

Basic Concepts

Some Key Points

Income [Section 2(24)]

The term “income” is defined in an inclusive manner. It includes certain items which are capital in nature but taxable as income. Examples are (i) amount received under keyman insurance policy; (ii) amount received in cash or kind in respect of non-compete agreement; and (iii) any sum received on account of capital asset (other than land or goodwill or financial instrument) being demolished, destroyed, discarded or transferred if the whole of such expenditure on capital asset was allowed as a deduction under section 35AD.

Limited Liability Partnership

The term ‘firm’ defined in section 2(23) shall include a limited liability partnership as defined in the Limited Liability Partnership Act, 2008.

A partnership formed under Limited Liability Partnership Act, 2008 shall also be treated as a partnership firm akin to a partnership formed under the Indian Partnership Act, 1932. The partners of the LLP shall be taxed in the same manner as any other partner of a partnership firm constituted under the Indian Partnership Act, 1932.

Diversion of income and application of income

An income when diverted before it reaches the assessee, it is not taxable since there is diversion of income.

Whereas when an income after it reaches the assessee, is applied by him then it is application of income. Therefore, the income is chargeable to tax regardless of its subsequent application.

Recent Amendments

1. For A.Y.2013-14, the general basic exemption limit for individuals/HUFs/AOPs/BOIs and artificial juridical persons has been increased from ₹ 1,80,000 to ₹ 2,00,000. The basic exemption limit for women residents has also been increased from ₹ 1,90,000 to ₹ 2,00,000. Hence, the basic exemption limit for both resident men and women would be ₹ 2,00,000. There is no change in the basic exemption limit of ₹ 2,50,000 for senior citizens, being resident individuals of the age of 60 years or more but less than 80 years. Also, resident individuals of the age of 80 years or more at any time during the previous year would be eligible for a higher basic exemption limit of ₹ 5,00,000.

The limit of beyond which tax shall be leviable @ 30% has been increased from ₹ 8,00,000 to ₹ 10,00,000.

1.2 Direct Tax Laws

2. Surcharge leviable on domestic company in case its income exceeds ₹ 1 crore is 5% and in case of foreign company the surcharge is 2%.
3. Unexplained share capital, share premium etc. credited in the books of account of a closely held company to be treated as income of such company [Section 68]
4. Unexplained money, investments etc. deemed as income under section 68 or 69 or 69A or 69B or 69C or 69D, to attract maximum marginal rate of tax @30% [New section 115BBE]

Question 1

Mr. C borrowed on Hundi, a sum of ₹ 15,000 by way of bearer cheque on 11-09-2012 and repaid the same with interest amounting to ₹ 20,000 by account payee cheque on 12-10-2012.

The Assessing Officer (AO) wants to treat the amount borrowed as income during the previous year. Is the action of AO valid?

Answer

Section 69D provides that where any amount is borrowed on a hundi or any amount due thereon is repaid otherwise than by way of an account-payee cheque drawn on a bank, the amount so borrowed or repaid shall be deemed to be the income of the person borrowing or repaying the amount for the previous year in which the amount was so borrowed or repaid, as the case may be.

In this case, Mr. C has borrowed ₹ 15,000 on Hundi by way of bearer cheque. Therefore, it shall be deemed to be income of Mr. C for the previous year 2012-13. Since the repayment of the same along with interest was made by way of account payee cheque, the same would not be hit by the provisions of section 69D. Therefore, the action of the Assessing Officer treating the amount borrowed as income during the previous year is valid in law.

Question 2

Mr. Bhargava, a leading advocate on corporate law, decided to reduce his practice and to accept briefs only for paying his taxes and making charities with the fees received on such briefs. In a particular case, he agreed to appear to defend one company in the Supreme Court on the condition that he would be provided with ₹ 5 lacs for a public charitable trust that he would create. He defended the company and was paid the sum by the company. He created a trust of that sum by executing a trust deed. Decide whether the amount received by Mr. Bhargava is assessable in his hands as income from profession.

