrowing from any public financial institution or a State financial corporation or a State industrial investment corporation; and
- (2) interest on any loan or advances from a scheduled bank.

A clarification has been given by way of Explanations 3C and 3D in section 43B. These *Explanations* clarify that if any sum payable by the assessee as interest on any such loan or borrowing or advance is converted into a loan or borrowing or advance, the interest so converted and not "actually paid" shall not be deemed as actual payment, and hence would not be allowed as deduction. The clarificatory explanations reiterate the rationale that conversion of interest into a loan or borrowing or advance does not amount to actual payment.

Direct Tax Laws

Therefore, Rs.1,08,00,000, being the aggregate of interest on loan (from a State Financial Corporation and a scheduled bank) converted into loan will not be allowed as deduction. Consequently, the claim of Mr. Sunil is not valid.

The manner in which the converted interest will be allowed as deduction has been clarified in Circular No.7/2006 dated 17th July, 2006. The unpaid interest, whenever actually paid to the bank or financial institution, will be in the nature of revenue expenditure deserving deduction in the computation of income. Therefore, irrespective of the nomenclature, the deduction will be allowed in the previous year in which the converted interest is actually paid.

Hence, the repayment of Rs.16,00,000 during the financial the year 2010-11, as detailed hereunder, will be allowed as deduction while computing the business income of Mr. Sunil in the assessment year 2011-12.

Particulars	Rs.
Paid to Punjab State Financial Corporation (36,00,000 x 6/36)	6,00,000
Paid to State Bank of India (72,00,000 x 5/36)	10,00,000
	16,00,000

Question 19

Mr. Q, a non-resident, operates an aircraft between Singapore and Chennai. He received the following amounts in the course of the business of operation of aircraft during the year ending 31.3.2011:

- (i) Rs.2 crores in India on account of carriage of passengers from Chennai.*
- (ii) Rs.1 crore in India on account of carriage of goods from Chennai.*
- (iii) Rs.3 crores in India on account of carriage of passengers from Singapore.*
- (iv) Rs.1 crore in Singapore on account of carriage of passengers from Chennai.*

The total expenditure incurred by Mr. Q for the purposes of the business during the year ending 31.3.2011 was Rs.6.75 crores.

Compute the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" for the assessment year 2011-12.

Answer

Section 44BBA incorporates special provisions for computing profits and gains of the business of operation of aircraft in the case of non-residents. Section 44BBA starts with a non-obstante clause. Therefore, section 44BBA overrides the provisions contained in sections 28 to 43A. As such, the business income of Mr. Q is required to be computed in accordance with the provisions of section 44BBA.

Profits and Gains of Business or Profession

Under section 44BBA(1), a sum equal to 5% of the aggregate of the amounts specified in sub-section (2) is deemed to be the profits and gains chargeable to tax under the head "Profits and gains of business or profession". Sub-section (2) specifies the following amounts -

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

Keeping in view the provisions of section 44BBA, the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" is worked out hereunder -

	Rs.
Amount received in India on account of carriage of passengers from Chennai	2,00,00,000
Amount received in India on account of carriage of goods from Chennai	1,00,00,000
Amount received in India on account of carriage of passengers from Singapore	3,00,00,000
Amount received in Singapore on account of carriage of passengers from Chennai	1,00,00,000
	7,00,00,000

Income from business under section 44BBA at 5% of Rs.7,00,00,000 is Rs.35,00,000, which is the income of Mr.Q chargeable to tax in India under the head "Profits and gains of business or profession" for the A.Y.2011-12.

Question 20

XYZ Ltd. incurred expenditure amounting to Rs.3,00,000 in connection with the issue of rights shares and Rs.2,00,000 in connection with the issue of bonus shares during the year ending 31.3.2011. The company seeks your opinion in the matter of eligibility for deduction of the expenditure incurred from its business profits for the assessment year 2011-12.

Answer

The Supreme Court has, in *Brooke Bond India Ltd. v. CIT* (1997) 225 ITR 798 (SC), held that expenditure incurred by a company in connection with issue of shares with a view to increase its share capital is directly related to the expansion of its capital base and, therefore, constitutes a capital expenditure. The issue of rights shares results in expansion of the capital base of XYZ Ltd. Hence, expenditure of Rs. 3,00,000 incurred by the company in connection with the issue of rights shares is a capital expenditure and is not allowable as a business expenditure.

On the other hand, the issue of bonus shares does not result in inflow of fresh funds or increase in the capital employed. It is merely capitalization of reserves. The issue of bonus shares does not expand the capital base of the company. The total funds available with the company and its capital structure will remain the same on issue of bonus shares. The Supreme Court, in *CIT v. General Insurance Corporation (2006) 286 ITR 232*, considered this effect of issue of bonus shares and ruled that expenditure incurred in connection with the issue of bonus shares was allowable as revenue expenditure. Hence, the expenditure amounting to Rs.2,00,000 incurred in connection with the issue of bonus shares is deductible from its business profits for the assessment year 2011-12.

