

Profits and Gains of Business or Profession

Some Key Points : Recent Amendments

Manufacturing companies investing more than ₹ 100 crore in new plant and machinery during the period from 1.4.2013 to 31.3.2015 entitled to investment allowance@15% [Section 32AC]

- (i) A new section 32AC has been inserted by the Finance Act, 2013 to provide a tax incentive by way of investment allowance to encourage huge investment in plant or machinery.
- (ii) Under new section 32AC, a manufacturing company is entitled to an investment allowance@15% of the aggregate amount of actual cost of new plant and machinery acquired and installed during the financial years 2013-14 & 2014-15, if the same exceeds ₹ 100 crore.
- (iii) As per section 32AC, a company assessee would be entitled to deduction@15% of aggregate investment in new plant and machinery if it is -
 - (a) engaged in the business of manufacture of an article or thing; and
 - (b) invests a sum of more than ₹ 100 crore in new plant or machinery during the period beginning from 1st April, 2013 and ending on 31st March, 2015.
- (iv) For A.Y. 2014-15, a manufacturing company would be entitled to deduction of 15% of aggregate amount of actual cost of new assets acquired and installed during the financial year 2013-14, if the aggregate cost of such assets exceeds ₹ 100 crore.
For A.Y.2015-16, a deduction of 15% of aggregate amount of actual cost of new assets, acquired and installed during the period beginning on 1st April, 2013 and ending on 31st March, 2015, as reduced by the deduction allowed, if any, for A.Y. 2014-15.
- (v) The investment allowance@15% under this section is in addition to the depreciation and additional depreciation allowable under section 32(1). Further, the investment allowance would not be reduced to arrive at the written down value of plant and machinery.

Deduction under section 36(1)(vii) in respect of bad debts written off to be allowed to the extent the same is in excess of the credit balance in the provision for bad and doubtful debts made under section 36(1)(vii), irrespective of whether the same relates to rural advances or urban advances.

Deduction for commodities transaction tax paid in respect of taxable commodities transactions

New clause (xvi) has been inserted in section 36(1) to provide that an amount equal to the commodities transaction tax (CTT) paid by the assessee in respect of the taxable commodities transactions entered into in the course of his business during the previous year shall be allowable as deduction, if the income arising from such taxable commodities transactions is included in the income computed under the head "Profits and gains of business or profession".

Trading in commodity derivatives not a speculative transaction

Clause (e) has been inserted in the proviso to section 43(5) to exclude an eligible transaction in respect of trading in commodity derivatives carried out in a recognized association from the definition of "speculative transaction".

Disallowance of royalty, licence fee, service fee etc. levied exclusively on State Government Undertakings by the State Government

New clause (iib) has been inserted in section 40(a) to provide that –

- (1) any amount paid by way of royalty, licence fee, service fee, privilege fee, service charge, etc., which is levied exclusively on, or
- (2) any amount appropriated, directly or indirectly, from

a State Government undertaking, by the State Government (SG), shall not be allowed as deduction while computing the income of such undertakings under the head "Profits and gains of business or profession".

Stamp duty value of land and building to be taken as the full value of consideration in respect of transfer, even if the same are held by the transferor as stock-in-trade

New section 43CA has been inserted to provide that where the consideration for the transfer of an asset (other than capital asset), being land or building or both, is less than the stamp duty value, the value so adopted or assessed or assessable (i.e., the stamp duty value) shall be deemed to be the full value of the consideration for the purposes of computing income under the head "Profits and gains of business or profession".

Benefit of additional depreciation@20% extended to new plant and machinery acquired and installed in power sector undertakings [Section 32(1)(iia)]

- (i) Under section 32(1)(iia), additional depreciation at the rate of 20% of the actual cost of new machinery or plant (other than ships and aircraft) is allowable to an assessee engaged in the business of manufacture or production of any article or thing in the year of acquisition and installation. This is in addition to the normal depreciation allowable under section 32(1) at the prescribed rates.
- (ii) With a view to encourage investment in plant or machinery by assessee engaged in the business of generation or generation and distribution of power, the benefit of additional

depreciation has now been extended to such assesseees. Consequently, assesseees engaged in manufacture or production of any article or thing as well as assesseees engaged in the business of generation or generation and distribution of power can claim an additional depreciation at 20% of the cost of new plant or machinery (other than ships and aircraft) acquired and installed during the previous year.

Depreciation on wind mill installed after 31.03.2012 restricted to 15% [Notification No. 15/2012 dated 30-3-2012]

As per the existing provisions, the plant and machinery in the nature of renewable energy devices being:

- (a) Wind mills and any specially designed devices which run on wind mills
- (b) Any special devices including electric generators and pumps running on wind energy are entitled to depreciation@80% under section 32.

The CBDT has, vide this notification, restricted the eligibility of claiming depreciation@80% to such wind mills and special devices installed on or before 31.03.2012. Accordingly, such plant and machinery installed on or after 1st April, 2012 shall be entitled to depreciation at the general rate applicable to plant & machinery i.e., 15%. However, such plant and machinery installed on or before 31st March, 2012 shall continue to claim depreciation@80%.

Weighted deduction in respect of expenditure incurred on notified agricultural extension project [Section 35CCC]

- (i) In order to incentivize the business entities to provide better and effective agriculture extensive services, new section 35CCC has been inserted to provide a weighted deduction of a sum equal to 150% of expenditure incurred by an assessee on agricultural extension project in accordance with the prescribed guidelines.
- (ii) The agricultural extension project eligible for this weighted deduction shall be notified by the Board.
- (iii) In case deduction in respect of such expenditure is allowed under this section then, no deduction in respect of such expenditure shall be allowed under any other provisions of the Act in the same or any other assessment year.

Weighted deduction in respect of expenditure incurred by companies on notified skill development project [Section 35CCD]

- (i) The National Manufacturing Policy (NMP) has been notified by the Department of Industrial Policy & Promotion (DIPP) vide *Press Note dated 4th November, 2011*. As per the notified NMP, the government will provide weighted standard deduction of 150% of the expenditure (other than land or building) incurred on Public Private Partnership (PPP) project for skill development in the ITIs in manufacturing sector. This is to encourage private sector to set up their own institution in coordination with National Skill Development Corporation.

- (ii) In order to encourage companies to invest on skill development projects in the manufacturing sector, a new section 35CCD has been inserted to provide for a weighted deduction of a sum equal to 150% of the expenditure (not being expenditure in the nature of cost of any land or building) on skill development project incurred by the company in accordance with the prescribed guidelines.
- (iii) The skill development project eligible for this weighted deduction shall be notified by the Board.
- (iv) In case deduction in respect of such expenditure is allowed under this section then, no deduction of such expenditure shall be allowed under any other provisions of the Act in the same or any other assessment year.

Presumptive income [Section of 44AD]

As per the presumptive taxation provisions contained in section 44AD, 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 ₹ 100 lacs 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 section 10AA 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.
- (h) Sub-section (6) has been inserted in section 44AD by the Finance Act, 2012 to specifically exclude the applicability of the presumptive provisions of section 44AD in respect of -
 - (i) a person carrying on profession as referred to in section 44AA(1) i.e., legal,

medical, engineering or architectural profession or the profession of accountancy or technical consultancy or interior decoration or any other profession as is notified by the Board (namely, authorized representatives, film artists, company secretaries and profession of information technology have been notified by the Board for this purpose);

- (ii) a person earning income in the nature of commission or brokerage; or
- (iii) a person carrying on any agency business.

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

Income from heavy goods vehicles, shall be an amount equal to ₹ 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 ₹ 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.

Question 1

- (a) *The partnership deed of a firm does not specify the remuneration payable to each individual working partner but lays down the manner of fixing the remuneration as follows:*

In case the book profits of the firm are up to ₹ 3 lakhs, then the partners would be entitled to remuneration up to ₹ 1.50 lakhs or 90% of book profits, whichever is more. In respect of balance book profits, it is 60%. "Book profits" shall be computed as defined in section 40(b) of the Income-tax Act, 1961. In case there is a loss in a particular year, the partners shall not be entitled to any remuneration. Remuneration payable to the working partners should be credited to the respective accounts at the time of closing of the accounting year and the working partners shall be entitled to equal remuneration.

Can the firm claim deduction in respect of remuneration paid to the working partners?

- (b) *Y. Ltd. was amalgamated with X. Ltd. in accordance with a scheme of amalgamation. Assets and liabilities were transferred and vested with X. Ltd. X. Ltd. is of the view that excess consideration paid by it over the value of net assets acquired from Y. Ltd. should be considered as goodwill arising on amalgamation. X. Ltd. claimed depreciation on such goodwill, but the claim was rejected by the Assessing Officer on the ground that goodwill is not an asset falling under Explanation 3 to section 32(1) of the Income-tax Act, 1961. Is the action of the Assessing Officer valid?*

- (c) *R. Ltd. was engaged in the business of manufacturing and trading activities. The company was declared a sick industrial company and as a part of a restructuring programme, a part of the term loan for purchase of machinery and cash credit and interest was waived. The Assessing Officer was of the view that the waiver of loans and interest amounted to remission or cessation of liability and was taxable under section 41(1) of the Income-tax Act, 1961. Give your views on the correctness of the action of the Assessing Officer.*

Answer

- (a) As per section 40(b), payment of remuneration to a working partner which is authorized by and is in accordance with the terms of the partnership deed is allowable as a deduction to the extent it does not exceed the limits specified in section 40(b)(v).

The issue under consideration is whether, in a case where the partnership deed does not specify the amount of remuneration payable to each partner, but lays down the manner of fixing the remuneration, can payment of such remuneration be allowed as deduction.

In this regard, the CBDT had, vide *Circular No. 739 dated 25.3.1996*, clarified that no deduction under section 40(b)(v) will be admissible 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.

The High Court, in *CIT v. Anil Hardware Store (2010) 323 ITR 368 (HP)*, held that where the manner of fixing the remuneration of the working partners has been specified in the partnership deed, the assessee-firm would be entitled to deduct the remuneration paid to such partners, subject to the limits specified under section 40(b)(v).

Therefore, in this case, since the partnership deed lays down the manner of quantifying the remuneration payable to working partners, the firm is entitled to claim deduction of remuneration paid to working partners, subject to the limits specified in section 40(b)(v).

- (b) The issue under consideration is whether X Ltd. can claim depreciation on the excess consideration paid by it over the value of net assets acquired from Y Ltd. in a scheme of amalgamation, by treating the same as goodwill, and considering it as an intangible asset within the meaning of *Explanation 3* to section 32(1).

This issue came up before the Supreme Court, in *CIT v. Smifs Securities Ltd. (2012) 348 ITR 302*, wherein it was observed that *Explanation 3(b)* to section 32(1) states that the expression 'asset' shall mean an intangible asset, being know-how, patents, copyrights, trademarks, licences, franchises or 'any other business or commercial rights of similar nature'.

A reading of the words 'any other business or commercial rights of similar nature' in *Explanation 3* indicates that "goodwill" would fall under the said expression, applying the principle of *ejusdem generis*. In the process of amalgamation, the amalgamated company had acquired a capital right in the form of goodwill because of which the market worth of the amalgamated company stood increased.

Therefore, it was held that the excess consideration paid by X Ltd. over the value of net assets acquired from Y Ltd. in the scheme of amalgamation constitutes goodwill, which is an intangible asset under *Explanation 3(b)* to section 32(1), thereby qualifying for depreciation under that section.

The action of the Assessing Officer in rejecting the claim of depreciation made by X Ltd. is, therefore, not valid.

- (c) The term loan for purchase of machinery is not a trading liability. Therefore, on writing off of the loans, no benefit or perquisite arose to R Ltd. in the revenue field. Therefore, the provisions of section 41(1) are not attracted in this case since the waiver is in respect of a term loan taken for a capital asset and hence, cannot be treated as remission or cessation of a trading liability. Thus, the waiver of such term loans cannot be treated as income of R Ltd.

However, where the loan is written off in the cash credit account, the benefit is in the revenue field as the money had been borrowed for day-to-day affairs and not for the purchase of capital asset. Therefore, the writing off of these loans on the cash credit account which was received for carrying out the day-to-day operations of the assessee amounted to remission of a trading liability and hence, has to be treated as income in the hands of R Ltd. by virtue of section 41(1). This is the crux of the Delhi High Court decision in *Rollatainers Ltd. v. CIT* (2011) 339 ITR 54.

In effect, the provisions of section 41(1) are attracted in respect of waiver of the working capital loan utilized for day-to-day business operations, since it amounted to remission of a trading liability. However, in the case of waiver of term loan for purchasing capital assets, the provisions of section 41(1) are not attracted since it cannot be treated as remission or cessation of a trading liability.

Waiver of interest on term loan is not taxable under section 41(1), since interest due but not paid would not have been allowed as deduction in the earlier years or current year, on account of the provisions of section 43B. Therefore, the question of taxability of interest waived does not arise.

Therefore, the action of the Assessing Officer in invoking the provisions of section 41(1) in respect of waiver of cash credit is correct. However, as regards invoking the provisions of section 41(1) in respect of waiver of term loan and interest, the action of the Assessing Officer is not correct.

Question 2

XYZ Limited purchased a machine on 1st April, 2013 for ₹ 10 crores by availing 70% loan facility from bank. The machine was required for extension of the business of the company and was put to use into effective production on 1st February, 2014. Interest on loan is charged at 12% per annum.

