

MOCK TEST PAPER – 1
FINAL COURSE: GROUP – II
PAPER – 7: DIRECT TAX LAWS
SUGGESTED ANSWERS / HINTS

1. (a) Computation of book profits of Instyle Exports Ltd. for levy of MAT for the year ended 31.3.2012

Particulars	₹	₹
Net Profit as per Profit & Loss Account		3,50,00,000
<i>Add :</i> Net profit to be increased by the following amounts as per <i>Explanation 1</i> to section 115JB		
Depreciation	1,70,00,000	
Reserve for currency exchange fluctuation, since the amount carried to any reserve, by whatever name called, has to be added back	90,00,000	
Provision for tax	30,00,000	
Proposed dividend	<u>80,00,000</u>	<u>3,70,00,000</u>
		7,20,00,000
<i>Less :</i> Net profit to be decreased by the following amounts as per <i>Explanation 1</i> to section 115JB		
Depreciation other than depreciation on revaluation of assets (₹ 170 lakhs - ₹ 60 lakhs)	1,10,00,000	
Withdrawal from revaluation reserve restricted to the extent of depreciation on account of revaluation of assets (₹ 80 lakhs or ₹ 60 lakhs, whichever is less)	60,00,000	
Unabsorbed depreciation or brought forward business loss, whichever is less, as per the books of account (₹ 25 lakhs or Nil)	<u>NIL</u>	<u>1,70,00,000</u>
Book profit under section 115JB		<u>5,50,00,000</u>

Note :

Explanation 2 below sub-section (2) of section 115JB clarifies that income-tax includes, inter alia, dividend distribution tax/tax on distributed income and any interest charged

under the Income-tax Act, 1961. Therefore, the entire provision of ₹ 30 lakhs for income-tax has to be added back for computing book profit for levy of MAT.

(b) Computation of net wealth of Dhan Laxmi Limited as on valuation date 31.3.2012

	Particulars	Note No.	₹ in lacs
(i)	Land in urban area	(1)	Nil
(ii)	Motor-cars used on hire	(2)	Nil
(iii)	Jewellery	(3)	24
(iv)	Cash balance	(4)	Nil
(v)	Bank balance	(5)	Nil
(vi)	Guest house	(6)	10
(vii)	Residential flat occupied by the Managing Director	(7)	16
(viii)	Residential house let out for 230 days	(8)	18
			68
	Less: Loan obtained for purchasing jewellery	(9)	13
	Loan for purchase of Motor-cars (not deductible)	(10)	Nil
	Net wealth as on 31.3.2012		55

Notes:

- (1) Land in urban area on which the construction is not permitted as per municipal laws in force is not an asset within the meaning of "asset" as defined under section 2(ea) and as such is excluded from taxability.
- (2) Motor car held as stock in trade or used on hire is not taxable.
- (3) Jewellery is taxable unless the same is held as stock in trade.
- (4) In case of a company, cash on hand is not taxable to the extent reflected in the books of account. In this case, since cash balance of ₹ 2,50,000 is as per books of the company, it is not taxable.
- (5) Bank balance is not an asset within the meaning of "asset" as defined in section 2(ea).
- (6) Guest house situated 30 kms away from the local limits of the municipality is an asset and is, therefore, taxable. Only in the case of farm house situated beyond 25 kms. from the local limits of any municipality, the taxability would not arise.
- (7) Residential flat which is allotted by a company to an employee or an officer or a director who is in whole time employment, having gross annual salary of ₹ 5 lacs or more is an asset within the meaning of "asset" as defined in section

2(ea). Accordingly, the residential flat occupied by the Managing Director is taxable since his annual remuneration is ₹ 5 lacs.

- (8) Any residential property which is let out for a minimum period of 300 days in the previous year is not an asset. In the given case, the residential house is taxable since it has been let out for only 260 days (i.e. less than 300 days during the previous year).
- (9) Debts incurred in relation to assets chargeable to wealth tax shall be allowed as deduction in the computation of net wealth. Accordingly, loan obtained for purchase of jewellery shall be allowed as deduction since jewellery is assessable to wealth tax.
- (10) Since Motor car is used in running them on hire and is therefore, not an asset and excluded while computing the net wealth, the loan borrowed for its purchase is not a deductible debt.