Question 21

What is an adventure in the nature of trade? State the factors which are relevant in deciding whether a transaction is an adventure in the nature of trade.

Answer

The term “business” has been defined in section 2(13) of the Income-tax Act, 1961 to include any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture. Adventure in the nature of trade implies that the adventure has the characteristics of trade but not all of them. That indeed is the distinguishing mark of an adventure since if it possessed all the characteristics, it would be a full blown trade straightaway.

The Supreme Court has, in *G. Venkataswami Naidu & Co. v. CIT (1959) 35 ITR 594* and *CIT v. H. Holck Larsen (1986) 160 ITR 67*, identified certain factors which are relevant in deciding whether a transaction is an adventure in the nature of trade.

In deciding whether a transaction is an adventure in the nature of trade, several factors are relevant such as, the motive, intention or purpose with which the article sold was bought earlier, the character of articles purchased and sold, that is, whether the articles are fit for sale as merchandise, ordinary occupation of the assessee, that is, whether he is a trader or not, whether the purchase of the commodity and its resale were allied to his usual trade or incidental to it, quantity of the commodity purchased and sold, acts prior to purchase showing a design or purpose, manner of disposal, similarity of transactions to operations usually associated with trade or business, repetition of transactions, period of holding, circumstances that led to the sale, treatment in books of account etc. In each case, it is the total effect of all relevant factors and circumstances that determine the character of the transaction.

Question 22

A Hindu undivided family is carrying on the business of purchase and sale of food grains. The Karta of the family manages the business. Can the Hindu undivided family pay salary to the Karta and claim the payment made as a deduction from the profits of its business? If so, what are the conditions and limitations for such payment?

Answer

The Supreme Court has, in *Jugal Kishore Baldeo Sahai v. CIT (1967) 63 ITR 238*, held that if remuneration is paid to the karta of a Hindu undivided family (HUF) under –

- (i) a valid agreement which is bona fide and
- (ii) is in the interest of, and expedient for, the business of the family and
- (iii) the payment is genuine and not excessive,

such remuneration would be an expenditure laid out wholly and exclusively for the purpose of business of the family and would be allowable as a deduction while computing the income of the HUF. The test which should be applied for judging, what is a valid agreement is, whether the agreement for payment of salary to the karta was by or on behalf of all the members of the family and whether it was in the interests of the business of the family so that it could be justified on the grounds of commercial expediency.

Thus, the HUF can pay salary to the karta for services rendered by him to the business of the family under a valid agreement, which may be expressed or implied. Such payment will be eligible for deduction from the business profits of the HUF, if it is not excessive and is not unreasonable.

Question 23

X Ltd., is a company engaged in the business of growing, manufacturing and selling of tea.

For the accounting year ended 31st March, 2011, its composite business profits, before an adjustment under section 33AB of the Income-tax Act, were Rs.60 lakhs. In the year, it deposited Rs.25 lakhs with NABARD.

The company has a business loss of Rs.10 lakhs brought forward from the previous year.

The company withdrew in February, 2011 Rs.20 lakhs from the deposit account to buy a non-depreciable asset for Rs.18 lakhs and could not use the balance before the end of the accounting year. The withdrawal and the purchase were under a scheme approved by the Tea Board.

The non-depreciable asset was sold in November, 2011 for Rs.29 lakhs.

Indicate clearly the tax consequences of the above transactions and the total income for the relevant years.

Answer

Computation of total income of X Ltd. for A.Y.2011-12

Particulars	Rs.
(i) Composite profits before allowing deduction under section 33AB	60,00,000
Less: Deduction u/s 33AB	
[Lower of 40% of Rs.60 lakhs (i.e. Rs.24 lakhs) or the actual amount deposited with NABARD (i.e. Rs.25 lakhs)]	24,00,000
	36,00,000

Direct Tax Laws

As per Rule 8 of Income-tax Rules, 40% of this sum is subject to income-tax and the balance 60% is treated as agricultural income.

Hence, the business income is 40% of Rs.36 lakhs 14,40,000

Add: Non-utilisation of amount withdrawn:

[i.e.(Rs.20 lakhs – Rs.18 lakhs)] x 40% (See Note 1) 80,000

Business income 15,20,000

Less: Business loss brought forward from the previous year 10,00,000

Total income 5,20,000

(ii) Computation of total income of X Ltd. for A.Y.2012-13

Particulars	Rs.
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Business income (See Note 2)	7,20,000
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Capital gains (Short-term) (See Note 3)	11,00,000
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Total Income	18,20,000
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Note 1

As per section 33AB amount withdrawn from deposit account maintained under this section if not utilized either wholly or in part, within that previous year, the whole of such amount which is not so utilized shall be deemed to be profits and gains of business and accordingly chargeable to income-tax as the income of that previous year [Section 33AB(7)].

Note 2 - Computation of business income

Since the asset is sold within 8 years, the cost of the asset i.e. Rs. 18 lakhs should be treated as income since the same has been allowed as deduction in the assessment year 2011-12.