Advise XYZ Limited on the treatment of interest payment made on this loan and depreciation allowable for the Assessment Year 2014-15. Assume that this machine is the only machine in the related block of assets.

Answer

(i) Interest on term loan for purchase of machinery

As per section 36(1)(iii), interest paid in respect of capital borrowed for acquisition of an asset for extension of existing business for a period beginning from the date of borrowal of loan for acquiring the asset till the date on which such asset is first put to use is not allowable as deduction. Interest for such period has to be capitalized, by adding the same to the cost of the asset. Therefore, interest@12% p.a. for a period of 10 months from 1st April, 2013 to 31st January, 2014 on ₹ 7 crores, being the amount of loan, has to be capitalized.

	₹
Cost of machinery	10,00,00,000
Add: Interest $[12\% \times 10/12 \times ₹ 7,00,00,000]$	<u>70,00,000</u>
Actual Cost of machinery	<u>10,70,00,000</u>
Interest @12% for two months (February, 2014 & March, 2014) after the asset is put to use is allowable as deduction under section 36(1)(iii) $[12\% \times 2/12 \times ₹ 7,00,00,000]$	14,00,000

(ii) Depreciation

	₹
Since the machinery is put to use for less than 180 days in the previous year 2013-14, the depreciation would be restricted to 50% of the amount calculated at the prescribed percentage of 15%. Therefore, depreciation = $50\% \times [15\% \times ₹ 10,70,00,000]$	80,25,000
Likewise, the additional depreciation would also be restricted to 50% of the amount calculated at the prescribed percentage of 20%, assuming that XYZ Ltd. is engaged in the manufacture or production of any article or thing and that the machinery acquired is a new machinery. Therefore, additional depreciation = $50\% \times [20\% \times ₹ 10,70,00,000]$	<u>1,07,00,000</u>
	<u>1,87,25,000</u>

Question 3

KLM Limited has gone for pension scheme referred to in section 80CCD. It contributes 20% of basic salary to the account of each employee under the scheme. Dearness allowance paid is 40% of basic salary. 50% of dearness allowance forms part of pay for retirement benefits. Total basic salary of employees during the year ended 31st March, 2014 amounted to ₹ 100

lakhs. You are a finance executive of the company and get a basic salary of ₹ 20,000 per month and contribute 20% of basic salary to the pension scheme. On these facts:

- (i) Compute the amount admissible as deduction under section 36(1)(iva) and the amount inadmissible under section 40A(9) in computation of business income of KLM Limited.
- (ii) Explain the tax treatment in your hands.

Answer

- (i) Computation of deduction allowable under section 36(1)(iva) and disallowance under section 40A(9) while computing business income of KLM Ltd.

Particulars	₹
Basic Salary	1,00,00,000
Dearness Allowance is 40% of basic salary, 50% of which forms part of pay for retirement benefits	<u>20,00,000</u>
Salary for the purpose of section 36(1)(iva) (Basic Salary + DA which forms part of pay for retirement benefits)	<u>1,20,00,000</u>
Actual contribution (20% of basic salary i.e., 20% of ₹ 100 lakh)	20,00,000
Less: Permissible deduction under section 36(1)(iva) (10% of salary computed as above = 10% of ₹ 1,20,00,000 = ₹ 12,00,000)	<u>12,00,000</u>
Excess contribution disallowed under section 40A(9)	<u>8,00,000</u>

- (ii) Tax treatment in the hands of the finance executive in respect of employer's and own contribution to pension scheme referred to in section 80CCD
 - (a) Employer's contribution to such pension scheme would be treated as salary since it is specifically included in the definition of "salary" under section 17. Therefore, ₹ 48,000, being 20% of basic salary of ₹ 2,40,000, will be included in salary.
 - (b) Own contribution to pension scheme is allowable as deduction under section 80CCD(1). However, the deduction is restricted to 10% of salary. Salary, for this purpose, means basic pay plus dearness allowance, if it forms part of pay for retirement benefits. Therefore, salary for the purpose of deduction under section 80CCD, in this case, would be –

Particulars	₹
Basic salary (₹ 20,000 × 12)	2,40,000
Dearness allowance = 40% of ₹ 2,40,000 = ₹ 96,000	
50% of DA forms part of pay = 50% of ₹ 96,000	<u>48,000</u>
Salary for the purpose of deduction under section 80CCD	<u>2,88,000</u>

Deduction u/s 80CCD(1) = 10% of ₹ 2,88,000 (as against actual contribution of ₹ 48,000, being 20% of basic salary of ₹ 2,40,000)	28,800
₹ 28,800 is allowable as deduction under section 80CCD(1). This would be taken into consideration and be subject to the overall limit of ₹ 1 lakh under section 80CCE.	

- (c) Employer's contribution to pension scheme would be allowable as deduction under section 80CCD(2), subject to a maximum of 10% of salary. Therefore, deduction under section 80CCD(2), would also be restricted to ₹ 28,800, even though the entire employer's contribution of ₹ 48,000 is included in salary under section 17.

However, this deduction of employer's contribution of ₹ 28,800 to pension scheme would be outside the overall limit of ₹ 1 lakh under section 80CCE i.e., this deduction would be over and above the other deductions which are subject to the limit of ₹ 1 lakh.

Question 4

- (a) *P. Limited has two divisions, engineering division and tea division. It has transferred engineering division to Q. Limited pursuant to a scheme of demerger which satisfies the conditions of section 2(19AA). P. Limited had a debt of ₹ 5 lakhs in engineering division which stood transferred to Q. Limited. The said debt has been written off as bad in the accounts of Q. Ltd. Can Q. Limited claim deduction on account of the bad debt?*
- (b) *BCFS Limited is a Non-Banking Financial Company (NBFC). The company has not credited interest of ₹ 30 lakhs due on certain loan accounts which had become non-performing assets in its profit & loss account. As per NBFC Prudential Norms (RBI) Directions, 1998, which is binding on the company, interest or discount or any other charges on non-performing assets shall be recognised as income only when it is actually realised. Can the Assessing Officer make addition of such interest on the ground that the assessee, being a company, follows mercantile system of accounting?*
- (c) *Mr. S, a lawyer by profession, incurred expenditure on his heart surgery. He claimed such expenditure arguing that the repair of vital organ i.e. the heart has directly impacted his professional competence as his gross income from profession increased manifold after the surgery, the heart should be treated as a plant and hence such expenses should be allowed under section 31 as current repairs to plant and machinery or section 37(1) as an expenditure incurred wholly and exclusively for the purpose of his profession. Is the claim of Mr. S tenable in law?*

Answer

- (a) As per the provisions of section 36(1)(vii), bad debts written off as irrecoverable by the assessee shall be allowed as deduction while computing income under the head "Profit and gains from business or profession" in case such debt has been taken into account in computing the income of the assessee in the current previous year or any of the earlier previous year.

However, as per the Supreme Court's ruling in *CIT v. T. Veerabhadra Rao (1985) 115 ITR 152*, a successor to a business will be entitled to claim an allowance for bad debt under section 36(1)(vii) even though the debt was not incurred by it (i.e., the successor) but was incurred by the predecessor before takeover of the business by the successor.

Therefore, the claim for bad debts will be allowed even if the relevant debt had been taken into account in computing the income of the predecessor only and not in computing income of the successor assessee.

However, it is important that the identity of the business after succession remains the same.

Therefore in the present case, deduction under section 36(1)(vii) on account of bad debts of ₹ 5 lakh shall be allowed to Q. Limited in relation to a debt incurred by P. Limited for the engineering division transferred to Q. Limited, even though the same is not taken into account in computing the income of Q. Limited of the current previous year or any of the earlier previous years, provided the identity of the business in the hands of Q Ltd remains the same.

- (b) The issue under consideration is whether in the case of an assessee following mercantile system of accounting, the interest from the NPA has in fact accrued to the assessee and whether such interest can be regarded as income accrued under section 5 of the Income-tax Act, 1961.

As per section 145, the income shall be computed in accordance with the method of accounting regularly followed by the assessee. In the case of a NBFC, it is bound by the RBI directives. The classification as NPA is as per prudential norms of the RBI.

In the case of NPAs, the recovery of the principal amount of loan itself is doubtful. Therefore, where the interest was not received on NPAs and possibility of recovery was almost nil, it could not be treated to have accrued in favour of the assessee. Accordingly, the assessee, on the basis of prudence, is justified in not accounting for interest in the books of account on the ground that there is no real accrual of interest from a NPA under section 5.

In the case of *DIT v. Brahamputra Capital Financial Services Ltd. (2011) 335 ITR 182*, the High Court took a similar view.

Hence the Assessing Officer cannot make an addition on the premise that the company follows mercantile system of accounting.

- (c) The issues under consideration are whether the expenses incurred on heart surgery can be regarded as:
- (a) Current repairs to plant, allowable under section 31 or
 - (b) A revenue expenditure, incurred wholly and exclusively for the purposes of the assessee's profession and hence, allowable under section 37(1).

These issues came up before the Delhi High Court in the case of *Shanti Bhushan v. CIT (2011) 336 ITR 26*, wherein it was observed that to allow the heart surgery expenditure as repair expenses to plant, the heart should have been first included in the assessee's balance sheet as an asset in the previous year and in the earlier years. Also, a value needs to be assigned for the same. The assessee would face difficulty in arriving at the cost of acquisition of such an asset for showing the same in his books of account. Though the definition of plant is inclusive in nature but the plant must have been used as a business tool which is not true in case of heart. Therefore, the heart cannot be said to be plant for the business or profession of the assessee. Therefore, the expenditure on heart surgery is not allowable as repairs to plant under section 31.

According to the provisions of section 37(1), *inter alia*, the said expenditure must be incurred wholly and exclusively for the purposes of the assessee's profession. As mentioned above, a healthy heart will increase the efficiency of human being in every field including its professional work. Therefore, there is no direct nexus between the expenses incurred by the assessee on the heart surgery and his efficiency in the professional field. Therefore, the claim for allowing the said expenditure under section 37(1) is also not tenable.

Therefore, applying the rationale of the above court ruling to the case on hand, the claim of S is not tenable in law.

Question 5

A partnership firm consisting of three partners X, Y and Z is engaged in the business of manufacturing and selling toys.

Turnover of the business for the year ended 31st March, 2014 amounts to ₹ 95 lakh. Bad debts written off in the books are ₹ 75,000. Interest at 12% is provided to partner Z on his capital of ₹ 6 lakh as authorized by the partnership deed.

The firm had business loss of ₹ 50,000 and unabsorbed depreciation of ₹ 1,50,000 carried forward from Assessment Year 2013-14. The firm did not pay tax under presumptive tax system in assessment year 2013-14. The firm opts for presumptive taxation under section 44AD for Assessment Year 2014-15.

- (i) *Compute the income of the firm chargeable under the head "Profits and gains of business or profession."*

- (ii) What would be the liability for interest under sections 234B and 234C, if the firm has not paid any advance tax?

Answer

- (i) Computation of income of the firm chargeable under the head "Profits and Gains of business or profession"

Particulars	₹
Presumptive income under section 44AD (8% of ₹ 95 lakh) [See Note 1]	7,60,000
Less: Interest @ 12% to Z (12% of ₹ 6 lakh) [See Note 3]	<u>72,000</u>
	6,88,000
Less: Brought forward business loss under section 72 [See Note 4]	<u>50,000</u>
Income of the firm chargeable under the head "Profits and Gains of business or profession"	<u>6,38,000</u>

Notes: -

- (1) A partnership firm falls within the definition of "eligible assessee" under section 44AD. The threshold limit of turnover for applicability of presumptive taxation scheme under section 44AD is ₹ 100 lakh. In this case, since the turnover of the business of the firm is ₹ 95 lakh, it falls within the definition of "eligible business" and therefore, the firm is eligible to opt for presumptive taxation under section 44AD. 8% of the total turnover would be deemed to be the business income of the firm.
 - (2) As per section 44AD(2), all deductions allowable under sections 30 to 38 shall be deemed to have been allowed in full and no further deduction shall be allowed.
Accordingly, no deduction shall be allowed for bad debts since the same is deductible under section 36(1)(vii) and unabsorbed depreciation since the same is deductible under section 32(2).
 - (3) However, where the "eligible assessee" is a firm, salary and interest would be allowed as deduction subject to the conditions and limits prescribed under section 40(b). Therefore, interest@12% to partner Z, which is authorized by the partnership deed, is allowable as deduction.
 - (4) Further, business loss of previous year 2012-13 can be set-off against current year business income as per section 72.
- (ii) As per section 44AD(4), the provisions of Chapter XVII-C would not apply to an eligible assessee in so far as they relate to the eligible business. Therefore, an assessee opting for presumptive taxation scheme under section 44AD is relieved from the requirement of advance tax payments. It would be sufficient compliance if they pay their tax while filing their return of income before the due date.

Therefore, in this case, the firm is not required to make advance tax payments. Accordingly, there would be no liability for interest under sections 234B and 234C.

Question 6

PQR Limited has written off certain debts as bad debts in the books of account and claimed deduction under section 36(1)(vii) in the return of income filed for Assessment Year 2014-15. The Assessing Officer made disallowance for deduction of bad debts on the ground that the debts have not been established to have become irrecoverable and bad in the previous year 2012-13.