2. (a) Computation of business income of M/s. XYZ for the A.Y 2012-13

Particulars	₹	₹
Net profit as per profit and loss account		45,000
Add : Remuneration to partners (considered separately)		<u>3,00,000</u>
		3,45,000
Add: Inadmissible expenses :		
Interest [₹ 45,000 – ₹ 27,000 (calculated@12%)]	18,000	
Provident fund payment outstanding as on date of filing of return - disallowed under section 43B	4,000	
Cash purchases [disallowed under section 40A(3)]	<u>86,000</u>	<u>1,08,000</u>
		4,53,000
Less :Amount credited but exempt		
Dividend from Indian company[Exempt under section 10(34)]		<u>8,000</u>
Book Profit		4,45,000
Less: Remuneration to working partners deductible (See Note-1 below)		<u>2,50,000</u>
Taxable business income		<u>1,95,000</u>

Note:

1. Computation of remuneration allowable as deduction as per 40(b)(v)

Particulars	Percentage allowable	₹
On first 3,00,000 of book profit	90%	2,70,000
On the balance book profit of ₹ 1,45,000	60%	<u>87,000</u>
Remuneration allowable as per 40(b)(v)		<u>3,57,000</u>

Since the actual remuneration to working partners of ₹ 2,50,000 is less than the allowable limit of ₹ 3,57,000, the entire remuneration of ₹ 2,50,000 is deductible. Salary paid to sleeping partner is not allowed as deduction.

2. Depreciation on motor car bought and used exclusively for the purposes of business is allowable though not registered in the name of the firm in view of the ratio of the decision of the Supreme Court in *Mysore Minerals Ltd. V. Cit* (1999) 239 ITR 775.

- (b) (i) As the main object of the institution is “advancement of object of general public utility”, it will lose its status as a “charitable institution” for the P.Y.2011-12, since it has received ₹ 30 lakhs from an activity in the nature of trade. The application of 100% of such receipt for its main object during the year would not help in retaining its status as a “charitable institution” for that year.
- (ii) If the institution receives only ₹ 25 lakhs in aggregate from an activity in the nature of trade during the P.Y.2011-12, then it will not lose its status as a “charitable institution” since receipt of up to ₹ 25 lakhs in a year from such activity is permissible as per the amendment by the Finance Act, 2011. The institution can claim exemption subject to fulfillment of other conditions under sections 11 to 13.
- (iii) The restriction regarding carrying on of a trading activity for a cess, fee or other consideration will not apply if the main object of the institution is “preservation of environment”. Therefore, receipt of ₹ 30 lakhs from a trading activity by such an institution will not affect its status as a “charitable institution”. The institution can claim exemption subject to fulfillment of other conditions under sections 11 to 13.

3. (a) As regards the issue of whether an assessee who has not claimed deduction under section 80-IB in the initial years can claim the said deduction for the remaining years during the period of eligibility, the Delhi High Court, in *Praveen Soni v. CIT* (2011) 333 ITR 324, held that the provisions of section 80-IB nowhere stipulated a condition that the claim for deduction under this section had to be made from the first year of qualification of deduction failing which the claim will not be allowed in

the remaining years of eligibility. Therefore, the deduction under section 80-IB should be allowed to the assessee for the remaining years up to the period for which his entitlement would accrue, provided the conditions mentioned under section 80-IB are fulfilled.

- (b) This question came up before the Bombay High Court in *CIT v. Parle Plastics Ltd.* (2011) 332 ITR 63. The Bombay High Court observed that under section 2(22), dividend does not include, *inter alia*, any advance or loan made to a shareholder by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company.

In that case, 42% of the total assets of the lending company were deployed by it by way of loans and advances. Further, if the income earned by way of interest is excluded, the other business had resulted in a net loss. These factors were considered in concluding that lending of money was a substantial part of the business of the company. Since lending of money was a substantial part of the business of the lending company, the money given by it by way of advance or loan to the assessee could not be regarded as a dividend, as it had to be excluded from the definition of "dividend" by virtue of the specific exclusion in section 2(22).

