

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.2014-15, the general basic exemption limit for individuals/HUFs/AOPs/BOIs and artificial juridical persons is ₹ 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% is ₹ 10,00,000.
2. In case of a domestic company, surcharge is leviable @ 5% of income-tax, if its total income exceeds ₹ 1 crore but does not exceed ₹ 10 crore. However, surcharge shall be levied @ 10%, in case of domestic companies whose total income exceeds ₹ 10 crore.
3. In case of a foreign company, surcharge is leviable @ 2%, if its income exceeds ₹ 1 crore but does not exceed ₹ 10 crore. However, surcharge shall be levied @ 5% in cases where the total income exceeds ₹ 10 crore.

4. Resident individuals whose total income does not exceed five lakh rupees shall be eligible for a rebate which is equal to the amount of income tax payable on the total income or ₹ 2,000, whichever is lower [New section 87A].
5. 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].
6. 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

MNO Limited is engaged in manufacturing activities. It received liquidated damages of ₹ 10 lakh from supplier of machinery due to delay in supply of machinery. State, with reasons, whether or not the income by way of liquidated damages is a revenue receipt subject to income-tax.

Answer

The issue under consideration in this case is whether the liquidated damages received by a company from the supplier of machinery for delay in supply of machinery is revenue in nature.

On this issue, the Apex Court, in the case of *CIT v. Saurashtra Cement Ltd. (2010) 325 ITR 422*, held that such liquidated damages were directly and intimately linked with the procurement of a capital asset 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.

Applying the rationale of the above Apex Court ruling in this case, the income by way of liquidated damages of ₹ 10 lakh received by MNO Ltd. from the supplier of machinery is a capital receipt.

Question 2

How do you deal with the following situations? Give reasons for your answer (The assessment year is 2014-15):

- (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).

Question 3

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 4

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, 2013. In the previous year 2013-14, 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)*.

Question 5

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 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

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)(iiia). 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 8

In the course of scrutiny assessment of Mr. X, the Assessing Officer, on the basis of information available with him, sought an explanation for the source of the expenditure of ₹ 20 lakhs incurred on the wedding of his daughter. The said expenditure was neither recorded in the books of account maintained nor was the explanation offered by Mr. X satisfactory. What are the consequences?

Answer

If any expenditure is incurred by an assessee in any financial year in respect of which he is not able to offer explanation about the source of such expenditure or the explanation offered by him is not satisfactory in the opinion of the Assessing Officer, then the amount of such

unexplained expenditure may be deemed as income of the assessee for such financial year as per section 69C.

Therefore, in this case, the expenditure of ₹ 20 lakhs incurred by Mr. X on the wedding of his daughter may be deemed as income of Mr. X as per section 69C.

Further, such unexplained expenditure which is deemed as the income of Mr. X shall not be allowed as deduction under any head of income.

Where the total income of Mr. X includes such unexplained expenditure of ₹ 20 lakhs, which is deemed as his income under section 69C, such deemed income would be taxed at the maximum marginal rate of 30% as per section 115BBE (plus surcharge, education cess@2% and secondary and higher education cess@1%).

Further, no basic exemption or allowance or expenditure shall be allowed to Mr. X under any provision of the Income-tax Act, 1961 in computing such deemed income.

Penalty under section 271(1)(c) shall be levied for concealment of income.

Question 9

Mr. C borrowed on Hundi, a sum of ₹ 15,000 by way of bearer cheque on 11-09-2013 and repaid the same with interest amounting to ₹ 20,000 by account payee cheque on 12-10-2013.

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 2013-14. 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.

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. Can expenditure incurred to earn dividend income (from both Indian companies and foreign companies) be claimed as deduction? Discuss.
6. 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 31.3.2014. 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 2014-15. 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

6. 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.