

The Suggested Answers for Paper 7: - Direct Taxes are based on the provisions applicable for A.Y. 2006-07, which is the assessment year relevant for May, 2006 examinations.

PAPER – 7 : DIRECT TAXES

Answer all questions

Question 1

ABC Ltd. is engaged in the manufacture and sale of textiles. Its net profit for the year ending 31.3.2006 after debit/credit of the following items to the Profit and Loss Account was Rs.75,00,000:

- (i) Payment to two employees of Rs.2,50,000 each in connection with their voluntary retirement.*
- (ii) Fringe benefit tax paid Rs.1,00,000.*
- (iii) Charges of Rs.2,00,000 paid for the advertisement in souvenir published by a Political Party registered with the Election Commission of India.*
- (iv) Retrenchment compensation paid to employees of one of the units closed down during the year Rs.10,00,000.*
- (v) Capital expenditure incurred for the purpose of promoting family planning amongst its employees Rs.3,00,000.*
- (vi) Banking cash transaction tax paid Rs.10,000.*
- (vii) Interest paid under section 234B for short payment of advance tax pertaining to the assessment year 2005-06 Rs.1,10,000.*
- (viii) Loss incurred in transactions of purchase and sale of shares of various companies Rs.3,00,000.*
- (ix) Compensation received from supplier for delay in supply of raw materials Rs.1,00,000.*
- (x) Dividend received from a foreign company Rs.2,00,000.*

The total sales of ABC Ltd. for the year was Rs.30 crores out of which export sales amounted to Rs.10 crores.

Compute the total income of ABC Ltd. for the assessment year 2006-07.

Furnish explanations for the treatment of the various items given above. (16 Marks)

Answer

Computation of total income of ABC Ltd. for the Assessment Year 2006-07

Particulars	Rs.
Net profit as per Profit and Loss Account	75,00,000
Add: Inadmissible expenditure	

4/5 th of Rs.5,00,000 paid to employees on voluntary retirement [1/5 th is allowable as deduction u/s 35DDA]	4,00,000
Fringe benefit tax u/s 40(a)(ic)	1,00,000
Advertisement charges of souvenir of political party u/s 37(2B)	2,00,000
4/5 th of Rs.3,00,000, being capital expenditure incurred for promoting family planning amongst employees [1/5 th is allowable as deduction u/s 36(1)(ix)]	2,40,000
Interest paid u/s 234B	1,10,000
Loss incurred in transactions of purchase and sale of shares considered as speculation loss	3,00,000
	88,50,000
Less: Dividend received from a foreign company considered under 'Income from other sources'	2,00,000
Business income	86,50,000
Income from other sources	
Dividend received from a foreign company	2,00,000
Gross total income	88,50,000
Less: Deduction u/s 80GGB	2,00,000
Total income	86,50,000

Explanations for the treatment of the various items in computing the total income of the company are furnished below -

- (i) Section 35DDA provides for amortisation of expenditure incurred under voluntary retirement scheme over a period of five years in equal instalments. The company is, therefore, entitled to deduction of Rs.1,00,000, being one-fifth of the total sum of Rs.5,00,000 paid to the two employees in connection with their voluntary retirement for the relevant assessment year.
- (ii) Fringe benefit tax paid is not allowable as deduction from business profits as per section 40(a)(ic). Hence, fringe benefit tax paid by the company is not deductible.
- (iii) Section 37(2B) prohibits allowance of any expenditure incurred by an assessee on advertisement in any souvenir, brochure, pamphlet or the like published by a political party. As such, advertisement charges paid in respect of souvenir published by a political party is not allowable as deduction from business profits of the company.

However, under section 80GGB, expenditure incurred by an Indian company on advertisement in any publication, including a souvenir, by a political party is deemed to be a contribution of such amount to the political party and is, therefore, allowable as deduction in the hands of the company. It is logical to presume that ABC Ltd. is an Indian company.