The expression used in the exclusion provision of section 2(22) is "substantial part of the business". Sometimes a portion which contributes a substantial part of the turnover, though it contributes a relatively small portion of the profit, would be termed as a substantial part of the business. Similarly, a portion which is relatively small as compared to the total turnover, but generates a large portion, say more than 50% of the total profit of the company, would also be a substantial part of its business.

Percentage of turnover in relation to the whole as also the percentage of the profit in relation to the whole and sometimes even percentage of manpower used for a particular part of the business in relation to the total manpower or work force of the company would be required to be taken into consideration for determining the substantial part of business.

The capital employed for a specific division of a company in comparison to total capital employed would also be relevant to determine whether the part of the business constitutes a substantial part.

- (c) This issue came up before the Apex Court in *CIT v. Saurashtra Cement Ltd.* (2010) 325 ITR 422.

The Apex Court affirmed the decision of the Gujarat High Court holding that the damages were directly and intimately linked with the procurement of a capital asset i.e., the cement plant, which lead to delay in coming into existence of the profit-making apparatus. It was not a receipt in the course of profit earning process. Therefore, the amount received by the assessee towards compensation for

sterilization of the profit earning source, not in the ordinary course of business, is a capital receipt in the hands of the assessee.

Therefore, in this case, the liquidated damages of ₹ 5 lakhs received by J.K. Cement Ltd., from the supplier of plant for failure to supply machinery to the company within the stipulated time is a capital receipt.

- (d) This issue came up before the Delhi High Court in *CIT v. Japan Airlines Co. Ltd.* (2010) 325 ITR 298.

On this issue, the Delhi High Court referred to the case of *United Airlines v. CIT* (2006) 287 ITR 281, wherein the issue arose as to whether landing and parking charges could be deemed as rent under section 194-I. The Court observed that rent as defined in the said provision had a wider meaning than “rent” in common parlance. It included any agreement or arrangement for use of land. The Court further observed that when the wheels of the aircraft coming into an airport touch the surface of the airfield, use of the land of the airport immediately begins. Similarly, for parking the aircraft in that airport, again, there is use of the land. Therefore, the landing and parking fee were definitely “rent” within the meaning of the provisions of section 194-I as they were payments for the use of the land of the airport.

Therefore, payment of landing and parking charges by an airline company to the Airports Authority of India is in the nature of rent and accordingly, the provisions of tax deduction at source under section 194-I are attracted.

4. (a) The statement is not correct, since exemption is not available in respect of all allowances and perquisites but is restricted to such allowances and perquisites as may be notified by the Central Government in this behalf.

The Finance Act, 2011 has inserted new clause (45) in section 10 to exempt specified allowances and perquisites received by Chairman or any other member, including retired Chairman/member, of the Union Public Service Commission (UPSC). The exemption would be available in respect of such allowances and perquisites as may be notified by the Central Government in this behalf.

Accordingly, the Central Government has notified the following allowances and perquisites for serving Chairman and members of UPSC, for the purpose of exemption under section 10(45) -

- (i) the value of rent free official residence,
- (ii) the value of conveyance facilities including transport allowance,
- (iii) the sumptuary allowance and
- (iv) the value of leave travel concession.

In case of retired Chairman and retired members of UPSC, the following have been

notified for exemption under section 10(45):

- (i) a sum of maximum ₹ 14,000 per month for defraying the service of an orderly and for meeting expenses incurred towards secretarial assistance on contract basis.
- (ii) the value of a residential telephone free of cost and the number of free calls to the extent of ₹ 1,500 per month (over and above free calls per month allowed by the telephone authorities).

(b) The statement is correct.

New section 115BBD has been introduced by the Finance Act, 2011 to provide for a concessional rate of tax on dividends received by Indian companies from specified foreign companies. Specified foreign company has been defined to mean a foreign company in which the Indian company holds 26% or more in nominal value of the equity share capital of the company.