However, out of this Rs.18 lakhs, 60% would be agricultural income and the balance 40% i.e. Rs.7.2 lakhs would be business income of A.Y.2012-13. This is because deduction under section 33AB was allowed in A.Y.2011-12 before disintegration of income into agricultural income and non-agricultural income.

Where any asset is sold or transferred within 8 years from the end of the year in which it was acquired, such part of the cost as is relatable to the deduction allowed under section 33AB(1) shall be deemed to be the profits and gains of business or profession of the previous year in which the asset is sold or otherwise transferred [section 33AB(8)]. In the problem the part of the cost of the asset as is relatable to the deduction allowed is not given. Therefore, the entire cost is assumed as deduction allowed at the time of deposit. Accordingly, 40% of cost of the asset is taxed as business income.

Note 3 – Computation of Capital Gains	Rs.
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Sale Proceeds	29,00,000
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Less: Cost of acquisition	18,00,000
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Short term capital gains (since the period of holding is less than 36 months)	11,00,000
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Question 24

State whether the provisions of section 41(1) of the Act can be applied to a case, where refund of excise duty has been obtained by the assessee on the basis of a decision of the CEGAT and where the matter has been taken up in further appeal to the Court by the Central Excise Department.

Answer

This question has been answered by the Apex Court in *Polyflex (India) Pvt. Ltd. v. CIT* [2002] 257 ITR 343. The Apex Court observed that in a case where a statutory levy in respect of goods dealt with by the assessee is discharged and subsequently the amount paid is refunded, it is the first part of section 41(1)(a) that more appropriately applies i.e. it will be a case where the assessee "has obtained any amount in respect of such expenditure". It will not be a case of "benefit by way of remission or cessation" of a trading liability. Where expenditure is actually incurred by reason of payment of duty on goods and a deduction or allowance is given in the assessment of an earlier period, the assessee is liable to discharge that benefit as and when he obtains refund of the amount so paid. The possibility of the refund being set at naught on a future date will not be a relevant consideration. Once the assessee gets back the amount which was claimed and allowed as business expenditure during an earlier year, the deeming provision in section 41(1) comes into play and it is not necessary that the Revenue should await the verdict of a higher court. If the higher court upholds the levy at a later date, the assessee is not without remedy to get back the relief.

Therefore, the refund of excise duty pursuant to the decision of the CEGAT would be subject to tax by virtue of section 41(1) and it is not necessary that the Revenue should await the verdict of a higher court.

Question 25

A company engaged in textile manufacturing, debited to its Profit & Loss Account a sum of Rs.6,00,000, being the interest on loan of Rs.60,00,000 taken for financing its expansion scheme. The plant and machinery purchased for the project with the loan were not received during the year and those were still in transit at the end of the year. A sum of Rs.60,000 was paid to a broker who arranged the loan. Discuss the admissibility or otherwise of the interest on borrowing.

Answer

Interest paid in respect of capital borrowed for the purposes of business or profession is admissible u/s 36(1)(iii). However, the proviso to section 36(1)(iii) says that interest paid in respect of capital borrowed for acquiring an asset for extension of existing business or profession (whether capitalized in the books of account or not) for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use will not be allowed as deduction.

Direct Tax Laws

In this case, the asset (plant & machinery) was not put to use till the end of the previous year. Therefore, interest of Rs.6,00,000 will not be allowed as a deduction. However, the cost of the asset shall be increased by the amount of interest and depreciation shall be admissible on the enhanced cost of Rs.66,00,000 once the asset is put to use.

As regards the brokerage of Rs.60,000 paid to a broker for arranging the loan there are two possible views –

The first view is that since the definition of the term “interest” u/s 2(28A) includes service fee or other charges in respect of moneys borrowed, “brokerage” can be considered to fall under the scope of the term “other charges” and is therefore covered by the definition “interest”. Hence, brokerage of Rs.60,000 for arranging the loan will be treated in the same way as interest and capitalized with the cost of the asset.

The alternate view is based on the High Court decision in *C.Moolchand v. CIT (1956) 29 ITR 449 (Hyd.)*, where it was held that brokerage or commission paid to an agent for arranging a loan for the purpose of business is not allowable as deduction u/s 36(1)(iii), but allowable under section 37(1). As per this view, Rs.60,000 paid to broker for arranging the loan is allowable under section 37(1).

Question 26

A partnership firm, consisting of three partners A, B and C was engaged in the business of Civil Construction and received the following amounts by way of contract receipts:

	Rs.
Contract work for supply of labour	59,00,000
Value of materials supplied by Government	<u>8,00,000</u>
Total value of contract	67,00,000

Each partner of the firm was entitled to draw Rs.10,000 per month by way of salary as authorized by the terms of the partnership deed. Interest of Rs.1,00,000 was also paid to partner C on the capital of Rs.5,00,000 contributed by him. The profit as per books of accounts, before deduction of salary to partners and interest to partner C amounted to Rs.5,50,000. Compute the total income of the firm, applying the provisions of section 44AD.