Examine the correctness of the action of the Assessing Officer.

Answer

As per section 36(1)(vii), the amount of any bad debts or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year is allowable as deduction in that year, subject to the provisions of section 36(2).

Section 36(2), *inter alia*, provides that such debt should have been taken into account in computing the income of the assessee for the previous year in which it was written off or any earlier previous year or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee.

Therefore, there is no requirement under section 36(1)(vii) to establish that the debt has become irrecoverable or bad. It is enough if the bad debts is written off as irrecoverable in the accounts of the assessee during the relevant previous year. It was so held by the Apex Court in the case of *T.R. F. Ltd. v. CIT* (2010) 323 ITR 397.

Applying the provisions of section 36(1)(vii), section 36(2) and the rationale of the Supreme Court decision, the action of the Assessing Officer in this case is incorrect, assuming PQR Ltd. had taken into account such debt in computing its income of this previous year or any earlier previous year.

Question 7

(A) *Examine the taxability or allowability or otherwise in the following cases while computing income under the head "Profits and gains from business or profession" to be declared in the return of income for the financial year ended on 31.3.2014:*

- (i) *Amount received towards power subsidy with a stipulation that the same is to be adjusted in the electricity bills.*
- (ii) *Donations received by a person in the course of carrying on vocation from his followers.*
- (iii) *Profit derived by an assessee engaged in carrying the business as dealers in shares on exchange of the shares held as stock in trade of one Company with the shares of other Company.*

- (iv) *The amount of margin money forfeited by a bank on the failure of its constituents of not taking the delivery of the shares purchased by such bank on their behalf.*
- (v) *Depreciation on the “decoders” given on loan to the cable operators but owned by the assessee who is engaged in the business of distributing satellite channels.*
- (B) *X Co. Ltd. was amalgamated with Y Co. Ltd. on 30.04.2013. X Co. Ltd. was engaged in real estate whereas Y Co. Ltd. was engaged in manufacture of textile articles. Y Co. Ltd. on amalgamation altered its objects clause of Memorandum of Association, to carry on real estate business.*

The stock in trade of X Co. Ltd. (being vacant lands) was taken over at ₹140 lacs by Y Co. Ltd. as against their original cost of ₹125 lacs to X Co. Ltd. for the purpose of amalgamation. Y Co. Ltd incurred ₹25 lacs towards development of those lands obtained on amalgamation. It sold the entire land for ₹160 lacs during the year ended 31.03.2014.

Determine the tax implication of the transaction in the hands of Y Co. Ltd. for the assessment year 2014-15.

Answer

- (A) (i) Power subsidy received by the assessee is revenue in nature as it goes towards reduction of the electricity bills. Therefore, the subsidy is taxable as business income. It was so held by the Supreme Court in *CIT vs. Rajaram Maize Products (2001) 251 ITR 427*.
- (ii) Donations received by a person from his followers in the course of carrying on vocation for the furtherance of the objects of his vocation were receipts arising from the carrying on of his vocation and not casual or non-recurring receipts. The Supreme Court, in *Dr. K. George Thomas vs. CIT (1985) 156 ITR 412*, held that such donations are taxable as a business income as there is a direct nexus between the vocation carried on by the assessee and the receipt of such donation.
- (iii) The difference between the cost/book value of shares of the first company and the market value of shares of the new company on the date of such exchange has to be treated as profit derived by the dealer in shares (on exchange of shares held as stock-in-trade of first company with the shares of the new company) in the normal course of his business, and hence such profit is taxable as business income. It was so held by the Supreme Court in *Orient Trading Co. Ltd. vs. CIT (1997) 224 ITR 371*.
- (iv) Since the bank is purchasing shares on behalf of the constituents, the forfeiture of margin money by the bank from the constituents for not paying the balance amount of purchase price and not taking delivery of shares purchased by the bank on their behalf is in the normal course of its banking business and hence, the forfeited amount is assessable as business income of the bank. The forfeited amount being revenue in nature cannot be adjusted against the purchase price of the shares. The

Supreme Court, in the case of *CIT vs. Lakshmi Vilas Bank Ltd. (1996) 220 ITR 305*, has confirmed this view.

- (v) Loan of decoders to cable operators is in the normal course of the assessee's business of distribution of satellite channels, and hence the same can be treated as use of asset for business purposes. Since the assessee is the owner of decoders used for business purposes, therefore, he is entitled to depreciation under section 32. The Delhi High Court, in *CIT vs. Turner International India (P) Ltd. (2008) 297 ITR 373*, has also confirmed this view.
- (B) The provisions of section 43C would be attracted in this case. Where an asset, not being an asset referred to in section 45(2), which becomes the property of an amalgamated company under a scheme of amalgamation is sold by the amalgamated company as its stock in trade, then, the cost of acquisition of the said asset to the amalgamated company in computing the profits and gains derived from sale of such asset would be the cost of acquisition of such asset to the amalgamating company plus the cost of any improvement incurred thereto and the expenditure incurred wholly and exclusively in connection with such transfer by the amalgamating company.

In this case, since the stock-in-trade of X Co. Ltd. is taken over by Y Co. Ltd. on amalgamation, the provisions of section 43C are attracted and the cost of acquisition of vacant lands to Y Co. Ltd. (the amalgamated company) will be ₹ 125 lacs, being the original cost of such lands to X Co. Ltd., the amalgamating company. Since the stock in trade of X Co. Ltd. (being vacant land) is taken over by Y Co. Ltd., which has altered its object clause on amalgamation to include real estate business, a view can be taken that the provisions of section 45(2) are not attracted in this case.

The business income of Y Co. Ltd. on sale of such lands would be calculated as under -

Particulars	₹ (in lacs)	
Sale price (in the hands of Y Co. Ltd.)		160
Less: Cost of acquisition under section 43C, being the original cost to the amalgamating company, X Co. Ltd.	125	
Cost of improvement (incurred by Y Co. Ltd)	<u>25</u>	<u>150</u>
Taxable business income chargeable in the hands of Y Co. Ltd		<u>10</u>

Question 8

R Limited transferred a building worth ₹25 lacs to the Chief Executive Officer, Mr. Mohan Lal, a resident individual on his retirement under an agreement for not carrying on any activity related to its business for a period of five years. In course of assessment under section 143(3), the Assessing Officer found that no tax had been deducted at source by R Limited and on that ground, he disallowed the expenditure by invoking the provision of section 40(a)(ia). Examine the correctness of the action of the Assessing Officer.

Answer

As per section 194J, any person, who is responsible for paying to a resident, any sum by way of fees for professional services, or fees for technical services or royalty or non- compete fees referred to in section 28(va) is required to deduct tax at source.

As per section 28(va), any sum received or receivable in cash or in kind under an agreement for not carrying out any activity in relation to any business is chargeable to income-tax under the head "Profits and gains of business or profession".

Therefore, the obligation to deduct tax under section 194J arises even if the non-compete fee is payable in kind. It is the responsibility of the payer to recover the amount of tax deductible from the recipient of the non-compete fee in kind.

Under section 40(a)(ia), non-deduction of tax at source in respect of the following amounts payable to a resident attracts disallowance –

1. Interest [Sections 193 & 194A];
2. Commission or Brokerage [Section 194H];
3. Rent [Section 194-I];
4. Royalty [Section 194J(1)(c)];
5. Fees for professional services [Section 194J(1)(a)];
6. Fees for technical services [Section 194J(1)(b)]; and
7. Amount payable to a contractor or sub-contractor [Section 194C].

Therefore, in respect of fees for professional services, fees for technical services and royalty, disallowance is attracted if tax is not deducted at source under section 194J. However, non-compete fee is classified separately under section 194J(1)(d), in respect of which there is no specific provision in section 40(a)(ia) for disallowance in case of non-deduction of tax at source.

Therefore, the action of the Assessing Officer is not correct since even though tax is required to be deducted at source under section 194J, disallowance under section 40(a)(ia) would not be attracted.

Question 9

ILT Limited is engaged in manufacturing pipes and tubes. The profit and loss account of the company for the year ended 31st March, 2014 shows a net profit of ₹ 405 lacs. The following information and particulars are furnished to you. You are required to compute total income of the company for Assessment Year 2014-15 indicating reasons for treatment of each item.

- (i) *A group free air ticket was provided by a supplier for reaching a certain volume of purchase during the financial year 2013-14. The same is encashed by the company for ₹10 lacs in April 2014.*

- (ii) A regular supplier of raw materials agreed for settlement of ₹ 8 lacs instead of ₹ 10 lacs for poor quality of material supplied during the previous year which was not given effect in the running account of the supplier.
- (iii) Andhra Bank sanctioned and disbursed a term loan in the financial year 2010-11 for a sum of ₹ 50 lacs. Interest of ₹ 8 lacs was in arrear. The bank has converted the arrear interest into a new loan repayable in ten equal instalments. During the year, the company has paid two instalments and the amount so paid has been reduced from Funded Interest in the Balance Sheet.
- (iv) The company remitted ₹ 5 lacs as interest to a company incorporated in USA on a loan taken two years ago. Tax deducted under section 195 from such interest has been deposited by the company on 15th July, 2014. The said interest was debited to profit and loss account.
- (v) Liquidated damage of ₹ 3 lacs received from KS Limited for delay in supply of plant and machinery has been shown under the head "Other income" in Profit & Loss Account.
- (vi) Sandeep, a sales executive stationed at HO at Delhi, was on official tour in Bangalore from 31st May, 2013 to 18th June, 2013 and 28th September, 2013 to 15th October, 2013 for the business development. The company has paid Sandeep's salary in cash, from its local office at Bangalore for the month of May, 2013 (payable on 1st June) and September 2013 (payable on 1st October), amounting to ₹ 25,000 and ₹ 27,000 respectively (net of TDS and other deduction), as Sandeep has no bank account at Bangalore. These were included in the amount of "salary" debited to Profit and Loss Account.
- (vii) The company has taken up initiative to restructure its debt and paid ₹ 20,000 to a finance company, M/s ABC Ltd., towards pre payment premium. As per the scheme, ₹ 50,000 loan was waived against its loan and ILT Limited directly credited it to its reserve account, considering loan waiver amount as capital receipt.
- (viii) The company has contributed ₹ 50,000 by cheque to an electoral trust and the same stands included under the head "General Expenses".

Answer

Computation of total income of ILT Ltd. for the A.Y.2014-15

Particulars	₹ (in lacs)	
Profits and gains from business or profession		
Net profit as per profit and loss account		405.00
Add : Items debited to profit and loss account, but to be disallowed and items not considered in accounts but to be taxed [See Note 1 below]		
Value of group free air ticket provided by a supplier is taxable as business income under section 28(iv), as the value of any benefit, whether convertible into money or not, arising from business is taxable as business income.	10	

Amount waived by the supplier of raw materials is a deemed income under section 41(1), as the expenditure was allowed as deduction in the last year and there is a benefit by way of remission or cessation of a trading liability. The fact that effect was not given in the running account of supplier is not relevant.	2	
Interest payable outside India to a foreign company is not allowable since tax deducted by the assessee is not deposited during the previous year or in the subsequent year within the time prescribed under section 200(1) [Section 40(a)(i)]. In this case, the tax deducted was deposited after the prescribed date after the end of the previous year and therefore, the assessee can claim deduction only in the F.Y.2014-15].	5	
Contribution to electoral trust is not an allowable expenditure while computing business income. Hence, the same has to be added back, since it is included in general expenses.	0.50	<u>17.50</u>
		422.50
Less: Amount of deduction allowable or amount credited to profit and loss account but not taxable [See Note 1 below]		
Under section 43B, interest on loan due to any scheduled bank, etc. is allowed as deduction, if such interest is actually paid irrespective of the method of accounting followed by the assessee. Conversion of arrear interest into a fresh loan by a bank cannot be considered as actual payment of interest. However, the amount of funded interest (i.e. converted loan) actually paid is allowable as deduction. Hence, ₹ 1,60,000, being two installments of ₹ 80,000 each, actually paid is deductible.	1.60	
Liquidated damages have been received due to delay in supply of plant and machinery by the supplier. As the liquidated damages relates to delayed supply of a capital asset, it is in the nature of capital receipt and not revenue receipt. As the amount has been wrongly credited to the profit and loss account, the same should be deducted.	3.00	
In the case of <i>CIT v. Gujarat Guardian Ltd. (2009) 177 Taxman 434 (Del.)</i> , it was held that pre-payment premium represents interest as per section 2(28A). Section 2(28A) defines interest to include any other charge in respect of money borrowed or debt incurred. Section 36(1)(iii) provides for deduction of interest paid in respect of capital borrowed for the purposes of business or profession. Under section 43B, such interest is allowable as deduction on actual payment. From a combined reading of section 2(28A), 36(1)(iii) and 43B it can be inferred that pre-payment premium is deductible as business expenditure in one lump-sum on actual payment.	0.20	<u>4.80</u>
Business Income		<u>417.70</u>

Gross total income		417.70
Less: Deduction under Chapter VI-A		
Deduction under section 80GGB in respect of contribution by the assessee company to an electoral trust.		<u>0.50</u>
Total Income		<u>417.20</u>

Notes

1. Since the question is silent as to whether the net profit of ₹ 405 lacs is after taking into account the adjustments in (i) to (viii), the problem has been worked out on the assumption that except for items (iv), (v) (vi) and (viii) in respect of which there is a specific mention about inclusion, all other adjustments i.e. (i), (ii), (iii) and (vii) have not been given effect to in the profit and loss account.
2. In respect of payment of salary to sales executive in cash, no disallowance under section 40A(3) is to be made as such payment falls within the scope of Rule 6DD(1). Salary paid to him in cash is allowable as the executive was temporarily posted for a continuous period of more than 15 days in Bangalore, not being the place of his normal duty, tax was deducted from such salary under section 192 and he does not maintain any bank account in Bangalore. Therefore, no disallowance under section 40A(3) is attracted in respect of such salary.
3. Remission of principal amount of loan does not amount to income under section 41(1) or under section 28(iv), where there is a waiver of loan taken from a bank or financial institution, unless the loan is taken for a trading activity. It is assumed that such loan is not taken for a trading activity and therefore, waiver of loan cannot be treated as income.