Dividends received by Indian companies from specified foreign companies to be subject to a concessional rate of 15% as against the existing rate of 30%. This rate of 15% would be applied on gross dividend, in the sense, that no expenditure would be allowable in respect of such dividend. However, this concessional rate would not be applicable in respect of dividend received from a foreign company in which the holding of the Indian company is less than 26% of the nominal value of the equity share capital.

Therefore, if the total income of an Indian company, includes income by way of dividend declared, distributed or paid by a specified foreign company, the income tax payable would be the aggregate of –

- (a) Income-tax @15% on gross dividend from such specified foreign company; and
- (b) Income-tax with which the assessee would have been chargeable had its total income been reduced by such dividend.

(c) This statement is correct.

The Finance Act, 2011 has expanded the powers of the Transfer Pricing Officer under section 92CA to empower him to -

- (i) determine the arm's length price of other international transactions, identified subsequently in course of proceedings before him. So far, his powers were restricted to determining the arm's length price of international transactions referred to him by the Assessing Officer.
- (ii) conduct a survey by exercising the powers conferred upon an income-tax authority under section 133A for the purpose of determining the arm's length price.

5. (a) **Computation of capital gains of Neelima for the assessment year 2012-13**

Particulars	₹	₹
Long-term capital gain on sale of house		1,15,000
Less: Short-term capital loss on sale of shares [Refer computation below]		
750 shares	31,500	
250 shares	5,000	(36,500)
Taxable long-term capital gains		78,500

Computation of capital gain on sale of shares of ABC Ltd. by Neelima

Date of purchase of shares		8.7.2011
Record date		8.8.2011
Date of sale of shares	22.9.2011	22.1.2012
Number of shares sold	750	250
Sale price per share	₹ 150	₹ 180

Particulars	₹	₹
Sale consideration	1,12,500	45,000
Less: Cost of acquisition	1,50,000	50,000
	(37,500)	(5,000)
Dividend income as per section 94(7) [750×100×8%] [See Note 1 below]	6,000	-
Short-term capital loss on sale of shares	(31,500)	(5,000)

Note:

- As per section 94(7), where any person buys any securities within a period of three months prior to the record date and sells such securities within a period of three months after such date and the dividend received on such securities is exempt, then the loss arising out of such purchase and sale of securities shall be ignored to the extent of such dividend income. In this case, 750 shares purchased within 3 months prior to the record date are sold within 3 months after such date, hence the loss to the extent of dividend income on such shares shall be ignored for computing income chargeable to tax of Neelima.
- 250 shares having been sold after 3 months of such date, section 94(7) is not applicable. So, the dividend income of ₹ 2,000 should not be deducted. Such dividend is exempt under section 10(34).
- Short-term capital loss can be set-off against long-term capital gains as per the

provisions of section 74(1)(a). Therefore, short-term capital loss on sale of shares can be set-off against long-term capital gains on sale of house.

- (b) Under section 268A(1), the CBDT is empowered to issue orders, instructions or directions to the other income-tax authorities, fixing such monetary limits, as it may deem fit, to regulate filing of appeal or application for reference by any income-tax authority.

Under section 268A(2), where an income-tax authority has not filed any appeal or application for reference on any issue in the case of an assessee for any assessment year, due to above-mentioned order/instruction/direction of the CBDT, such authority shall not be precluded from filing an appeal or application for reference on the same issue in the case of the same assessee for any other assessment year or any other assessee for the same or any other assessment year. Further, in such a case, it shall not be lawful for an assessee, being a party in any appeal or reference, to contend that the income-tax authority has acquiesced in the decision on the disputed issue by not filing an appeal or application for reference in any case.

In view of the above provision, it would be in order for the Income-tax Department to move an appeal to the Tribunal against the orders of the Commissioner (Appeals) for A.Y.2011-12 in respect of both Mr. Atharv and Mr. Vikalp.