Answer

As per section 44AD, in the case of an assessee, carrying on the business of civil construction, whose gross receipts from such business does not exceed Rs.60 lakhs, a sum equal to 8% of the gross receipts paid or payable to the assessee or such higher sum as declared by the assessee in his return of income shall be deemed to be the income from such business.

Profits and Gains of Business or Profession

“Gross receipts” will not include the value of material supplied by Government. Therefore, in this case, the gross receipts would be only Rs.59,00,000.

8% of the gross receipts of Rs.59 lakhs will be Rs.4,72,000. The profit as per books of accounts, before deduction of salary and interest to partners, is Rs.5,50,000. Since profit as per books of account is Rs.5,50,000, which is higher than 8% of the gross receipt, it will be adopted and on this working partner salary and interest to partners as per section 40(b) would be allowed.

Computation of allowable deduction in respect of salary and interest paid to partners –

The allowance of salary and interest paid to partners is subject to the conditions and limits specified in section 40(b). The allowable salary and interest has been worked out below –

Salary to partners – Rs.1,20,000 × 3 = 3,60,000

This is within the ceiling limit provided in section 40(b)(v)

First Rs.3,00,000 @ 90% 2,70,000

On the balance Rs.2,50,000 @ 60% 1,50,000

4,20,000

But actual salary paid is only Rs. 3,60,000 - Which is eligible for deduction 3,60,000

Interest to partner C limited to 12% of Rs.5,00,000 60,000

Total deduction allowable in respect of salary and interest 4,20,000

Income of the firm as per books (before allowing deduction in respect of salary and interest to partners) 5,50,000

Less: Salary and interest allowable as deduction 4,20,000

Total income of the firm **1,30,000**

Question 27

A company had an inventory of closing stock on 31.3.11, the cost of manufacture of which was Rs.100 lakhs. The goods were liable for excise duty. Since the excise duty was eligible for deduction only on actual payment, the company valued the closing stock at cost viz. Rs.100 lakhs. Discuss the position from the taxation point of view.

Answer

Under section 145A, the valuation of inventory has to be carried out by including the amount of duty actually paid or incurred by the assessee to bring the goods to the place of its location and condition on the date of valuation. Therefore, excise duty should be included in the valuation of closing stock and the deduction of such excise duty shall be available as per the provisions of section 43B.

Direct Tax Laws

Question 28

The WDV of Plant and Machinery on 01-04-10 of X Ltd. engaged in manufacturing of PVC granules is Rs.1,000 lakhs. Company purchased additional plant and machinery for Rs.800 lakhs on 18-04-10 inclusive of a second-hand machine imported from China of Rs.200 lakhs to increase its installed capacity of production from 1000 TPA to 1500 TPA. The production from new machine was taken w.e.f. 1-12-10. Workout, by giving reasons, the amount of allowable depreciation.

Answer

Provisions of section 32(1)(ia) specify that the assessee engaged in the business of manufacture or production of any article or thing is entitled for an additional depreciation @ 20% of the actual cost of such plant & machinery acquired and installed after 31.3.05.

It is further stated in the proviso to section 32(1)(ia) that the additional depreciation shall not be available in respect of those plant & machinery which, before its installation by the assessee, were used either within India or outside India by any other person.

The depreciation allowable will be as under:-

Particulars	Amount of Depreciation Rs. in lakhs
- Depreciation on WDV of machinery as on 1 st April Rs.1000 lakhs @ 15%	150
- Depreciation on Plant & Machinery purchased on 18th April but actual production commenced w.e.f. 1 st December. Depreciation will be restricted to 50% of the normal depreciation i.e. 50% of (Rs. 800 lakhs x 15%)	60
- Additional depreciation @ 20% of the actual cost of new Plant & Machinery. This depreciation is also to be restricted to 50% since production has commenced only on 1 st December. 50% of (20% of Rs.600 lakhs)	<u>60</u>
Total Depreciation	<u>270</u>

Note - Increase in capacity is not a condition or relevant factor for the purpose of getting additional / accelerated depreciation from the assessment year 2005-06 onwards.

Question 29

Alpha Ltd., a manufacturing company, which maintains accounts under mercantile system, has disclosed a net profit of Rs.12.50 lakhs for the year ending 31st March, 2011. You are required to compute the taxable income of the company for the Assessment year 2011-12,

Profits and Gains of Business or Profession

after considering the following information, duly explaining the reasons for each item of adjustment:

- (i) Advertisement expenditure includes the sum of Rs.60,000 paid in cash to the sister concern of a director, the market value of which is Rs.52,000.
- (ii) Legal charges include a sum of Rs.45,000 paid to consultant for framing a scheme of amalgamation duly approved by the Central Government.
- (iii) Repairs of plant and machinery includes Rs.1.80 lakhs towards replacement of worn out parts of machineries.
- (iv) A sum of Rs.6,000 on account of liability foregone by a creditor has been taken to general reserve. The same was charged to the Revenue Account in the Assessment Year 2008-09.
- (v) Sale proceeds of import entitlements amounting to Rs.1 lakh has been credited to Profit & Loss Account, which the company claims as capital receipt not chargeable to income-tax.
- (vi) Being also engaged in the biotechnology business, the company incurred the following expenditure on in-house research and development as approved by the prescribed authority:
 - (a) Research equipments purchased Rs.1,50,000.
 - (b) Remuneration paid to scientists Rs.50,000.