Question 10

ITP Limited is engaged in growing and manufacturing tea in India. It commenced its operation from 1st April, 2013. It acquired plant and machinery, factory building and furniture at cost of ₹ 40 lacs, ₹ 25 lacs and ₹ 10 lacs, respectively, in the previous year 2013-14. All the assets were put to use for more than 180 days during the P. Y. 2013-14. Compute the written down value of each block of assets as on 1st April, 2014.

Answer

As per section 32, depreciation to be allowed has to be computed at the prescribed percentage on the written down value of any block of assets.

As per section 43(6), in the case of assets acquired before the previous year, the written down value means the actual cost to the assessee less all depreciation "actually allowed" to him under the Income-tax Act, 1961.

As per Rule 8 of the Income-tax Rules, 1962, only 40% of income from business of growing and manufacturing of tea in India is deemed to be income liable to tax. The balance 60% would be agricultural income, which is not chargeable to tax.

Explanation 7 to section 43(6) provides that in cases of composite income, for the purpose of computing written down value of assets acquired before the previous year, the total amount of depreciation shall be computed as if the entire composite income of the assessee is chargeable to tax under the head "Profits and gains of business or profession". The depreciation so computed shall be deemed to have been "actually allowed" to the assessee.

Therefore, even if only 40% of ITP Limited's income from sale of tea grown and manufactured in India is taxable, full depreciation (and not 40%) should be taken as "actually allowed" for the purpose of computing WDV. Accordingly, the WDV of each block as on 1st April 2014 will be as follows:

Plant & Machinery = ₹ 40 lacs – ₹ 6 lacs (15% of ₹ 40 lacs) = ₹ 34 lacs.

Building (Factory) = ₹ 25 lacs – ₹ 2.50 lacs (10% of ₹ 25 lacs) = ₹ 22.50 lacs.

Furniture = ₹ 10 lacs – ₹ 1 lacs (10% of ₹ 10 lacs) = ₹ 9 lacs.

Question 11

"Bhardwaj Textiles Ltd." had availed a term loan of ₹ 400 lacs from a nationalized bank for acquiring the fixed assets. However, due to financial difficulties, it could not meet its obligation for the last three years and decided to avail the benefit of "One Time Settlement Scheme" announced by the bank to reduce its NPA. The bank as per scheme allowed waiver of principal of ₹ 5 lacs and of outstanding interest of ₹ 20.30 lacs in total of ₹ 25.30 lacs. The company directly credited the amount so waived to the general reserve. The Assessing Officer contends that the entire amount so waived by the bank is chargeable to tax as business income under section 28(iv) or under section 41(1). Discuss the correctness of contention of the Assessing Officer.

Answer

The amount waived by the nationalized bank in respect of outstanding principal and interest on term loan is not assessable as business income applying the provisions of section 28(iv) [*Mahindra and Mahindra v. CIT* (2003) 261 ITR 501 (Bom)]. Section 28(iv) seeks to bring to charge the value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession. The Bombay High Court pointed out that what was sought to be taxed was a benefit or perquisite, that is, something received in kind. Waiver of term loan taken for acquiring fixed assets and interest on such term loan, cannot be said to be a benefit or perquisite, since what was waived was not in kind.

Section 41(1) has no application because there was no cessation of trading liability. The assessee had availed term loan for acquiring fixed assets which was not a trading liability but a capital liability. Section 41(1) can, inter alia, apply only where there is cessation of trading liability and not where there is cessation of capital liability. Therefore, the decision of the Bombay High Court in *Solid Containers Ltd. v. DCIT* (2009) 308 ITR 417 will not apply to this case which states that if the loan is taken for a trading activity and ultimately upon waiver the

amount was retained in the business by the assessee then the waived amount shall become assessee's income and was assessable.

As regards the interest portion, the assessee could not have availed any deduction, in view of the provisions of section 43B. Section 41(1) is attracted only when an allowance or deduction is made in the previous year in respect of such expenditure and subsequently, any amount in respect of such expenditure is received in any later year. In this case, since interest was never allowed as deduction, section 41(1) is not attracted.

Therefore, the contention of the Assessing Officer is not correct.

Note: Similar ruling has been pronounced by the Madras High Court in Iskraemeco Regent Ltd. v. CIT (2011) 331 ITR 317 (Mad.), wherein it was held that, the waiver of principal amount and the interest in respect of the loan taken for purchase of capital asset would not amount to remission of a trading liability to attract the provisions of section 41(1). Also such waiver cannot be treated as a benefit arising out of business and consequently, section 28(iv) will not apply in respect of such loan transaction.

Question 12

Examine the correctness or otherwise of the following case in the context of provisions contained in the Income-tax Act, 1961 relevant/applicable for the assessment year 2014-15:

B. Ltd., the holding company of A. Ltd., had entered into an agreement by which the textile unit belonging to it was transferred to A. Ltd. The agreement also stipulates for the protection of service conditions and continuity of service of the workmen employed in the textile unit so transferred to/taken over by A. Ltd. B. Ltd. delivered the possession of the properties to A. Ltd. and also transferred all the employees working in the textile unit with the benefit of continuity of service and protection of service conditions. A. Ltd. claimed deduction for the amount of gratuity payment in respect of the workers of erstwhile textile unit of B. Ltd., who had retired during the relevant previous year. The Assessing Officer disallowed this claim of A. Ltd. on the ground that the liability towards gratuity payment to the employees of erstwhile company for the period prior to the takeover of the unit is not a revenue expenditure but is a capital expenditure.

Answer

The facts given in the problem are identical to the facts of the case decided by the Madras High Court in *Sree Akilandeswari Mills Pvt. Ltd. v. Dy. CIT (2005) 274 ITR 1*, where the Court has held that "the company, by virtue of the deed of transfer, had taken over the liability towards the employees of the transferor company and on the date of transfer, the liability relating to the gratuity was an ascertained liability on the basis of actuarial valuation. This also formed an integral part of the sale consideration to be discharged by making actual payment to the employee in subsequent years. The payment of gratuity, thus, was in the nature of a capital expenditure."

In the given problem, A. Ltd., by virtue of the deed of transfer, had taken over the possession of the textile unit of B. Ltd. with a liability of the transferor company towards the continuity of service and the protection of service conditions of the employees on the date of transfer. The gratuity liability was, thus, also an ascertained liability on the basis of actuarial valuation payable to the employees retiring after the date of transfer.

Hence, in this case, the expenditure incurred by A Ltd. towards discharge of the gratuity liability of the employees of the unit taken over from B Ltd., is a capital expenditure. Therefore, the reasoning of the Assessing Officer is correct.

Note – The Supreme Court, in CIT v. Hoogly Mills Co. Ltd. (2006) 287 ITR 333, held that such expenditure was a capital expenditure as it was incurred for acquiring an asset of enduring nature. However, no depreciation is allowable in respect of gratuity liability even if it is regarded as capital expenditure.

Question 13

Explain in brief, the treatment as to their taxability and/or allowability, under the provisions of Income-tax Act, 1961, for the assessment year 2014-15, in the following cases:

- (i) 'A' Ltd., an investment company, received dividend income of ₹ 1,00,000 on its investment in shares in domestic companies. It incurred interest expenditure of ₹ 2,00,000 on the borrowed capital utilized in the investment of shares.
- (ii) 'B' Ltd. is a company engaged in the business of financing and investment in shares. It suffered loss of ₹ 3,00,000 on account of futures and options, a transaction in the form of derivatives in which the underlying asset was shares.
- (iii) 'C' Ltd., which did not have any active business carried on by it incurred capital expenditure on scientific research amounting to ₹ 5,00,000 that related to its subsidiary companies.

Answer

- (i) The dividend income earned by 'A' Ltd. on the shares held as investment is exempt under the provisions of section 10(34). As per section 14A, no expenditure is allowable in respect of income which does not form part of total income. The interest paid on borrowed capital is an expenditure incurred in respect of shares purchased for investment. Since the dividend income received on shares is exempt and does not form part of total income of 'A' Ltd., the interest expenditure is not allowable as deduction.
- (ii) A transaction in derivatives, in which underlying asset is shares, is exempt from the purview of the speculative transaction, in terms of clause (d) of the proviso to section 43(5). As per the said clause, an eligible transaction in respect of trading in derivatives carried out in a recognized stock exchange shall not be deemed to be a speculative transaction. Accordingly, in the given case, if the transaction falls within the meaning of "eligible transaction" as defined in the *Explanation* therein, then the loss would be treated as an ordinary business loss eligible for set-off loss as per normal set-off provisions. On the other hand, if the transaction does not fall within the meaning of "eligible transaction",

the loss would be treated as a speculation loss and can be set-off only against speculative income.

- (iii) As per section 35(1)(iv), deduction in respect of capital expenditure on scientific research would be admissible under the provisions of section 35(2) only if the scientific research relates to the business carried on by the assessee.

However, in the given case, 'C' Ltd., did not have any active business carried on by it to which the said scientific research related to. The capital expenditure incurred by 'C' Ltd. related to its subsidiary companies. Therefore, 'C' Ltd. is not eligible for deduction under the provisions of section 35(1)(iv) read with section 35(2).

Question 14

Indian Gas Limited commenced its operation of the business of laying and operating a cross country natural gas pipeline network for distribution on 1st July, 2013. The company incurred capital expenditure of ₹ 300 lacs (including cost of land ₹ 45 lacs and cost of financial instrument ₹ 5 lacs) during the period from 1st April, 2013 to 30th June, 2013. The company did not claim deduction for such expenditure in the earlier assessment years. The entire expenditure was capitalised on 1st July, 2013. Further, during the previous year 2013-14 (from July 2013), the company incurred capital expenditure of ₹ 200 lacs exclusively for the said business.

- (i) *Compute the amount of deduction allowable under section 35AD assuming that the company has fulfilled all the conditions specified in section 35AD.*
- (ii) *If the company has loss from such business in the assessment year 2014-15, how the same is to be set off and carried forward?*

Answer

- (i) Section 35AD provides for investment-linked tax incentive for specified business. One such specified business is business of 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. The benefit will be available in a case where the business relates to laying and operating a cross country natural gas pipeline network for distribution, if such business commences its operations on or after 1st April, 2007.

Under section 35AD, 100% of the capital expenditure incurred during the previous year, wholly and exclusively for the above business would be allowed as deduction from the business income. However, expenditure incurred on acquisition of any land, goodwill or financial instrument would not be eligible for deduction.

Further, the expenditure incurred, wholly and exclusively, for the purpose of specified business prior to commencement of operation would be allowed as deduction during the previous year in which the assessee commences operation of his specified business. A condition has been inserted that such amount incurred prior to commencement should be capitalized in the books of account of the assessee on the date of commencement of its operations.

Therefore, the deduction admissible under section 35AD for A.Y. 2014-15 would be:

Particulars	₹ (in lacs)
Capital expenditure incurred during the previous year 2013-14	200
Capital expenditure incurred during the period from 1st April 2013 to 30th June, 2013 (i.e. prior to commencement of business) and capitalized in the books of account on 1st July, 2013 (₹ 300 lacs - ₹ 50 lacs)	250
Total deduction under section 35AD for A.Y.2014-15	450

However, the actual deduction under section 35AD for A.Y. 2014-15 would be restricted to the profits derived from specified business for that year. The difference would be treated as loss from specified business to be carried forward as per section 73A.

- (ii) Section 73A provides that any loss computed in respect of the specified business shall be set off only against profits and gains, if any, of any other specified business. The unabsorbed loss, if any, will be carried forward for set off against profits and gains of any specified business in the following assessment year and so on. There is no time limit specified for carry forward and set-off and therefore, such loss can be carried forward indefinitely for set-off against income from specified business.