- (c) The Assessing Officer cannot issue notice under section 148 to reopen the same assessment order on the same grounds for which the Commissioner had issued notice under section 263 of the Income-tax Act, 1961, since the second proviso to section 147 specifically provides that the Assessing Officer may assess or reassess an income which is chargeable to tax and has escaped assessment, other than the income involving matters which are the subject matter of any appeal, reference or revision. Therefore, if the income relates to a matter which is the subject matter of revision under section 263, then the Assessing Officer cannot issue notice under section 148 to reopen the assessment order.

6. (a) **Computation of tax liability of Soumya for the A.Y. 2012-13**

Particulars	₹	
Indian Income		5,10,000
Foreign Income		<u>1,10,000</u>
Gross Total Income		6,20,000
Less: <u>Deduction under section 80C</u>		
Deposit in PPF	65,000	
<u>Under section 80CCC</u>		
Contribution to approved Pension Fund of LIC	<u>37,000</u>	
		<u>1,02,000</u>

The aggregate deduction under section 80C, 80CCC and 80CCD has to be restricted to ₹ 1,00,000 as per section 80CCE		1,00,000	
<u>Under section 80CCF</u>			
Subscription to notified long-term infrastructure bonds, ₹ 25,000, restricted to ₹ 20,000, being the maximum deduction allowable under section 80CCF		20,000	
<u>Under section 80D</u>			
Contribution to Central Government Health Scheme ₹ 20,000 is also allowable as deduction under section 80D, but restricted to ₹ 15,000		15,000	
Medical insurance premium of ₹ 25,000 paid for father aged 82 years. Since the father is a non-resident in India, he will not be entitled for the higher deduction of ₹ 20,000 eligible for a senior citizen, who is resident in India. Hence, the deduction will be restricted to maximum of ₹ 15,000.		15,000	1,50,000
Total Income			<u>4,70,000</u>
<u>Tax on Total Income</u>			
Income-tax (See Note below)		22,000	
Add : Education cess @ 2%		440	
Add: SHEC @ 1%		<u>220</u>	22,660
Average rate of tax in India (i.e. $22,660 / 4,70,000 \times 100$)		4.82%	
Average rate of tax in foreign country (i.e. $11,000 / 1,10,000 \times 100$)		10%	
Rebate under section 91 on ₹ 1,10,000 @ 4.82% (lower of average Indian-tax rate or average foreign tax rate)			5,302
Tax payable in India (₹ 22,660 - ₹ 5,302)			17,358

Note :

The Finance Act, 2011 has increased the basic exemption limit for senior citizens from ₹ 2,40,000 to ₹ 2,50,000 and reduced the age criterion for qualifying as a "senior citizen" to be eligible for the higher basic exemption limit from 65 years to 60 years. Accordingly, Soumya will be eligible for the higher basic exemption limit of ₹ 2,50,000, since she is 60 years old.

- (b) No capital gain tax would arise in the case of conversion of a private limited company into an LLP, since such a conversion is not regarded as transfer by virtue

of section 47. As per section 72A(6A), the LLP would be able to carry forward and set-off the unabsorbed depreciation and business loss of ₹ 27 lakhs and ₹ 30 lakhs, respectively, of SSI Pvt. Ltd. since at the time of conversion, all the conditions specified in section 47(xiiib) have been fulfilled. The LLP can set off the unabsorbed depreciation and business loss aggregating to ₹ 57 lakhs against its business profits of ₹ 75 lakhs for A.Y.2012-13.

However, if in any subsequent year, the LLP fails to fulfill any of the conditions mentioned in section 47(xiiib), the business loss or unabsorbed depreciation of the company already set off by the LLP would be deemed to be the income chargeable to tax of the LLP for the year in which it fails to fulfill such conditions.

One of the conditions is that the erstwhile shareholders of the company continue to be entitled to receive at least 50% of the profits of the LLP for a period of 5 years from the date of conversion. Since two partners (who were erstwhile shareholders of SSI Pvt. Ltd.) holding in aggregate 51% of the profit-sharing in the LLP have resigned on 5.9.2012, the LLP has failed to fulfill this condition.

Therefore, the amount of ₹ 57 lakhs representing unabsorbed depreciation and business losses set-off against profits of the LLP for the A.Y. 2012-13, would be deemed to be income of the LLP for the A.Y.2013-14, being the year in which it failed to fulfill the conditions.