The total amount of Rs.2,00,000 is debited to the Profit & Loss account.

Answer

Computation of taxable income of Alpha Ltd. for the A.Y. 2011-12

	Particulars	Rs.
	Net profit as per Profit & Loss account	12,50,000
	Add: (a) Items debited to profit and loss A/c but not deductible	
1.	Payment of advertisement expenditure of Rs.60,000	
	(i) Rs.8,000, being the excess payment to a relative disallowed under section 40A(2)	(+) 8,000
	(ii) As the payment is made in cash and since the remaining amount of Rs.52,000 exceeds Rs.20,000, 100% shall be disallowed under section 40A(3)	(+) 52,000
2.	Legal charges for framing amalgamation scheme (deductible under section 35DD in five years). 1/5th of Rs.45,000 i.e. Rs.9,000 to be allowed in the current year. Balance Rs.36,000 (Rs.45,000 - Rs.9,000) is to be added back. (See Note below)	(+) 36,000

Direct Tax Laws

- 3 Under section 31, expenditure relatable to current repairs regarding plant, machinery or furniture is allowed as deduction.
The test to determine whether replacement of parts of machinery amounts to repair or renewal is whether the replacement is one which is in substance replacement of defective parts or replacement of the entire machinery or substantial part of the entire machinery - *CIT v. Darbhanga Sugar Co. Ltd.* [1956] 29 ITR 21 (Pat).
Here expenditure on repairs does not bring in any new asset into existence. Such replacement can only be considered as current repairs. Hence no adjustment
Add: Items chargeable as business income but not credited to profit and loss A/c
4. Liability foregone by creditor [taxable under section 41(1)] (+) 6,000
5. Sale proceeds of import entitlements. The sale of the rights gives rise to profits or gains taxable under section 28(iia). As the amount has already been credited to Profit and Loss Account, no further adjustment is necessary.
Less: Amount not debited to profit and loss account but allowable as deduction
6. Expenditure on in-house research and development is entitled to a weighted deduction of 200% of the expenditure (both capital and revenue) so incurred under section 35(2AB)(1)
= 2 x 2 lakhs = 4 lakhs
Expenditure Rs.2,00,000 already debited to Profit & Loss Account
Additional deduction of Rs.2 lakh is further allowed (-) 2,00,000
- | | |
|-----------------------|------------------|
| Taxable Income | 11,52,000 |
|-----------------------|------------------|

Note: As per the provisions of section 35DD, any expenditure incurred wholly and exclusively for the purpose of amalgamation, would be allowed as a deduction in 5 successive years (1/5th each year) commencing from the year in which the amalgamation takes place. The problem has been worked out on the assumption that the amalgamation has taken place during the previous year itself.

Question 30

By virtue of an agreement entered into on 1.9.2010 between X Ltd. and Y Ltd., X Ltd. agrees not to carry on any business relating to computer software in India for the next 3 years, for which Y Ltd. agrees to pay a sum of Rs.12,00,000 to X Ltd. The said amount was paid on 1st December, 2010. Indicate treatment of such receipt in the hands of X Ltd. for the assessment year 2011-12?

Answer

As per section 28(va) the following sums received or receivable, in cash or kind under an agreement shall be taxable as income from business: (a) any sum for not carrying out any activity in relation to any business; or (b) any sum for not sharing any know-how, patent, copyright, trade mark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services.

The instant case clearly falls within the ambit of section 28(va)(a). As such, the receipt of Rs.12,00,000 is chargeable to tax as business income in the hands of X Ltd

Question 31

You are engaged to carry out the tax audit of a firm under section 44AB and in carrying out this assignment, you are required to tackle the following issues. Indicate how you will deal with them.

- (i) *Duty of the auditor to report on a penalty or fine imposed on the firm.*
- (ii) *Expenditure incurred in respect of which payment has been made in a sum exceeding Rs.20,000, otherwise than by account payee crossed cheque / bank draft.*
- (iii) *Sum payable as an employer by way of contribution to a provident fund.*
- (iv) *Particulars of loans or deposits exceeding the limit specified in section 269SS taken during the year.*
- (v) *Accounting ratios in a trading concern.*

Answer

- (i) In Form No.3CD the tax auditor has to specify the penalty or fine for violation of law and any other penalty or fine as well as expenditure incurred for any purpose which is an offence or which is prohibited by law.

The tax auditor should obtain in writing the details of all payments by way of penalty or fine for violation of law or otherwise and how such amount has been dealt with in the books of account. The tax auditor is not required to express any opinion as to the allowability or otherwise of the amount. He is only required to give details of such items as have been charged in the profit and loss account.