Answer

In the instant case, the trust was created by Mr. Bhargava himself out of his professional income. The client did not create the trust. The client did not impose any obligation in the nature of a trust binding on Mr. Bhargava. Thus, there is no diversion of the money to the trust before it became professional income in the hands of Mr. Bhargava. This case is one of application of professional income and not of diversion of income by overriding title. Therefore, the amount received by Mr. Bhargava is chargeable to tax under the head "Profits and gains of business or profession".

Question 3

What is a zero coupon bond? State briefly the treatment of zero coupon bonds in the hands of the issuer and the investor under the Income-tax Act, 1961.

Answer

Section 2(48) of the Income-tax Act, 1961 defines zero coupon bond. It means a bond issued by any infrastructure capital company or infrastructure capital fund or a public sector company or scheduled bank on or after 1.6.2005, in respect of which no payment and benefit is received or receivable before maturity or redemption from such issuing entity and which the Central Government may specify by way of notification in the Official Gazette.

Discount, which is the difference between the amount received or receivable by the issuer on issue of the zero coupon bond and the amount payable by the issuer on maturity or redemption thereof, would be allowed as deduction in the hands of the issuer on a pro rata basis having regard to the period of life of the bond as provided in section 36(1)(iiiia). In other words, the discount on issue of zero coupon bonds is to be deducted pro-rata during the period of life of such bond. No tax is required to be deducted at source under section 194A in respect of income paid or payable in relation to such bond.

Maturity or redemption of a zero coupon bond will be treated as a transfer for purposes of capital gains in the hands of the investor as provided in section 2(47)(iva). Zero coupon bond held for not more than 12 months will be treated as a short-term capital asset. Thus, a zero coupon bond held for more than 12 months will be treated as a long-term capital asset. The proviso to section 112(1) will be applicable to long-term capital gain arising from the transfer of zero coupon bonds. Consequently, where the tax payable in respect of long-term capital gain arising from the transfer of zero coupon bonds exceeds 10% of the amount of capital gains computed without indexation, then, such excess shall be ignored while computing the tax payable by the investor.

Question 4

Explain with reasons about the taxability of the following transactions for the A.Y. 2013-14:

- (i) *Raja was declared winner in a lucky dip on 15th August, 2012. He was paid cash of ₹ 1,00,000 as prize money.*
- (ii) *Mr. Ravi, citizen of India and a non-resident purchased the Savings Certificates issued by Central Government from out of Dollars remitted from USA on 11-07-2012 on which the interest for the year ended on 31-03-2013 was ₹ 3 Lacs.*

Answer

- (i) The prize money of ₹ 1 Lac received by Mr. Raja is fully chargeable to tax under the head 'Income from other sources'. The amount will be subject to tax at a flat rate of 30% (plus education cess) as per section 115BB.

1.4 Direct Tax Laws

- (ii) As per section 10(4B), interest on investment made by a non-resident Indian out of money transferred in foreign currency for purchase of saving certificates issued before 1.6.2002 is exempt from tax. However, where the certificates are issued on or after 01.06.2002, the tax exemption would not apply. Since the saving certificates were issued and acquired after 1.6.2002, the interest of ₹ 3 Lacs so derived by the non-resident assessee on the saving certificates purchased on 11.7.2012 is liable to tax and exemption under section 10(4B) will not be available.

Question 5

How do you deal with the following situation? Give reasons for your answer (The assessment year is 2013-14):

- (a) *Basu, Managing Director of a company is entitled to commission on sales as per the service agreement entered into with the company. A part of the commission is converted into purchasing a single premium deferred annuity policy from Life Insurance Corporation of India. Basu claims that the commission diverted to secure the deferred annuity cannot be taxed in his personal assessment.*
- (b) *Nija Traders engaged in manufacturing activity was in receipt of sales-tax subsidy from State Government as the unit was located in a backward area. The subsidy is related to the sale of its products and payable once the production is commenced. Nija Traders claims that the subsidy is a capital receipt and hence cannot be included as income.*