Question 15

The trading and profit and loss account of Pingu Trading Pvt. Ltd. having business of agricultural produce, consumer items and other products for the year ended 31.03.2014 is as under:

Trading Account

Particulars	₹	Particulars	₹
Opening Stock	3,75,000	Sales	1,55,50,000
Purchases	1,25,75,000	Closing Stock	4,50,000
Freight & Cartage	1,26,000		
Gross profit	29,24,000		
	1,60,00,000		1,60,00,000

Profit and Loss Account

Particulars	₹	Particulars	₹
Bonus to staff	47,500	Gross profit	29,24,000
Rent of premises	53,500	Income-tax refund	20,000
Advertisement	5,000	Warehousing charges	15,00,000
Bad Debts	75,000		
Interest on loans	1,63,500		
Depreciation	75,500		
Sales-tax demand paid	1,08,350		

Miscellaneous expenses	5,25,650		
Net profit of the year	33,90,000		
	44,44,000		44,44,000

On scrutiny of records, the following further information and details were extracted/gathered:

- (i) There was a survey under section 133A on the business premises on 31.3.2014 in which it was revealed that the value of closing stocks of 31.3.2013 was ₹ 8,75,000 and a sale of ₹ 75,000 made on 13.3.2014 was not recorded in the books. The value of closing stocks after considering these facts and on the basis of inventory prepared by the department as on 31.3.2014 worked out at ₹ 12,50,000, which was accepted to be correct and not disputed.
- (ii) Income-tax refund includes amount of ₹ 4,570 of interest allowed thereon.
- (iii) Bonus to Staff includes an amount of ₹ 7,500 paid in the month of December 2013, which was provided in the books on 31.03.2013.
- (iv) Rent of premises includes an amount of ₹ 5,500 incurred on repairs. The assessee was under no obligation to incur such expenses as per rent agreement.
- (v) Advertisement expenses include an amount of ₹ 2,500 paid for advertisement published in the souvenir issued by a political party. The payment is made by way of an account payee cheque.
- (vi) Miscellaneous expenses include:
 - (a) amount of ₹ 15,000 paid towards penalty for non-fulfillment of delivery conditions of a contract of sale for the reasons beyond control,
 - (b) amount of ₹ 1,00,000 paid to the wife of a director, who is working as junior lawyer for taking an opinion on a disputed matter. The junior advocate of High Courts normally charge only ₹ 25,000 for the same opinion,
 - (c) amount of ₹ 1,00,000 paid to an Electoral Trust by cheque.
- (vii) Sales-tax demand paid includes an amount of ₹ 5,300 charged as penalty for delayed filing of returns and ₹ 12,750 towards interest for delay in deposit of tax.
- (viii) The company had made an investment of ₹ 25 lacs on the construction of a warehouse in rural area for the purpose of storage of agricultural produce. This was made available for use from 15.09.2013 and the income from this activity is credited in the Profit and Loss account under the head "Warehousing charges".
- (ix) Depreciation under the Income-tax Act, 1961 works out at ₹ 65,000.
- (x) Interest on loans includes an amount of ₹ 20,000 on which tax was not deducted.

Compute the income chargeable to tax for assessment year 2014-15 of Pingu Trading Pvt. Ltd, ignoring MAT. Support your answer with working notes.

Answer

Computation of Income of Pingu Trading Pvt. Ltd. chargeable to tax for the A.Y.2014-15

Particulars	₹
Net profit as per profit and loss account	33,90,000
<i>Add:</i> Difference in the value of stocks detected on survey under section 133A on 31.03.2014 chargeable as income (See Note 1)	<u>3,75,000</u>
	37,65,000
<i>Less:</i> Income tax refund credited in the Profit and Loss Account, out of which interest is to be considered separately under the head "Income from other sources"	<u>20,000</u>
	37,45,000
<i>Add:</i> Expenses either not allowable or to be considered separately but charged in the profit & loss account	
Repair expenses on rented premises where assessee is under no obligation to incur such expenses are not allowable as per section 30(a)(i). However, if such expenses are required for carrying on the business efficiently, the same are allowable under section 37.	
Advertisement in the souvenir of political party not allowable as per section 37(2B) (See Note 3)	2,500
Payment made to the wife of a director examined as per section 40A(2) and the excess payment made to be disallowed (See Note 5)	75,000
Payment made to electoral trust by cheque (See Note 6)	1,00,000
Penalty levied by the sales tax department for delayed filing of returns not allowable as being paid for infraction of law (See Note 7)	5,300
Depreciation as per books	75,500
Interest paid on loan without deduction of tax at source not allowable as per section 40(a)(ia)	20,000
	<u>40,23,300</u>
<i>Less:</i> Depreciation allowable as per Income-tax Act, 1961	65,000
	<u>39,58,300</u>
<i>Less:</i> Income from specified business (warehousing charges) credited to profit and loss account, to be considered separately (See Note 8)	15,00,000
Income from business (other than specified business)	<u>24,58,300</u>
Computation of income/loss from specified business (See Note 8)	
Income from specified business	₹ 15,00,000
<i>Less:</i> Deduction under section 35AD @ 150% of ₹ 25 lakhs	<u>₹ 37,50,000</u>
Loss from specified business to be carried forward as per section 73A	<u>(22,50,000)</u>

Income from Other Sources			
Interest on income-tax refund			4,570
	Gross Total Income		24,62,870
Less: Deduction under section 80GGB			
Contribution to political party (See Note 3)	₹ 2,500		
Contribution to an Electoral trust (See Note 7)	₹ 1,00,000		1,02,500
	Total Income		23,60,370

Notes :

- (1) The business premises were surveyed and differences in the figures of opening and closing stocks and sales were found which have not been disputed and accepted by the assessee. Therefore, the trading account for the year is to be re-casted to arrive at the correct amount of the gross profit/ net profit for the purpose of return of income to be filed for the previous year ended on 31.3.2014.

RECASTED TRADING ACCOUNT

Particular	₹	Particular	₹
Opening Stock	8,75,000	Sales	1,56,25,000
Purchases	1,25,75,000	(₹ 1,55,50,000 + ₹ 75,000)	
Freight and Cartage	1,26,000	Closing Stock	12,50,000
Gross Profit	32,99,000		
	1,68,75,000		1,68,75,000

The difference of gross profit of ₹ 32,99,000 - ₹ 29,24,000 = ₹ 3,75,000 is to be added as income of the business for the year.

- (2) Bonus for the previous year 2012-13 paid after the due date for filing return for that year would have been disallowed under section 43B for the P.Y.2012-13. However, when the same has been paid in December 2013, it should be allowed as deduction in the P.Y.2013-14 (A.Y.2014-15). Since it is already included in the figure of bonus to staff debited to profit and loss account of this year, no further adjustment is required.
- (3) The amount of ₹ 2,500 paid for advertisement in the souvenir issued by a political party attracts disallowance under section 37(2B). However, such expenditure falls within the meaning assigned to "contribute" under section 293A of the Companies Act, 1956¹, and is hence, eligible for deduction under section 80GGB. As per the Finance Act, 2013, any contribution to the political party or electoral trust made by way of cash is not allowed as deduction under section 80GGB. Since in the present case, the payment to the political party is made by way of an account payee cheque, it is allowed as deduction under section 80GGB.

¹ Section 182 of Companies Act, 2013

- (4) The penalty of ₹ 15,000 paid for non-fulfilment of delivery conditions of a contract for reasons beyond control is not for the breach of law but was paid for breach of contractual obligations and therefore, is an allowable expense.
- (5) It has been assumed that ₹ 25,000 is the reasonable payment for the wife of Director, working as a junior lawyer, since junior advocates of High Courts normally charge only ₹ 25,000 for the same opinion and therefore, the balance ₹ 75,000 has been disallowed.
- (6) Payment to an electoral trust qualifies for deduction under section 80GGB since the payment is made by way of a cheque. However, since the amount has been debited to profit and loss account, the same has to be added back for computing business income.
- (7) The interest of ₹ 12,750 paid on the delayed deposit of sales tax is for breach of contract and hence, is allowable as deduction. However, penalty of ₹ 5,300 for delay in filing of returns is not allowable since it is for breach of law.
- (8) Weighted deduction @ 150% of the capital expenditure is available under section 35AD in respect of specified business of setting up and operating a warehouse facility for storage of agricultural produce which commences operation on or after 1.04.2012. It is presumed that ₹ 25 lacs does not include expenditure on acquisition of any land.

The loss from specified business under section 35AD (warehousing) should be segregated from the income from other businesses, since, as per section 73A(1), any loss computed in respect of any specified business referred to in section 35AD shall not be set off except against profits and gains, if any, of any other specified business.

In view of the provisions of section 73A(1), the loss of ₹ 22.5 lacs from the specified business cannot be set-off against income from other businesses. Such loss has to be carried forward to be set-off against profit from specified business in the next assessment year.

Question 16

- (a) *A Company Ltd. issued 11% Debentures and raised ₹ 600 lacs. The debentures are redeemable after 6 years at a premium of 10%. The company wants to provide ₹ 10 lacs for meeting the premium on redemption of debentures and claimed the same as revenue expenditure. Is it a permissible deduction?*
- (b) *Balaram & Co., engaged in real estate business, acquired an old building for ₹ 75 lacs from Mr. X. The firm demolished the building and sold scrap materials for ₹ 5 lacs. The purchase consideration could not be paid immediately and therefore, it settled to pay in installments to Mr. X with interest @6% and the amount of interest was ₹ 4,50,000. The Assessing Officer treated the income from sale of scrap materials as business income, but whereas the claim of interest on delayed payment of purchase consideration claimed as revenue expenditure was disallowed. Decide the correctness of the action of assessee vis-a-vis the Assessing Officer.*

Answer

- (a) The issue under consideration in this case is whether premium on redemption of

debentures can be claimed on pro-rata basis over the life of the debentures.

In *Universal Cables Ltd. v. CIT* (2000) 243 ITR 371, the Calcutta High Court held that premium payable on redemption of convertible secured debentures issued during the year has to be spread over the period of debentures.

In *CIT v. S.M. Holding and Finance (P) Ltd.* (2003) 264 ITR 370, the Bombay High Court held that where zero-interest convertible debentures redeemable after ten years are issued at a premium, such premium has to be spread over the life of the debentures.

The Apex Court, in *Madras Industrial Investment Corporation Ltd v. CIT* (1997) 225 ITR 802, has held that the discount on issue of debentures has to be spread proportionately over the life of the debentures. Applying the same analogy, the amount payable by way of premium on redemption of debentures when set apart, is eligible for deduction, since the liability is ascertained and definite.

Therefore, in view of the above decisions, the company can claim deduction of ₹ 10 lacs as revenue expenditure during the year, since it represents pro-rata amount (i.e., one-sixth) of the premium of ₹ 60 lacs (being 10% of ₹ 600 lacs).

- (b) In this case, the assessee is engaged in real estate business in which acquisition and sale of immovable properties are regular in nature. When sale of scrap materials on demolition of building is assessed as business income, then, the payment of interest towards purchase price of stock-in-trade (building, in this case) is also to be treated as revenue in nature.

The Apex Court, in *Kerala Roadlines v. CIT* (2008) 299 ITR 343 (SC), held that when the amount realised on sale of scrap material of the structures standing on the lands is treated as business income, the interest on delayed payment of purchase price can be claimed as revenue expenditure.

Therefore, the treatment given by the Assessing Officer disallowing interest on delayed payment of purchase consideration is incorrect and the assessee is justified in claiming the interest on delayed payment of purchase consideration as revenue expenditure.

Question 17

During the year ended 31.3.2014, Geojit Marine Products Ltd. has made payment in cash to the tune of ₹ 60,000 on a single day to local fishermen, who regularly supply to them lobsters and crabs. Will such cash payments be hit by the provisions of section 40A(3) of the Income-tax Act, 1961? Will your answer be different, if such cash payments are made to a hawker who supplies lobsters and crabs?

Answer

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 ₹ 60,000 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 ₹ 60,000 on a single day is made to a hawker who supplies lobsters and crabs.

Question 18

Discuss the allowability of the expenses incurred on partly-convertible debenture while computing income under the head "Profits and gains of business or profession".

Answer

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).

Question 19

XYZ Ltd. commenced operations of the business of laying and operating a cross-country natural gas pipeline network for distribution on 1st April, 2013. The company incurred capital expenditure of ₹ 32 lacs during the period January to March, 2013 exclusively for the above business, and capitalized the same in its books of account as on 1st April, 2013.

Further, during the financial year 2013-14, it incurred capital expenditure of ₹ 95 lacs (out of which ₹ 60 lacs was for acquisition of land) exclusively for the above business. Compute the deduction under section 35AD for the A.Y.2014-15, 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.2014-15 would be –

Particulars	₹
Capital expenditure incurred during the P.Y.2013-14 (excluding the expenditure incurred on acquisition of land) = ₹ 95 lacs – ₹ 60 lacs	35 lacs
Capital expenditure incurred prior to 1.4.2013 (i.e., prior to commencement of business) and capitalized in the books of account as on 1.4.2013	<u>32 lacs</u>
Total deduction under section 35AD for A.Y.2014-15	<u>67 lacs</u>

Question 20

Mr. A, a civil contractor and builder, paid a compensation of ₹ 5 lacs 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 21

- (a) *A Ltd. paid IDBI a lump sum prepayment premium of ₹ 1.2 lacs on 7.4.2013 for restructuring its debts and reducing its rate of interest. It claimed the entire sum as business expenditure for the P.Y.2013-14. 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.2013-14. 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 22

The business profit of T Ltd., a tea growing and manufacturing company, is ₹ 120 lacs (before deduction under section 33AB) for the assessment year 2014-15. It deposits ₹ 50 lacs with NABARD for claiming deduction under section 33AB. It wants to claim set-off of brought forward business loss of ₹ 40 lacs. Find out the taxable income of T Ltd. for the assessment year 2014-15.

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.