- (ii) The tax auditor should obtain a list of all payments in respect of expenditure exceeding Rs.20,000 made during the year and it should also include the list of payments exempt as per Rule 6DD. The list should be verified with the books of account to ascertain whether the conditions are satisfied. Expenditure items in respect of which specific exemption has been granted are not required to be stated. Where there are practical difficulties in verifying whether payments have actually been made through account payee crossed cheques or account payee crossed bank drafts, suitable qualification

should be made as under "It is not possible to verify whether the payment in excess of Rs.20,000 has been made otherwise than by account payee crossed cheques or account payee crossed bank drafts as necessary evidence is not in possession of the assessee".

Also, a certificate from the assessee must be obtained as regards whether all payments covered by section 40A(3) read with rule 6DD have been complied with or not by issuing account payee crossed cheques or bank draft. The receipt of certificate must be stated in the Form No.3CD in clause 17(h).

- (iii) In respect of P.F.contributions, detailed information is to be furnished with regard to amount received during the previous year, due date for payment, amount paid during the previous year, liability incurred during the previous year and discharge of such liability.

In view of the voluminous nature of the information the tax auditor can apply test checks and compliance tests to obtain satisfaction in this regard. In the case of big assesseees, where the information to be stated is voluminous, the tax auditor may exercise his professional judgment and state only those cases where the actual date of payment is beyond the due date of payment.

- (iv) The particulars to be given in the case of loan or deposit accepted during the previous year exceeding the limit specified in section 269SS:

- (a) Name and address and PAN (if available) of the lender or depositor.
- (b) Amount of loans or deposit taken or accepted.
- (c) Whether the loan was squared up during the previous year.
- (d) Maximum amount outstanding in the account at any point during the previous year.
- (e) Whether the loan or deposit was taken or accepted otherwise than by an account payee cheque or bank draft.

The tax auditor should verify all loans or deposits where the balance has reached Rs.20,000 or more during the previous year, because the total of the deposits of Rs.20,000 and above are covered even though each individual item may be less than Rs.20,000. There are practical difficulties in verifying whether the loan or deposit is taken by crossed cheque or crossed draft. He should obtain a certificate from the assessee and accordingly report in clause 24 of Form 3CD.

- (vi) The accounting ratios to be given in the case of a trading concern are

Gross profit to turnover

Net profit to turnover

Stock in trade to turnover

Material consumed to finished products produced.

While calculating these ratios, the tax auditor should assign meanings to the above terms as understood by generally accepted accounting principles.

Question 32

An assessee incurs expenditure of a capital nature on scientific research related to the business carried on by him. Such expenditure, which is allowable under section 35 remains unabsorbed in the business in which it was incurred. How will the unabsorbed portion be dealt with?

Answer

As per section 35(4) read with section 32(2), the unabsorbed portion shall be set off against the profits and gains, if any, of any other business or profession carried on by the assessee in the same assessment year.

If the unabsorbed capital expenditure on scientific research cannot be wholly set off under the clause above, the amount not so set off shall be set off from the income under any other head in the same assessment year. The unabsorbed portion of expenditure shall be carried forward to the next assessment year and set off against income under the head "profits and gains from business or profession". It is eligible for set off regardless of the continuance of the business to which it relates.

However, such unabsorbed capital expenditure on scientific research can be carried forward only for a maximum of 8 assessment years immediately succeeding the assessment year in which such capital expenditure was incurred.

Question 33

- (i) *A corporation was set up by the State Government transferring all the buses owned by it for a consideration of Rs.75 lakhs, which was discharged by the Corporation by issue of equity shares. The Corporation in its assessment claimed depreciation. Can the depreciation be denied in the Corporation's hands on the ground that there was no registration of the buses in favour of the Corporation?*
- (ii) *Ravi succeeded to his father's business in the year 2008. In the previous year ending 31.3.2011, Ravi has written off the balance in the name of 'Y' which relates to supply made by his father, when he carried on business. Ravi desires to know whether the write off could be eligible for deduction.*

Answer

- (i) The decision of the Supreme Court in *Mysore Minerals Ltd v. CIT* (1999), 239 ITR 775 is relevant in the context of the facts stated. The term "asset used" in section 32 must be assigned a wider meaning and anyone in possession of property in his own title, exercising dominion over the property, to the exclusion of others and having the right to use and enjoy it, must be taken to be the owner.

Direct Tax Laws

Registration of the buses is only a formality to perfect the title and does not bar enjoyment. The Corporation cannot therefore be denied depreciation on the buses. A similar decision was also taken in *CIT v. J & K Tourism Development Corporation* 114 *Taxman* 734 (J&K).

- (ii) The deduction of bad debt is allowed if it is written off in the books of account of the assessee. In this case Ravi has succeeded to the business carried on by his father. Under clause (vii) of section 36(1) the amount has been written off in the books of account as irrecoverable is eligible for deduction provided the debt has been taken into account in computing the income of the business in an earlier previous year [vide section 36(2)].