Answer

- (a) The claim of Basu is inadmissible regardless of the assessment year to which the issue relates. The commission income had accrued to the managing director Basu and then it was applied to secure an annuity contract from LIC. Since it forms part of the salary structure as per contract of service, it will be includible in the total income of Basu. {*CIT v. Navnit Lal Sakar Lal* (2001) 247 ITR 70 (SC) / (2000) 113 Taxman 692 (SC)}.
- (b) The Supreme Court in its judgment in the case of *Sahney Steel And Press Works Ltd v. CIT* (1997) 228 ITR 253 (SC) has held that the payment from public funds to assist the assessee in carrying on trade or business must be treated as revenue receipt. The subsidy granted to the assessee such as sales tax refund, power concession or refund of bills paid and exemption from payment of water charges are to be treated as revenue receipts chargeable to tax. It was held that the character of the subsidy in the hands of the recipient will have to be determined having regard to the purpose for which the subsidy is given. If the monies are given for assisting the assessee in carrying out the business operations and the money is given only after and conditional upon commencement of production, the assistance must be treated as assistance for the purpose of the trade. Therefore on the facts of the case, the sales tax subsidy was nothing but supplementary trade receipts chargeable to tax. Also refer *CIT v. Rajaram Maize Products* (2001) 251 ITR 427 (SC).

Students may note that the Madras High Court in *CIT v. Kanyakumari District Co-operative Spinning Mills Ltd* (2003) 264 ITR 684 (Mad.) has held that subsidy received

for providing employment to weaker sections of the society was held as capital receipt and not chargeable to tax.

Question 6

Anand was the Karta of HUF. He died leaving behind his major son Prem, his widow, his grandmother and brother's wife. Can the HUF retain its status as such or the surviving persons would become co-owners?

Answer

In the case of *Gowli Buddanna v. CIT* (1966) 60 ITR 293 (SC), the Supreme Court has made it clear that there need not be more than one male member to form a HUF as a taxable entity under the Income-tax Act, 1961. The expression "Hindu Undivided family" in the Act is used in the sense in which it is understood under the personal law of the Hindus.

Under the Hindu system of law, a joint family may consist of a single male member and the widows of the deceased male members and the Income-tax Act, 1961 does not mandate that it should consist of at least two male members. Therefore, property of a joint Hindu family does not cease to belong to the family merely because the family is represented by a single co-parcener who possesses the right which an owner of property may possess.

It may be noted that the Hindu Succession (Amendment) Act, 2005 w.e.f. 06-09-2005 confers the same rights in the coparcenary property on females as that is available to the male members of the family. A daughter is a coparcener of Hindu family property having right to seek partition of the coparcenary property similar to that of a son.

Therefore, the HUF would retain its status as such.

Question 7

A liability towards expenditure as per agreement was provided in the books of account though it was disputed before the Court of law on the interpretation of some of the clauses of the agreement. Can it be claimed as a deduction in the year of provision?

Answer

The Supreme Court in *Kedarnath Jute Mfg. Co. Ltd. v. CIT* 82 ITR 363 (SC), had held that where liability exists in *presenti*, the claim for the same cannot be denied merely because it has been disputed, where the assessee maintains books of account under mercantile system of accounting. Thus, the assessee is eligible to claim the amount provided in the books as a deduction. For the purposes of allowability of a claim or expenditure under the provisions of Income-tax Act, 1961, it is the document that has to be taken into account, based on which the provision has been made. According to the agreement, there was a liability in *presenti*. The liability in *presenti* is not a contingent liability unlike a future liability. A liability in *presenti* has to be provided so that the same cannot be denied at a later date on the premise that it has not been provided in the year in which the liability has really accrued. In the circumstances, though the liability provided in the books was disputed, since it is a liability in *presenti* as per the agreement, the same can be claimed in the year of provision.

Question 8

What meaning has been assigned to "India" under the Income-tax Act, 1961?

Answer

Section 2(25A) defines the term "India" to mean the territory of India as referred to in Article 1 of the Constitution, its territorial waters, seabed and sub-soil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976 and the air space above its territory and territorial waters.