Computation of taxable income of T Ltd. for the A.Y.2014-15

Particulars	₹ (in lacs)	₹ (in lacs)
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 ₹ 120 lacs	<u>48</u>	<u>48.00</u>
		72.00
Less: 60% of ₹ 72 lacs, being agricultural income as per Rule 8		<u>43.20</u>
		28.80
Less: Set of 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 ₹ 11.20 lacs (i.e., ₹ 40 lacs – ₹ 28.80 lacs) 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 23

The Net Profit of "Simran Ltd." for the year ended 31.3.2014 is ₹50 lacs after debit of the following:

(i)	Amount of ₹1,50,000 contributed to Employees Welfare Trust.
(ii)	Amount of ₹15,00,000 paid towards college fee and hostel expense for the MBA course of a close relative of a director.
(iii)	Amount of ₹3,00,000 incurred on installation of a traffic signal, so as to facilitate its employees coming to office to overcome traffic jam and save office time.
(iv)	Amount of ₹5,00,000 on the gift articles distributed to various dealers under sales incentive scheme.
(v)	Expenses of ₹5,00,000 incurred on the travelling of the wife of Managing Director, who accompanied him on a tour to U.K. on the invitation of Trade and Commerce Chamber, London.
(vi)	Amount of ₹3,00,000 paid on 11.5.2013 consequent upon change in currency rate due to exchange fluctuation in excess of the amount due to the suppliers of machinery.

Following further information are also provided by the company:

- Both the employees and employers contribution towards PF amounting to ₹2 lacs each for the month of March, 2014 were deposited on 1.7.2014.
- Provision for audit fees of ₹5 lacs made in the books for the year ended 31.03.2013 was paid to the auditors in September, 2013 after deducting tax under section 194J and the tax so deducted was remitted by 7.10.2013.
- A contractor who carried out repairing work in the office was paid in cash on 25.9.2013 by two vouchers No. 175 of ₹17,000 and No.180 of ₹8,000.
- TDS, out of payment of interest of ₹1 lac in February, 2013 and of ₹2 lacs in March, 2014, was remitted to the Government in July, 2014.

Compute the income chargeable to tax in A.Y. 2014-15 and work out the amount of tax payable on such income. Ignore MAT provisions.

Answer

Computation of total income of Simran Ltd. for the A.Y.2014-15

Particulars	₹
Profits and gains of business or profession	
Net profit for the year as per P&L Account	50,00,000
Add: Expenses debited to Profit and Loss Account but not allowable	
(i) Contribution to Employees Welfare Trust disallowed under section 40A(9)	1,50,000

(ii)	Expenses on the education of a relative of Director, who is not in employment of Simran Ltd., is not deductible under section 37 [Enkay (India) Rubber Co. Pvt. Ltd v. CIT (2003) 263 ITR 521 (Del)]. Hence, it should be added back to compute business income.	15,00,000
(iii)	Expenses on installation of traffic signal, to facilitate its employees to overcome traffic jam and be on time, is an allowable expense under section 37(1)	--
(iv)	Expenses on distribution of gift articles to dealers under sales incentive scheme would promote goodwill and is made in the interest of business. Such gifts are prompted by commercial expediency and hence, the expenditure is allowable under section 37(1) [CIT v. Avery Cycle Industries Ltd. (2006) 157 Taxman 382/ 298 ITR 239 / 296 ITR 393 (Punjab & Haryana)]	--
(v)	Expenses on travelling to UK of the wife of Managing Director on the invitation of Trade and Commerce Chamber, London, is an allowable expense for the purposes of business	--
(vi)	Increase in liability due to change in currency rate and paid to the suppliers of machine is to be added to cost of the asset irrespective of the method of accounting as per section 43A. Hence, it should be added back to compute business income.	3,00,000
		69,50,000
Add:	Employees contribution to PF to be included in income as per section 2(24)(x)	2,00,000
		71,50,000
Less:	Expenditure allowable as deduction but not debited to profit and loss account (See Note below)	
(a)	Employers contribution towards PF paid before due date for filing of return is allowable as per section 43B Employees contribution to PF is not remitted before the due date under the PF Act. Therefore, it is not allowable as deduction under section 36(1)(va).	2,00,000 -
(b)	Provision for audit fees for the year ended 31.3.2013 for which tax was not deducted in the F.Y. 2012-13 but was deducted and paid in F.Y. 2013-14 is allowable in the year of payment as per the proviso to section 40(a)(ia).	5,00,000
(c)	Payment to a contractor for repairing work in a day by two vouchers in cash, the aggregate exceeding the limit of ₹ 20,000 is not an allowable expense as per section 40A(3).	-

(d)	Interest for the month of February & March, 2014, on which TDS was remitted to the Government before the due date of filing of return, is allowable as per section 40(a)(ia).	3,00,000	
(e)	Depreciation on the amount of ₹ 3 lacs added in cost of machine @ 15% for the year	<u>45,000</u>	<u>10,45,000</u>
	Total income		<u>61,05,000</u>

Computation of tax liability for A.Y.2014-15

Particulars		₹
Tax on ₹ 61,05,000 @ 30%		18,31,500
Add: Education cess @ 2%	₹ 36,630	
Secondary and higher education cess @ 1%	₹ <u>18,315</u>	<u>54,945</u>
Total Tax Payable		<u>18,86,445</u>

Note – The first sentence of the question states that the net profit of the company has been arrived at after debit of the following expenditure, which implies that the items of expenditure in serial nos. (i) to (vi) (given below the first sentence) have been debited to profit and loss account. Thereafter, the question states that following further information are also provided by the company, after which items in serial nos. (a) to (d) are given. From a plain reading of the question, it is apparent that items of expenditure in serial nos. (a) to (d) have not been debited to profit and loss account and employees' contribution to PF has not been credited to profit and loss account. Therefore, the deductibility or otherwise of these items of expenditure and taxability of employees' contribution to PF have to be considered while computing the business income and dealt with accordingly. Accordingly, the items of expenditure in (a) to (d), which are allowable as per the provisions of the Act, have to be deducted while computing business income and no adjustment is required of items of expenditure disallowed since they have not been debited to profit and loss account. Further, employees' contribution to PF has to be added while computing business income, since the same has not been credited to profit and loss account.

Question 24

Sea Port Shipping Line, a non-resident foreign company operating its ships on the Indian Ports during the previous year ended on 31.3.2014, had collected freight of ₹ 100 lacs, demurrages of ₹ 20 lacs and handling charges of ₹ 10 lacs inclusive of an amount of ₹ 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 ₹ 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, 1961.

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 on deemed profit of ₹ 9.75 lacs (7½% on the total receipts of ₹ 130 lacs).

Question 25

Work out the taxable income for A.Y. 2014-15 of a partnership firm engaged in retail trade from the following particulars:

- (i) Net profit of ₹ 3,65,000 arrived at after debit of interest on capital of partners of ₹ 1,80,000 and salaries to working partners of ₹ 4,80,000.
- (ii) Total capital of the partners on which interest paid is debited in the profit and loss account was ₹ 10,00,000.

Answer

Computation of taxable income of the partnership firm for A.Y.2014-15

Particulars	₹	₹
Net Profit as per profit and loss account		3,65,000
<i>Add :</i> Interest on Capital		1,80,000
Salaries to Partners		<u>4,80,000</u>
		10,25,000
<i>Less:</i> Interest on capital allowable @ 12% on ₹ 10 lacs		<u>1,20,000</u>
Book Profits		9,05,000
<i>Less:</i> Admissible amount of salary as a percentage of book profits or actual paid, whichever is less		
90% of ₹ 3,00,000	2,70,000	
60% of ₹ 6,05,000	<u>3,63,000</u>	
		<u>6,33,000</u>

Since, the actual salary of ₹ 4,80,000 paid to the working partners is lesser than the admissible amount of ₹ 6,33,000, the entire amount of ₹ 4,80,000 is allowable as deduction.		<u>4,80,000</u>
Taxable Income		<u>4,25,000</u>

Note: It is presumed that the salary and interest payments are authorized by the partnership deed.

Question 26

The net result of the business carried on by a branch of foreign company in India for the year ended 31.03.2014 was a loss of ₹ 100 lacs after charge of head office expenses of ₹ 200 lacs allocated to the branch. Explain with reasons the income to be declared by the branch in its return for the assessment year 2014-15.

Answer

Section 44C restricts the allowability of the head office expenses to the extent of lower of an amount equal to 5% of the adjusted total income or the amount actually incurred as is attributable to the business of the assessee in India.

For the purpose of computing the adjusted total income, the head office expenses of ₹ 200 lacs charged to the profit and loss account have to be added back.

The amount of income to be declared by the assessee for A.Y. 2014-15 will be as under:

Particulars	₹(in lacs)
Net loss for the year ended on 31.03.2013	(100)
Add: Amount of head office expenses to be considered separately as per section 44C	<u>200</u>
Adjusted total income	100
Less: Head Office expenses allowable under section 44C is the lower of	
(i) ₹ 5 lacs, being 5% of ₹ 100 lacs and	
(ii) ₹ 200 lacs.	<u>5</u>
Income to be declared in return	<u>95</u>

Question 27

Atul Housing Finance Co. Ltd., engaged in the business of providing long-term finance for construction or purchases of houses in India for residential purposes, provides you the following particulars from its accounts for the year ended on 31.3.2014 and seeks your opinion as to availability of deduction under section 36(1)(viii) and the amount thereof:

Profits from the business computed as per Part D of Chapter IV of the Income-tax Act, 1961, but before claiming deduction under section 36(1)(viii) is ₹ 560 lacs

-Paid-up share Capital

₹ 500 lacs

-General Reserve	₹ 100 lacs
-Balance in reserve created under section 36(1)(viii) on 31.3.2013	₹ 1,100 lacs

Answer

According to section 36(1)(viii), a special deduction is allowed to specified entities engaged in eligible business. A housing finance company is a specified entity which is eligible for deduction under section 36(1)(viii) in respect of profits derived from the eligible business of providing long-term finance for construction or purchase of houses in India for residential purposes. The quantum of deduction, however, should not exceed 20% of the profits derived from eligible business computed under the head "Profits and gains of business or profession" (before making deduction under section 36(1)(viii)) carried to a special reserve account.

However, where the aggregate amount carried to such reserve account exceeds twice the amount of paid up share capital and general reserve, no deduction shall be allowed in respect of such excess.

Atul Housing Finance Co. Ltd. is a specified entity engaged in carrying on the eligible business of providing long-term finance for the construction or purchase of houses in India for residential purposes and accordingly, it is entitled to claim the deduction under section 36(1)(viii).

The maximum deduction would be ₹ 112 lacs (20% of ₹ 560 lacs, being the profits for the year). However, in such a case, the aggregate amount carried to special reserve account i.e. ₹ 1,212 lacs (₹ 1,100 lacs + ₹ 112 lacs) would exceed twice the amount of paid-up share capital and general reserve i.e., ₹ 1,200 lacs (2 x ₹ 600 lacs). Therefore, deduction will not be allowed under section 36(1)(viii) in respect of the excess ₹ 12 lacs (₹ 1,212 lacs – ₹ 1,200 lacs). Deduction under section 36(1)(viii) for the A.Y. 2014-15 would be ₹ 100 lacs (₹ 1,200 lacs – ₹ 1,100 lacs).

Question 28

Explain the meaning of "eligible expense" for the purpose of claiming benefit of section 35D.

Answer

The following are the expenditure eligible for amortization as a preliminary expense under section 35D -

- (a) Expenditure in connection with –
 - (i) the preparation of feasibility report;
 - (ii) the preparation of project report;
 - (iii) conducting market survey or any other survey necessary for the business of the assessee;
 - (iv) engineering services relating to the assessee's business.

- (b) legal charges for drafting any agreement between the assessee and any other person for any purpose relating to the setting up to conduct the business of assessee.
- (c) Where the assessee is a company, in addition to the above, expenditure incurred –
 - (i) by way of legal charges for drafting the Memorandum and Articles of Association of the company;
 - (ii) on printing the Memorandum and Articles of Association;
 - (iii) by way of fees for registering the company under the Companies Act, 1956;
 - (iv) in connection with the issue, for public subscription, of the shares in or debentures of the company, being underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of the prospectus; and
- (d) such other items of expenditure (not being expenditure eligible for any allowance or deduction under any other provision of the Act) as may be prescribed by the Board for the purpose of amortisation.

In the case of expenditure specified in item (a) above, the work in connection with the preparation of the feasibility report or the project report or the conducting of market survey or any other survey or the engineering services referred to must be carried out by the assessee himself or by a concern which is for the time being approved in this behalf by the Board.