Therefore Ravi is eligible for deduction in respect of the amount due in the name of Y which is written off in the books of account as bad debt, even though the debt represents the amount due for the supplies made by previous owner viz. deceased father of Ravi. [*CIT v. T. Veerabhadra Rao K. Koteswara Rao and Co* (1985) 155 ITR 152 (SC)].

Question 34

A is an association governed by the provisions of Section 44A of the Income-tax Act. The subscription receipts for the year ended 31st March, 2011 were Rs.3,60,000. The expenditure in the normal course of its activities was Rs.3,85,000. Its other income taxable under the Act works out to Rs.1,75,000. On these facts, you are consulted as to how A's taxable income will be determined for assessment year 2011-12.

Answer

Under section 44A, the income from subscriptions shall be set off against expenditure incurred solely for the protection or advancement of the interest of its members and if there is a deficiency it shall be first be set off against the association's income under the head "Profits and gains of Business or Profession" and if there is still a deficiency it shall be set off against income under any other head. This section supersedes the other provisions of the Act.

	Rs.
Income from subscription	3,60,000
Less: Expenses incurred in the course of its activities	3,85,000
Balance deficiency	(-)25,000
Less: Other income	1,75,000
Taxable income	1,50,000

There is a ceiling on the deduction admissible by way of deficiency being that it shall not exceed one-half of the income of the association. This ceiling has not been exceeded above (vide section 44A(3)).

Question 35

Praveen was a partner in a firm in his capacity as the Karta of his HUF. On the amounts deposited by the partners, the firm paid interest. Praveen, in his individual capacity had made deposits in the same firm in which he was a partner. The assessee claimed that the interest paid in his individual capacity should not be disallowed. The Assessing Officer did not agree and disallowed the interest paid to Praveen in his individual capacity. Discuss.

Answer

Explanation 1 to section 40(b) clearly states that where an individual is a partner in a firm, in a representative capacity, interest paid by the firm to such individual in his individual capacity shall not be taken into account for the purposes of clause (b) of section 40.

Since Praveen is a partner in his capacity as the karta of his HUF and the interest is paid by the firm in his individual capacity, such interest is not hit by the provisions of section 40(b).

This position was brought out by the Supreme Court in *Brij Mohan Das Laxman Das v. CIT* (1997) 223 ITR 825 and followed by the Madras High Court in a recent case *R.M.Appavu Chettiar Sons v. CIT* (2002) 256 ITR 289 (Mad). Therefore, the Assessing Officer's action in disallowing the interest paid to Praveen in his individual capacity is not correct.

Question 36

Write a note on: successor in business for the purpose of profits chargeable to tax under section 41 of the Income-tax Act, 1961.

Answer

For purposes of section 41(1) of the Income-tax Act, "successor in business" means –

- (i) In the case of amalgamation of companies, the amalgamated company.
- (ii) In the case a person is succeeded by another person in that business or profession of the first mentioned person, the other person.
- (iii) Where a firm carrying on a business is succeeded by another firm, the other firm.
- (iv) Where there has been a demerger, the resulting company.

Question 37

Capsule Ltd, during the financial year ending 31.3.2011 paid production bonus of an amount of Rs.3 lakhs pursuant to a settlement arrived with the workers in addition to the statutory payment of Rs.1 lakh as per Bonus Act. On these facts, your advise is sought.

- (a) *whether the sum of Rs.3 lakhs is deductible as per the provisions of section 36(i)(ii) of the Act?.*
- (b) *If the claim is not so deductible, can it be claimed under any other provision?.*

Answer

Section 36(1)(ii) refers to amounts payable as bonus or commission for services rendered where such sums would not have been payable to him as profits or dividend, if it had not been paid as bonus or commission. Rs 3 lakhs paid as production bonus is deductible as per the provisions of section 36(1)(ii) subject to section 43B. In case production bonus is not deductible under section 36(1)(ii), it can be claimed as deduction under section 37(1), as the expenditure is laid out wholly and exclusively for business purposes.

Question 38

You are consulted on the justifiability of the following claims. Your advice is to be framed based on the provisions of the Income-tax Act, 1961.

- (i) *A company paid the full consideration for building for its Administrative office and occupied the same as the possession was taken. The Registration could not take place before the end of the previous year for some reason or other. Can the depreciation claim be made?.*
- (ii) *Secret commission was paid and debited under Commission Account. Is it allowable expenditure.*

Answer

- (i) One of the conditions for the claim of depreciation under the provisions of section 32 of the Income-tax Act, 1961 is that the assessee should be the owner of the asset. In the facts of the given case, the asset is an immovable property, namely, buildings acquired for the administrative office. Full consideration has been paid. However, the registration could not take place before the end of the previous year.

The Supreme court had an occasion to consider this issue in the case of *Mysore Minerals Ltd v. CIT* (239 ITR775). The Supreme court stated that the very concept of depreciation suggests that tax benefit on account of depreciation legitimately belongs to one who has invested in the capital asset and is utilizing the capital asset.