Question 9

MKG Agency is a partnership firm consisting of father and three major sons. The partnership deed provided that after the death of father, the business shall be continued by the sons, subject to the condition that the firm shall pay 20% of the profits to the mother. Father died in March, 2012. In the previous year 2012-13, the reconstituted firm paid ₹ 1 Lac (equivalent to 20% of the profits) to the mother and claimed the amount as deduction from its income. Examine the correctness of the claim of the firm.

Answer

The issue raised in the problem is based on the concept of diversion of income by overriding title, which is well recognised in the income tax law. In the instant case, the amount of ₹ 1 Lac, being 20% of profits of the firm, paid to the mother gets diverted at source by the charge created in her favour as per the terms of the partnership deed. Such income does not reach the assessee-firm.

Rather, such income stands diverted to the other person as such other person has a better title on such income than the title of the assessee. The firm might have received the said amount but it so received for and on behalf of the mother, who possesses the overriding title. Therefore, the amount paid to the mother should be excluded from the income of the firm. This view has been confirmed in *CIT vs. Nariman B. Bharucha & Sons (1981) 130 ITR 863 (Bom)*.

Self-examination questions

1. Define the following terms under the Income-tax Act, 1961 -
(i) Assessee; (ii) Person; (iii) Previous year
2. Write short notes on the following -
(i) Year of accrual of dividend; (ii) Marginal relief
3. "Income of a previous year will be charged to tax in the assessment year following the previous year"- Discuss the exceptions to this general rule.
4. In certain cases, unexplained cash credit, unexplained investment, unexplained money or unexplained jewellery etc. is detected by the Assessing Officer. What is the previous year for charging such income to tax? Explain.
5. Define "Infrastructure capital company" and "Infrastructure capital fund".

6. Can expenditure incurred to earn dividend income (from both Indian companies and foreign companies) be claimed as deduction? Discuss.
7. What is the significance of heads of income under the Income-tax Act, 1961?
8. Rajdhani Ltd. deposited the share application money with its banker and earned interest thereon. The Assessing Officer sought to tax the interest earned on the deposit as income for the relevant assessment year, when the allotment process was not yet complete. The allotment process was completed only in the next assessment year. Is the Assessing Officer right in bringing to tax interest earned on such deposit in the current assessment year when the allotment process was not complete?
9. The Assessing Officer found, during the course of assessment of a firm, that it had paid rent in respect of its business premises amounting to ₹ 60,000, which was not debited in the books of account for the year ending 31.3.2013. The firm did not explain the source for payment of rent. The Assessing Officer proposes to make an addition of ₹ 60,000 in the hands of the firm for the assessment year 2013-14. The firm claims that even if the addition is made, the sum of ₹ 60,000 should be allowed as deduction while computing its business income since it has been expended for purposes of its business. Examine the claim of the firm.

Answers

8. The Madras High Court in *CIT v. Henkel Spic India Ltd. (2004) 266 ITR 490* observed that until the allotment process was complete, the application money and the interest due thereon would remain with a trust in favour of the general body of the applicants. The prohibition incorporated in section 73(3A) of the Companies Act, 1956 was absolute and the amount so deposited cannot be transferred to any other account. The amount of interest earned on application money, to the extent to which it is not required for being paid to the applicants to whom moneys have become refundable by reason of delay in making refund, will belong to the company only when the trust terminates and it is only at that point of time that the amount can be said to have accrued to the company.

In this case, since the process of allotment was completed only in the next year, the interest can be said to have accrued in the next year only. Therefore, the Assessing Officer was not correct in bringing to tax interest earned on such deposit in the current assessment year.
9. The claim of the firm for deduction of the sum of ₹ 60,000 in computing its business income is not tenable. The action of the Assessing Officer in making the addition of ₹ 60,000, being the payment of rent not debited in the books of account (for which the firm failed to explain the source of payment) is correct in law since the same is an unexplained expenditure under section 69C. The proviso to section 69C states that such unexplained expenditure, which is deemed to be the income of the assessee, shall not be allowed as a deduction under any head of income. Therefore, the claim of the firm is not tenable.