Question 29

'X' Ltd., transferred its fertilizer business to a new company 'Y' Ltd., by way of demerger with effect from appointed date of 1.4.2013 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 1.4.2013 is ₹ 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 ₹ 50 lacs as at 31.3.2013;*

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 31.3.2013 duly calculating the depreciation.*
- (ii) *State how the unabsorbed depreciation has to be dealt with for the assessment year 2014-15.*

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* below section 43(1), where in a scheme of demerger, if the demerged company transfers any capital asset to the resulting company, being an 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:

Particulars	₹ (in crores)	
	'X' Ltd.	'Y' Ltd.
WDV of plant and machinery as at 1 st April, 2013	30.00	70.00
Less: Depreciation @ 15%	4.50	10.50
WDV as at 31 st March, 2014	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 30

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 31

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. 2014-15:

- (a) *Depreciation on the instruments, imported from U.K. for ₹ 2 lacs cleared by customs on 22.3.2014 on payment of duty of ₹ 1 lac, installed and ready for use on 26.3.2014. Only one operation with the help of such instruments was performed till 31.3.2014.*
- (b) *The book profits calculated as per section 40(b) are ₹ 3 lacs and payment of salary to working partners was ₹ 1 lac. 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 ₹ 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 ₹ 7,500 p.m. or less.*
- (d) *Purchase of medicines in cash on 18.12.2013 for ₹ 35,000.*
- (e) *Capital expenditure of ₹ 10,000 incurred for promoting family planning amongst its employees.*
- (f) *Interest of ₹ 3,000 paid on an overdraft of ₹ 1 lac taken for making payment of installment of advance tax of ₹ 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 2014-15 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 31.3.2014 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 ₹ 3 lacs and the amount of depreciation thereon works out to ₹ 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 and hence the same shall not be allowable.
- (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 ₹ 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 ₹ 7500 p.m. Therefore, disallowance under section 40A(2) is attracted to the extent of ₹ 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 ₹ 20,000 otherwise than by way of account payee cheque or account payee bank draft. Therefore, the entire amount of ₹ 35,000 incurred for purchase of medicines in cash is disallowed under section 40A(3).
- (e) Section 36(1)(ix) provides for deduction of 1/5th of capital 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 32

Raja Ltd., made a provision on 31.3.2014 of ₹ 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. 2014-15. The amount of ₹ 40,000 not paid to the party till 31.3.2014 was paid in cash on 11.6.2014. The Assessing Officer issued show cause notice to the company to rectify the computation of income for the A.Y. 2014-15 on account of payment made in cash on 11.6.2014. 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 ₹ 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 ₹ 40,000 in respect of a liability incurred and allowed earlier. Accordingly, ₹ 40,000, will be added in the computation of income for the A.Y.2015-16 (considering that the payment was made on 11.6.2014).

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 33

“Easy Call Ltd.”, to provide telecom services in Mumbai, obtained a licence on 11.4.2011 for a period of 10 years ending on 31.3.2021 against a fee of ₹ 27 lacs to be paid in 3 installments of ₹ 10 lacs, 9 lacs and 8 lacs by April, 2011, April, 2012 and April, 2013, respectively. The company has commenced business on 1.05.2011.

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. 2014-15.

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 instalments during the number of years for which the license is in force. If

the is payment 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. 2014-15 is ₹ 3 lacs as worked out below:-

(1)	(2)	(3)	(4) = (3)/(2)
Previous year of payment	Unexpired period of license	Instalment paid (₹)	Deduction in respect of each instalment (₹)
2011-12	10 years	10,00,000	1,00,000
2012-13	9 years	9,00,000	1,00,000
2013-14	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 2014-15 onwards till A.Y. 2021-22 will be ₹ 3 lacs each year.

Question 34

GP Ltd. was incorporated on 31.12.2012 for manufacture of tyres and tubes for motor vehicles. The manufacturing unit was set up on 30.4.2013. The company commenced its manufacturing operations on 1.5.2013. The total cost of the plant and machinery installed in the unit is ₹ 100 crores. The said plant and machinery included second hand plant and machinery bought for ₹ 10 crores and new plant and machinery for scientific research relating to the business of the assessee acquired at a cost of ₹ 10 crores.

Compute the amount of depreciation allowable under section 32 of the Income-tax Act, 1961 in respect of the assessment year 2014-15. Furnish explanations in support of your computation.

Answer

Computation of depreciation allowable for the A.Y. 2014-15 in the hands of GP Ltd.

Particulars	₹ (in crores)
Total cost of plant and machinery	100.00
Less: Used for Scientific Research (Note 1)	<u>10.00</u>
	<u>90.00</u>
Normal Depreciation @ 15% on ₹ 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) ₹ 10.00	<u>20.00</u>

	80.00	
Additional Depreciation @ 20%		<u>16.00</u>
Depreciation allowable for A.Y.2014-15		<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)(iia), 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 or engaged in the business of generation or generation and distribution of power, 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).
3. The Finance Act, 2013 has inserted new section 32AC to provide that a manufacturing company is entitled to an investment allowance of 15% of the aggregate amount of actual cost of new plant and machinery acquired and installed during the previous year 2013-14 and 2014-15, if the investment in new plant and machinery exceeds ₹ 100.00 crores. This is in addition to the depreciation and additional depreciation allowed under section 32.

In the present case, no deduction under section 32AC shall be allowed to the company for A.Y. 2014-15 since the investment in new plant and machinery is less than ₹ 100.00 crores during the year 2013-14. New plant & machinery excludes, *inter alia*, second-hand plant & machinery and plant & machinery, the whole of the actual cost of which is allowed as a deduction in computing the income chargeable under the head of "Profits and Gains of Business or Profession" of any previous year.

Question 35

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:

S.No.	Particulars	₹
(i)	Punjab State Financial Corporation (Previous years 2010-11, 2011-12 & 2012-13)	36,00,000
(ii)	State Bank of India (Previous years 2011-12 & 2012-13)	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 2013-14, converted the above interest arrear as loan repayable in 36 equal installments.

During the year ended 31.3.2014, Sunil paid six installments to Punjab State Financial Corporation and five installments to State Bank of India.

Sunil claimed the entire interest of ₹ 1,08,00,000 as an expenditure while computing the income from business of purchase and sale of agricultural commodities for the financial year 2013-14.

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* below 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. Therefore, ₹ 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 ₹ 16,00,000 during the financial the year 2013-14, as detailed hereunder, will be allowed as deduction while computing the business income of Mr. Sunil in the assessment year 2014-15.

Particulars	₹
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 36

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 31.3.2014:

- (i) ₹ 2 crores in India on account of carriage of passengers from Chennai.
- (ii) ₹ 1 crore in India on account of carriage of goods from Chennai.
- (iii) ₹ 3 crores in India on account of carriage of passengers from Singapore.
- (iv) ₹ 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 31.3.2014 was ₹ 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 2014-15.

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.

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 -

Particulars	₹
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 ₹ 7,00,00,000 is ₹ 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.2014-15.

Question 37

XYZ Ltd. incurred expenditure amounting to ₹ 3,00,000 in connection with the issue of rights shares and ₹ 2,00,000 in connection with the issue of bonus shares during the year ending 31.3.2014. The company seeks your opinion in the matter of eligibility for deduction of the expenditure incurred from its business profits for the assessment year 2014-15.

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 ₹ 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 ₹ 2,00,000 incurred in connection with the issue of bonus shares is deductible from its business profits for the assessment year 2014-15.

Question 38

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 39

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. If the salary payment made to the Karta is excessive or unreasonable, the excess amount would be disallowed under section 40A(2).

Question 40

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 CESTAT 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 CESTAT 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 41

A company engaged in textile manufacturing, debited to its Profit & Loss Account a sum of ₹ 6,00,000, being the interest on loan of ₹ 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 ₹ 60,000 was

paid to a broker who arranged the loan. Discuss the admissibility or otherwise of the interest and brokerage on borrowing.

Answer

Interest paid in respect of capital borrowed for the purposes of business or profession is admissible under section 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.

In this case, the asset (plant & machinery) was not put to use till the end of the previous year. Therefore, interest of ₹ 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 ₹ 66,00,000, once the asset is put to use.

As regards the brokerage of ₹ 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” under section 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 ₹ 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 under section 36(1)(iii), but allowable under section 37(1). As per this view, ₹ 60,000 paid to broker for arranging the loan is allowable under section 37(1).

Question 42

A company had an inventory of closing stock on 31.3.2014, the cost of manufacture of which was ₹ 100 lacs. 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. ₹ 100 lacs. 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 as on 31.3.2014 and the deduction of such excise duty shall be available as per the provisions of section 43B.

Question 43

The WDV of Plant and Machinery on 01-04-2013 of X Ltd. engaged in manufacturing of PVC granules is ₹ 1,000 lacs. Company purchased additional plant and machinery for ₹ 800 lacs on 18.04.2013 inclusive of a second-hand machine imported from China of ₹ 200 lacs to increase its installed capacity of production from 1000 TPA to 1500 TPA. The production from new machine was taken w.e.f. 1.12.2013. 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 or engaged in the business of generation of generation and distribution of power is entitled for an additional depreciation @ 20% of the actual cost of such plant & machinery acquired and installed.

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	₹ (in lacs)
Depreciation on WDV of machinery as on 1 st April, 2013 - ₹ 1000 lacs @ 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 (₹ 800 lacs 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.	<u>60</u>
50% of (20% of ₹ 600 lacs)	
Total Depreciation	<u>270</u>

Note - Increase in capacity is not a condition or relevant factor for the purpose of getting additional / accelerated depreciation.

Question 44

Alpha Ltd., a manufacturing company, which maintains accounts under mercantile system, has disclosed a net profit of ₹ 12.50 lacs for the year ending 31st March, 2014. You are required to compute the taxable income of the company for the Assessment year 2014-15, after considering the following information, duly explaining the reasons for each item of adjustment:

- Advertisement expenditure includes the sum of ₹ 60,000 paid in cash to the sister concern of a director, the market value of which is ₹ 52,000.
- Legal charges include a sum of ₹ 45,000 paid to consultant for framing a scheme of amalgamation duly approved by the Central Government.

- (iii) Repairs of plant and machinery includes ₹ 1.80 lacs towards replacement of worn out parts of machineries.
- (iv) A sum of ₹ 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 A.Y. 2011-12.
- (v) Sale proceeds of import entitlements amounting to ₹ 1 lac 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:
- Research equipments purchased ₹ 1,50,000.
 - Remuneration paid to scientists ₹ 50,000.

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

Answer

Computation of taxable income of Alpha Ltd. for the A.Y. 2014-15

Particulars	₹
Net profit as per profit and loss account	12,50,000
Add: Items debited to profit and loss A/c but not deductible	
1. Payment of advertisement expenditure of ₹ 60,000	
(i) ₹ 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 ₹ 52,000 exceeds ₹ 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 ₹ 45,000 i.e. ₹ 9,000 to be allowed in the current year. Balance ₹ 36,000 (₹ 45,000 - ₹ 9,000) is to be added back. (See Note below)	36,000
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 - <i>CIT v. Darbhanga Sugar Co. Ltd. [1956] 29 ITR 21 (Pat)</i> . 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 is required.	

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(iii). 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 lacs x 200% = ₹ 4 lacs	
Expenditure of ₹ 2,00,000 has already been debited to Profit & Loss Account, therefore only additional deduction of ₹ 2 lacs further to be 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 45

By virtue of an agreement entered into on 1.9.2013 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 ₹ 12,00,000 to X Ltd. The said amount was paid on 1st December, 2013. Indicate treatment of such receipt in the hands of X Ltd. for the assessment year 2014-15?

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 ₹ 12,00,000 is chargeable to tax as business income in the hands of X Ltd.

Question 46

- (i) *A corporation was set up by the State Government transferring all the buses owned by it for a consideration of ₹ 75 lacs, 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 2010. In the previous year ending 31.3.2014, 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.

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* (2001) 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 and 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 47

A is an association governed by the provisions of Section 44A of the Income-tax Act, 1961. The subscription receipts for the year ended 31st March, 2014 were ₹ 3,60,000. The expenditure in the normal course of its activities was ₹ 3,85,000. Its other income taxable under the Act works out to ₹ 2,75,000. On these facts, you are consulted as to how A's taxable income will be determined for assessment year 2014-15.

Answer

As per section 44A, the deficiency arising on account of income from members by way of, *inter alia*, subscriptions, falling short of the expenditure incurred solely for the protection or advancement of the interest of its members, shall first be set off against the association's

income under the head “Profits and gains of Business or Profession”. If there is no such income under this head, the deficiency shall be set off against income under any other head.

Particulars	₹
Income from subscription	3,60,000
Less: Expenses incurred in the course of its activities	3,85,000
Deficiency	(-)25,000
Less: Other income	2,75,000
Taxable income	2,50,000

There is a ceiling on the deduction admissible by way of deficiency being that it shall not exceed one-half of the total income of the association computed before making any allowance under this section. This ceiling has not been exceeded above, since the deficiency of ₹ 25,000 is less than ₹ 1,37,500 being one-half of ₹ 2,75,000 [vide section 44A(3)].

Question 48

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 under section 40(b). 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 attract disallowance under section 40(b).

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 49

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, 1961, “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 50

Capsule Ltd, during the financial year ending 31.3.2014 paid production bonus of an amount of ₹ 3 lacs pursuant to a settlement arrived with the workers in addition to the statutory payment of ₹ 1 lac as per the Payment of Bonus Act, 1965. On these facts, your advise is sought:

- (a) *Whether the sum of ₹ 3 lacs is deductible as per the provisions of section 36(1)(ii) of the Act?*
- (b) *If the claim is not so deductible, can it be claimed under any other provision?*

Answer

Under section 36(1)(ii), deduction is allowed in respect of any sum paid to an employee 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.

₹ 1 lac being paid as bonus as per the Payment of Bonus Act, 1965 is deductible as per the provisions of section 36(1)(ii).