In the facts of the given case, though the document of title was not executed, the full consideration has been paid and the dominion over the property by taking possession excluded the owner who had to transfer the asset and therefore the right to use and occupy the property and enjoy it was exercised by taking possession and the execution of the formal deed of title may take place at any given point of time.

Following the decision of the Supreme Court, depreciation can be claimed in respect of the building that is acquired for the administrative office, though registration has not yet taken place.

- (ii) Secret commission is one of the forms of commission payment generally made by business organizations. Secret commission is a payment for obtaining business orders or contracts from parties and /or customers and paid to employees and / or officials of those

parties and / or customers or companies from whom business orders are obtained by the assessee.

The Explanation to section 37(1) of Income-tax Act, 1961 provides that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law, shall not be deemed to have been incurred for the purpose of business and no deduction or allowance shall be made in respect of such expenditure. In view of the Explanation, any expenditure incurred for a purpose which is an offence and prohibited by law cannot be allowed as expenditure. Therefore, secret commission payment, if it could be established as a payment for an offence prohibited by law, the same cannot be allowed deduction.

Question 39

An assessee purchases know-how for manufacture of fuel injection pipes on 10-04-2010. He wants proportional reduction for six assessment years under section 35AB of the Act commencing from assessment year 2011-12. Is this allowable?

Answer

Section 32 allows depreciation on intangible assets like know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, if they are acquired on or after 1st April, 1998.

Since in this case the assessee had acquired the know-how after 1st April 1998, it is to be treated as capital expenditure and eligible for depreciation.

Question 40

M/s. PR and M/s. ST are firms with common partners carrying on different businesses. M/s. PR had taken a loan from M/s. ST for the purpose of its business. Interest on the loan for the year ending 31.3.2011 worked out to Rs.20,000. M/s. PR deducted tax of Rs.2,000 on interest and paid the balance sum of Rs.18,000 in cash to M/s. ST on 31.3.2011. Tax deducted was remitted to the credit of the Central Government on 30.4.2011. How will you treat the interest paid while computing the total income of M/s. PR for the assessment year 2011-12?

Answer

Section 40(a)(ia) provides that interest paid shall not be allowed as deduction in computing business income, if tax deductible at source has not been deducted thereon or if deducted, has not been paid within the prescribed time. The time limit for remitting the TDS amount is upto the 'due date' for filing the return prescribed under section 139(1). Thus, the remittance on 30.04.2011 is in accordance with the provisions of law warranting no disallowance of expenditure.

Question 41

An Indian company is engaged in the manufacture and sale of coffee grown by it in its own estates. Will it be liable to tax under the Income-tax Act, 1961 and if so, how will its income be determined?

Answer

As per Rule 7B, income derived from the sale of coffee grown and cured by the seller in India, shall be computed as if it were income derived from business and 25% of such income shall be deemed to be income liable to tax.

Income derived from the sale of coffee grown, cured, roasted and grounded by the seller in India with or without mixing chicory or other flavouring ingredients, shall be computed as if it were income from business and 40% of such income shall be deemed to be income chargeable to tax.

In computing such income, an allowance shall be made in respect of the cost of planting coffee plants in replacement of plants which have died or have become permanently useless in an area already planted, if such area has not previously been abandoned and for the purpose of determining the cost, no deduction shall be made in respect of the amount of any subsidy which under the provisions of section 10(31), is not includible in the total income.

Question 42

R Ltd. paid Rs.5 lakhs as sales commission to Mr. Francis (non-resident), who acted as its agent for booking orders from various customers who are outside India. The assessee has not deducted tax at source on the commission payment for the year ended 31.3.2011. On these facts:

- (i) *Decide whether the commission is chargeable to tax in the hands of Mr. Francis in India.*
- (ii) *Decide about the deductibility of the commission payment in the assessment of R Ltd.*

Answer

- (i) A foreign agent of an Indian exporter operates in his own country and no part of his income arises in India. His commission is usually remitted directly to him and is, therefore, not received by him or on his behalf in India. Such an agent is not liable to income-tax in India on the commission. The commission paid to the non-resident agent of the Indian exporter for services rendered outside India is not chargeable to tax in India. Though the Circular No.23, dated 23.7.1969 has been withdrawn clause (b) of the Explanation 1 to section 9(1) says that in the case of non-resident no income shall be deemed to accrue or arise in India in respect of activities which are confined to purchase of goods in India for the purpose of export. In the case of foreign non resident agent, there would be no activity within India. Therefore, commission income for booking orders by non-resident who remains outside India could not be subjected to tax in India.
- (ii) Section 40(a)(i) requires deduction of tax at source in respect of any interest, royalty, fees for technical services or other sum chargeable under this Act, which is payable outside India or in India to a non-resident. Since the non-resident agent has acted outside India his income would not be subjected to tax in India in view of clause (b) of the Explanation 1 to section 9(1). When the income is not chargeable to tax, the question of deducting tax at source does not arise. Hence, disallowance under section 40(a)(i) is not attracted, and the commission payment is deductible in the assessment of R Ltd.