- (c) Section 245Q(3) of the Income-tax Act, 1961 provides that an applicant, who has sought for an advance ruling, may withdraw the application within 30 days from the date of the application. Since more than 30 days have elapsed since the date of application by Mr. Albert to the Authority for Advance Rulings, he cannot withdraw the application.

7. (a) (i) The statement is not correct.

Section 254(2A) provides that the Appellate Tribunal, where it is possible, may hear and decide an appeal within a period of four years from the end of the financial year in which such appeal is filed.

The Appellate Tribunal may, on merit, pass an order of stay in any proceedings relating to an appeal. However, such period of stay cannot exceed 180 days from the date of such order. The Appellate Tribunal has to dispose of the appeal within this period of stay.

Where the appeal has not been disposed of within this period and the delay in disposing the appeal is not attributable to the assessee, the Appellate Tribunal can further extend the period of stay originally allowed. However, the aggregate of period originally allowed and the period so extended should not exceed 365 days even if the delay in disposing of the appeal is not attributable to the assessee. The Appellate Tribunal is required to dispose of the appeal within this extended period. If the appeal is not disposed of within such period

or periods, the order of stay shall stand vacated after the expiry of such period or periods.

Therefore, the statement given in the question is not correct.

(ii) The statement is not correct.

Section 245D(4) stipulates that the Settlement Commission shall pass an order after giving an opportunity of being heard to the applicant and the Commissioner. Under section 245F(1), the Settlement Commission has been conferred all the powers which are vested in an income-tax authority under the Act. Under section 154, an income-tax authority has the power to amend any order passed by it in order to rectify any mistake apparent from the record. However, there are High Court rulings holding that the order made by the Settlement Commission is conclusive and final and therefore, the same cannot be rectified under section 154. This view, however, does not convey the true legislative intent.

Therefore, in order to reflect the correct intention of the legislature, sub-section (6B) has been inserted in section 245D by the Finance Act, 2011 to specifically provide that the Settlement Commission may amend any order passed by it under section 245D(4) to rectify any mistake apparent from the record. However, the time limit for effecting such amendment is within six months from the date of its order, as against the permissible time limit of four years provided for under section 154(7).

Further, the Settlement Commission should not make a rectification which has the effect of modifying the liability of the applicant, without –

- (1) giving a notice to the applicant and the Commissioner of its intention to do so; and
- (2) allowing the applicant and the Commissioner an opportunity of being heard.

(b) Under section 40A(3), disallowance is attracted in the computation of income in a case where a payment or aggregate of payments exceeding ₹ 20,000 is made to a person in a day, otherwise than by an account payee cheque drawn on a bank or an account payee bank draft.

However, payment made otherwise than by an account payee cheque drawn on a bank or by an account payee bank draft exceeding ₹ 20,000 does not attract the aforesaid disallowance in certain circumstances as prescribed under Rule 6DD of the Income-tax Rules, 1962. Such exceptions, *inter-alia*, refer to payment made to the producer for the purchase of fish or fish products under sub-clause (iii) of clause (e) of Rule 6DD.

With regard to this sub-clause, the CBDT has, vide *Circular 10/2008 dated*

5.12.2008, issued the following clarifications –

- (i) The expression 'fish or fish products' would include 'other marine products such as crab, lobster etc.'.
- (ii) The 'producers' of fish or fish products would include, besides the fishermen, any headman of fishermen, who sorts the catch of fish brought by fishermen from the sea, at the sea shore itself and then sells the fish or fish products to traders, exporters etc.

In view of the above circular, cash payment of ₹ 25,000 made to local fishermen for supply of lobsters and crabs, would not be hit by the provisions of section 40A(3).

However, the above exception will not be available in respect of payment for the purchase of fish or fish products from a person who is not proved to be a 'producer' of these goods and is only a trader, broker or any other middleman, by whatever name called.

Therefore, the disallowance under section 40A(3) would be attracted if such cash payment of ₹ 25,000 on a single day is made to a trader who supplies lobsters and crabs.