- (iv) Retrenchment compensation paid to employees at the time of closure of one of the units of the business is allowable as per the decision of the Allahabad High Court in *CIT (Central) Kanpur vs. JK Cotton Spinning & Weaving Co. Ltd. (2005) 145 Taxman 591*.
- (v) Capital expenditure incurred for the purpose of promoting family planning amongst employees is deductible over a period of 5 years as per the first proviso to section 36(1)(ix). Hence, only Rs.60,000 is deductible in the current year in respect of such expenditure incurred by the company.
- (vi) Banking cash transaction tax paid by the company is eligible for deduction in view of section 36(1)(xiii).
- (vii) Interest paid for delayed payment of tax by the assessee is part and parcel of the liability to pay income-tax. When income-tax paid is itself not allowable as a deduction under section 40(a)(ii), the interest paid under section 234B cannot qualify for deduction. Thus, interest paid under section 234B is not deductible.
- (viii) Loss of Rs.3 lakhs incurred by the company in dealing of shares constitutes speculation loss in view of the Explanation to section 73. In the absence of any speculative profit for the year, speculation loss is to be carried forward under section 73(2) for set off against speculation profits of subsequent assessment years. It can be carried forward for a maximum of 4 assessment years
- (ix) Compensation received from supplier for delay in supplying the raw materials is a trading receipt.
- (x) Dividend received from a foreign company is assessable under the head "Income from other sources".
- (xi) Deduction under section 80HHC in respect of profits from export business is not allowable for and from the assessment year 2005-06.

Question 2

- (a) *A charitable trust registered under section 12AA of the Income-tax Act, 1961 has, out of its income of Rs.3,90,000 for the year ending 31.3.2006 and sale proceeds of a capital asset, held by it for less than 36 months, amounting of Rs.9,60,000, purchased a building during the year ending 31.3.2006 for Rs.13,50,000. The capital asset was sold during the year ending 31.3.2006. The building is held only for charitable purposes. The trust claims that the purchase of the building amounts to application of its income for charitable purposes and that the capital gain arising on the sale of the capital asset is deemed to have been applied to charitable purposes. Are the claims made by the charitable trust valid in law?*

(5 Marks)

- (b) *R, an individual resident in India, bought 1,000 equity shares of Rs.10 each of A Ltd. at Rs.50 per share on 30.5.2005. He sold 700 equity shares at Rs.35 per share on 30.9.2005 and the remaining 300 shares at Rs.25 per share on 20.12.2005. A Ltd. declared a dividend of 50%, the record date being 10.8.2005. R sold on 1.2.2006, a house from which he derived a long-term capital gain of Rs.75,000.*

Compute the amount of capital gain arising to R for the assessment year 2006-07.

(5 Marks)

Answer

- (a) Section 11(1)(a) stipulates that in order to avail exemption of income derived from property held under trust wholly for charitable or religious purposes, the trust is required to apply for charitable or religious purposes, 85% of its income from such property for the year. In this case, the trust has earned income of Rs.3,90,000 for the year ending 31.3.2006. It has also earned short term capital gain from sale of capital asset for Rs.9,60,000. The trust had utilized the entire amount of Rs.13,50,000 for the purchase of a building held for charitable purposes.

The Supreme Court in *S.R.M. M. CT. M. Tiruppani Trust v. CIT (1998) 230 ITR 636* ruled that the assessee-trust, which applied its income for charitable purposes by purchasing a building for use as a hospital, was entitled to exemption under section 11(1) in respect of such income. The ratio of the decision squarely applies to the case of the charitable trust in question. Therefore, the charitable trust is justified in claiming that the purchase of the building amounted to application of its income for charitable purposes.

Under section 11(1A), where the whole of the sale proceeds of a capital asset held by a charitable trust is utilised by it for acquiring another capital asset, the capital gain arising therefrom is deemed to have been applied to charitable purposes and would be exempt. Section 11(1A) does not make any distinction between a long-term capital asset and a short-term capital asset. The claim of the charitable trust to the effect that the capital gain is deemed to have been applied to charitable purposes is, therefore, in accordance with law.

- (b) The amount of capital gains arising to R has to be computed applying the provisions of sub-section (7) of section 94, which provides that "where:
- (a) any person buys or acquires any securities or unit within a period of three months prior to the record date; and
 - (b) such person sells or transfers -
 - (i) such securities within a period of three months after such date; or
 - (ii) such unit within a period of nine months after such date; and
 - (c) the dividend or income on such securities or unit received or receivable by such person is exempted,

then the loss, if any, arising to him on account of such purchase and sale of securities or unit, to the extent such loss does not exceed the amount of dividend or income received

or receivable on such securities or unit, shall be ignored for the purpose of computing his income chargeable to tax".

For this purpose, "record date" means such date as may be fixed by a company for the purpose of entitlement of the holder of the securities to receive dividend and "securities" includes stocks and shares.