Further, as per the Madras High Court ruling in *CIT v. Kasturi Mills Ltd. (1998) 234 ITR 538*, the remaining ₹ 2 lacs can be claimed as deduction under section 37(1) on the grounds of commercial expediency since the expenditure is laid out wholly and exclusively for business purposes.

However, the allowability of deduction in respect of bonus would be subject to the provisions of section 43B.

Question 51

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 as deduction?*

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 ITR 775. 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* below 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, if secret commission payment could be established as a payment for an offence prohibited by law, the same cannot be allowed deduction.

Question 52

An assessee purchases know-how for manufacture of fuel injection pipes on 10-04-2013. He wants proportional reduction for six assessment years under section 35AB of the Act commencing from assessment year 2014-15. 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.

The provisions of section 35AB applies only to acquisition of know how for purpose of business before 01.04.1998.

Since in this case the assessee had acquired the know-how after 1st April 1998, it is to be treated as capital expenditure and is hence, eligible for depreciation under section 32.

Question 53

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 31.3.2014 worked out to ₹ 20,000. M/s. PR deducted tax of ₹ 2,000 on interest and paid the balance sum of ₹ 18,000 in cash to M/s. ST on 31.3.2014. Tax deducted was remitted to the credit of the Central Government on 1.12.2014. How will you treat the interest paid while computing the total income of M/s. PR for the assessment year 2014-15?

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 on or before 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) i.e. 30th September, 2014. Thus, the remittance on 1.12.2014 i.e., after the due date of filing of return, would attract disallowance under section 40(a)(ia). The fact that M/s PR & M/s ST are firms with common partners is not relevant in this context.

Question 54

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.

Self-examination questions

1. Is it compulsory for an assessee to claim depreciation under section 32 of the Income-tax Act, 1961?

2. The written down value of plant and machinery in the books of Alpha Ltd. is ₹ 75,00,000 as on 1st April, 2013, on which date, the installed capacity of the company was 12,000 tons. Alpha Ltd. borrowed ₹ 10,00,000 @ 10% p.a. from ICICI Bank on 1.8.2013 for purchase of new plant and machinery costing ₹ 15 lacs for extension of its existing business, which would increase its installed capacity to 13,000 tons. The new plant and machinery was purchased on the same date but was put to use only w.e.f. 1.11.2013. Compute the depreciation admissible under section 32 for the A.Y.2014-15, assuming the applicable rate of depreciation on plant and machinery to be 15%.
3. A Ltd. was a wholly owned subsidiary company of B Ltd. An agreement was entered into between B Ltd. and A Ltd., by which the textile unit belonging to B Ltd. was transferred to A Ltd. The agreement provided, inter-alia, for continuity of service of workmen who were employed in the textile unit of B Ltd. taken over by A Ltd. and the agreement also protected the conditions of service of workmen. B Ltd. delivered possession of the properties to A Ltd. and the employees of B Ltd. working in the textile unit were transferred to A Ltd. with the benefit of continuity of service. For the subsequent two assessment years, A Ltd. claimed deduction of a certain sum as gratuity payment to workers (who were erstwhile employees of B Ltd.), who had retired during the relevant previous years. The Assessing Officer disallowed the same on the ground that the liability of A Ltd. towards gratuity payment for the employees for the services rendered by them in the period prior to the takeover of the unit would be a capital expenditure. Is the reasoning of the Assessing Officer correct? Discuss.
4. The assessee-firm had received a sum of money of ₹ 5,25,250 in the P.Y.2013-14 towards credit note of excise duty. Out of the said sum, the assessee did not refund an amount of ₹ 2,10,000 to its customers and credited the same to its profit and loss account. The amount has also been distributed amongst the partners. The assessee claimed that such sum credited to profit and loss account does not form part of total income. The Assessing Officer, however included the said amount in the total income of the assessee. On appeal, the Commissioner (Appeals), however, set aside the order of the Assessing Officer. Discuss, giving reasons, whether the Assessing Officer is correct or the Commissioner (Appeals) is correct?
5. Is expenditure incurred by a company on account of stamp duty and registration fees for the issue of bonus shares allowable as revenue expenditure?
6. XYZ Ltd. donated a bus to a school where the employee's children were studying and debited the same to the Workmen and Staff Welfare Account. It claimed the expenditure as deduction on the ground that it was incurred wholly and exclusively for the purpose of the assessee's business. Discuss whether the contention of the assessee is correct.
7. The assessee was a dealer in two-wheelers manufactured by TVS Suzuki Ltd. It was carrying on its business in leasehold premises. The assessee constructed a ground floor above the existing basement floor according to the specifications given by TVS Suzuki Ltd. to all its dealers. As per the stipulation in the lease deed, reimbursement of such

expenditure from the owner of the premises was also not possible. The assessee claimed the expenses incurred for construction as revenue expenditure for the relevant assessment year. Can such expenditure be allowed as a revenue expenditure?

8. Rallis Ltd. was situated in a remote place and its employees were the members of a club. The club was the only source of recreation to the employees. Rallis Ltd. paid a sum of ₹ 5 lakhs to the club for renovation and repairs of the club building which had been damaged. Rallis Ltd. claimed deduction of the same as business expenditure. Discuss whether its claim is tenable in law?
9. Alpha Ltd is a public limited company. As a good corporate citizen and as a measure of gaining goodwill of the people living in and around its industry, which is to some extent a polluting industry, it provided funds for establishing drinking water facilities to the residents in the vicinity of the refinery and also provided aid to the school run for the benefit of the children of those local residents. The Assessing Officer declined to allow that expenditure on the ground that it was not an item of expenditure incurred by the assessee for earning the income. The company, however, claimed that such social costs can be claimed as deduction. Is the claim of Alpha Ltd. tenable in law? Discuss.
10. The scheme of amalgamation of A Ltd. with B Ltd. was sanctioned by the High Court on 1.5.2013. However, the amalgamation was effective from 1.1.2013. A Ltd. incurred ₹ 2.3 lakhs during the previous year 2012-13 towards legal expenses in connection with its amalgamation with B Ltd. A Ltd. contended that such expenses were revenue in nature and hence, were to be allowed as deduction for previous year 2012-13. Discuss the correctness of the contention of A Ltd., if such amalgamation is resorted to by A Ltd. for the smooth and efficient conduct of the business through the transferee-company, namely, B Ltd.
11. (a) Can a bank guarantee be equated with actual payment as required under section 43B for allowance as deduction in computation of profits?
(b) Can interest payable to sales tax department also be considered as a "tax" under the provisions of section 43B?

Answers

3. This issue came up before the Madras High Court in *Sree Akilandeswari Mills (P.) Ltd. v. Dy. CIT (2005) 145 Taxman 474 / 274 ITR 0001*. The High Court observed that as far as the gratuity liability is concerned, the obligation to pay gratuity on the part of the assessee to all its employees for the service rendered in a particular year is a definite and ascertainable liability on the basis of actuarial valuation. The assessee, by virtue of the deed of transfer, had taken over the liability of the transferor-company towards gratuity of the employees of the transferor-company on the date of transfer. The gratuity liability was an ascertained liability on the basis of actuarial valuation and this liability, which formed part of the sale consideration, was discharged later by actual payment by the assessee to the employees in subsequent years. The Court held that if an

ascertained liability of the predecessor on the date of transfer was taken over by the successor in business, and later on it was discharged, the expenditure incurred would be capital in nature and is not allowable as business expenditure.

Hence, in this case, the expenditure incurred by A Ltd., towards discharge of the gratuity liability of the employees of the unit taken over from B Ltd., is a capital expenditure. Therefore, the reasoning of the Assessing Officer is correct.

4. This question came up before the Allahabad High Court in *CIT v. London Machinery Company (2005) 146 Taxman 326*. The High Court observed that the provisions of section 41(1) would be attracted if the following conditions are satisfied –
 - (1) An allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee.
 - (2) Subsequently, during any previous year, the assessee must have obtained -
 - (i) any amount in respect of such loss; or
 - (ii) any benefit in respect of such trading liability by way of remission or cessation thereof.

In case either of the events mentioned in (2) above happen, the deeming provision enacted in the closing part of sub-section (1) of section 41 comes into play. Accordingly, the amount obtained by the assessee or the value of benefit accruing to him is deemed to be the profits and gains of business or profession and it becomes chargeable to income-tax as the income of that previous year. The transfer of unpaid excise credit to the profit and loss account of the assessee falls under the first clause of section 41(1) [as stated in 2(i) above] and is, therefore, chargeable to tax as profit of the year.

Therefore, in this case, the view taken by the Assessing Officer is correct since the first clause of section 41(1) is attracted. The amount of ₹ 2,10,000 on account of unpaid excise credit received by the assessee-firm and credited to its profit and loss account and not passed on to its customers is chargeable as profits of the firm for the previous year 2013-14.

5. This issue has been settled by the Supreme Court in *CIT v. General Insurance Corporation (2006) 286 ITR 232*. The Supreme Court observed that there is no inflow of fresh funds or increase in capital employed on account of issue of bonus shares. There is merely a reallocation of company's fund on account of issue of bonus shares by capitalization of reserves. Therefore, the company has not acquired a benefit or advantage of enduring nature. The total funds available with the company will remain the same and there is no change in the capital structure of the company consequent to the bonus issue. Thus, issue of bonus shares does not result in the expansion of capital base of the company. Therefore, the expenditure incurred by the company on account of stamp duty and registration fees for the issue of bonus shares is allowable as revenue expenditure.

6. This issue came up before the Rajasthan High Court in *CIT v. Rajasthan Spinning and Weaving Mills Ltd. (2006) 281 ITR 408*. The High Court observed that the contention of the assessee, that such expenses were incurred for the welfare of the children of staff/workmen of the company as part of the employee welfare expenses for the purpose of securing efficient services of such employees, was true. Since the assessee had not acquired any asset, it was not a capital expenditure. Therefore, the expenditure was deductible.
7. This question was answered by the Madras High Court in *CIT v. Hari Vignesh Motors P. Ltd. (2006) 282 ITR 338*. The High Court observed that the assessee had undertaken the construction in view of the requirements of the business. The assessee did not acquire any capital asset by incurring the expenditure. As per the stipulation in the lease deed, reimbursement of such expenditure from the owner of the premises was also not possible. The High Court, therefore, held that the expenditure was revenue in nature and can be allowed as deduction.
8. This issue came up for consideration before the Calcutta High Court in *Assam Brook Ltd. v. Commissioner of Income-tax (2004) 139 Taxman 229*. The High Court observed that since the company was situated in a remote place, the club was the only source of recreation for its employees, who were also members of the club. So, if the assessee-company paid some amount for the upliftment/running of the club in an effective way, then such payment was made in the interest of the assessee, so that its employees remained happy and, consequently, the work of the assessee was not hampered in any way due to dissatisfaction on the part of the employees. As the payment of ₹ 5 lakhs was made by the assessee to the club keeping its business interest in mind, the said payment must be held to be business expenditure, and accordingly, as per section 37 the assessee-company was entitled to get deduction.

The claim of Rallis Ltd. is, therefore, tenable in law.

9. The Madras High Court has recognized the relevance of social costs to business in deciding the case of *CIT v. Madras Refineries Ltd. (2004) 138 Taxman 261*. The High Court observed that the concept of business is not static. It has evolved over a period of time to include within its fold the concrete expression of care and concern for the society at large and the people of the locality in which the business is located in particular. Further, to be known as a good corporate citizen brings goodwill of the local community, as also with the regulatory agencies and the society at large, thereby creating an atmosphere in which the business can succeed in a greater measure with the aid of such goodwill. In this case, the High Court upheld the order of the Tribunal allowing deduction for the amount spent on bringing drinking water to the locality and in aiding a local school.

Thus, in view of the above case, the claim of Alpha Ltd. is tenable in law.

10. A similar question arose before the Gujarat High Court in *CIT v. Akme Electronics & Control (P.) Ltd. (2004) 137 Taxman 263*. The High Court held that when the legal

expenses were to be paid in connection with the amalgamation of the assessee-company with another company, the liability to pay legal expenses arose in respect of the period when the amalgamating company still continued to exist. The effective date of amalgamation in many cases may even be a date prior to the date of sanction of the scheme, but so long as the scheme was not sanctioned, the transferor-company continued to exist and since the amalgamation was resorted to for the smooth and efficient conduct of the business through the transferee-company, the legal expenses were deemed to be laid out wholly and exclusively for the purpose of the business of the amalgamating assessee-company.

Therefore, in this case, the contention of A Ltd. is correct. A Ltd. can claim ₹ 2.3 lakhs as revenue expenditure for the previous year 2012-13, when A Ltd. continued to exist, since the scheme of amalgamation was yet to be sanctioned during that previous year.

11. (a) The Rajasthan High Court, in *CIT v. Udaipur Distillery Co. Ltd. (2004) 134 Taxman 398*, observed that the requirement of section 43B is the actual payment and not deemed payment of any of the expenses (as specified in section 43B) incurred by the assessee during the relevant previous year for claiming the deduction. Furnishing bank guarantee cannot be equated with actual payment. Actual payment requires that money must flow from the assessee to the public exchequer as such as specified in section 43B.
- (b) The Rajasthan High Court, in *Mewar Motors v. CIT (2004) 135 Taxman 155*, opined that the amount of interest paid is part of the sales tax and the provisions of section 43B are applicable to it.