Computation of capital gains of Mr. R for the assessment year 2006-07

Particulars	Rs.	Rs.
Long-term capital gain on sale of building		75,000
Less: Short-term capital loss on sale of shares		
700 shares	7,000	
300 shares	7,500	14,500
Taxable long-term capital gains		60,500

Computation of capital gain on sale of shares of A Ltd. by Mr.R

Date of purchase of shares		30.5.2005
Record date		10.8.2005
Date of sale of shares	30.9.2005	20.12.2005
Number of shares sold	700	300
Sale price per share	Rs.35	Rs.25

Particulars	Rs.	Rs.
Sale consideration	24,500	7,500
Less: Cost of acquisition	35,000	15,000
	10,500	7,500
Less: Dividend income as per section 94(7) [700×10×50%] [See Note below]	3,500	-
Short-term capital loss on sale of shares	7,000	7,500

Note:

- 700 shares are sold within 3 months of record date, hence related dividend income should be deducted from the loss as per section 94(7).
- 300 shares having been sold after 3 months of record date, section 94(7) is not applicable. So, the dividend income of Rs.1,500/- should not be deducted. Such dividend is exempt under section 10(34).

3. Short-term capital loss can be set-off against long-term capital gains as per the provisions of section 74(1)(a). Therefore, short-term capital loss on sale of shares can be set-off against long-term capital gains on sale of building.

Question 3

- (a) *Examine the obligation of the person responsible for paying the income to deduct tax at source and indicate the due date for payment of such tax, wherever applicable, in respect of the following items:*

- (i) *MNO Ltd., the employer, credited salary due for the financial year 2005-06 amounting to Rs.2,40,000 to the account of Q, an employee, in its books of account on 31.3.2006. Q has not furnished any information about his income/loss from any other head or proof of investments/payments qualifying for deduction under section 80C.*
- (ii) *T, an individual whose total sales in business during the year ending 31.3.2005 was Rs.1.20 crores, paid Rs.9 lakhs by cheque on 1.1.2006 to a contractor, for construction of his business premises, in full and final settlement. No amount was credited earlier to the account of the contractor in the books of T.*
- (iii) *BCD Ltd. credited Rs.18,000 towards fees for professional services and Rs.12,000 towards fees for technical services to the account of HG in its books of account on 6.10.2005. The total sum of Rs.30,000 was paid by cheque to HG on 18.12.2005*

(6 Marks)

- (b) *H, a mentally retarded minor, has a total income of Rs.1,20,000 for the assessment year 2006-07. The total income of his father L and of his mother R for the relevant assessment year is Rs.2,40,000 and Rs.1,80,000 respectively. Discuss the treatment to be accorded to the total income of H for the relevant assessment year.*

(3 Marks)

- (c) *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 31.3.2006 worked out to Rs.20,000. M/s. PR deducted tax of Rs.2,244 on interest and paid the balance sum of Rs.17,756 in cash to M/s. ST on 31.3.2006. Tax deducted was remitted to the credit of the Central Government on 30.4.2006. How will you treat the interest paid while computing the total income of M/s. PR for the assessment year 2006-07?*

(3 Marks)

Answer

- (a) (i) Section 192 requires deduction of tax from salary at the time of payment. Thus, the employer is not required to deduct tax at source when salary has not been paid but is merely credited to the account of the employee in its books of account. MNO Ltd, therefore, is not required to deduct tax at source in respect of the salary merely credited to the account of Q and not paid.
- (ii) Section 194C(1) which governs tax deduction on payments to contractor is not applicable where the contract is between an individual and a contractor. Therefore,

T, who is an individual, need not deduct tax on payment of Rs.9 lakhs made to the contractor for construction of his business premises.

- (iii) The limit of Rs.20,000 for non-deduction of tax under section 194J has been separately fixed for fees for professional services and fees for technical services. This means that if a person has rendered services falling under both the categories, tax need not be deducted if the fees for each category does not exceed Rs.20,000 even though the aggregate of the amounts credited to the account of such person or paid to him for both the categories of services exceed Rs.20,000. Therefore, BCD Ltd., is not required to deduct tax at source in respect of the fees either at the time of credit or at the time of payment.
- (b) Section 64(1A) provides that all income accruing or arising to a minor child has to be included in the income of that parent, whose total income is greater. However, the income of a minor child suffering from any disability of the nature specified in section 80U shall not be included in the income of the parents but shall be assessed in the hands of the child. Thus, the total income of H has to be assessed in his hands and cannot be included in the total income of either his father or his mother.
- (c) 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 during the previous year or in the subsequent year before the time prescribed in section 200(1). M/s PR had to remit the tax deducted (on interest paid to M/s ST) on or before 7.4.2006 as per section 200(1) read with Rule 30. Since it remitted the tax deducted on 30.4.2006, which was beyond the due date prescribed in section 200(1), it will not be entitled to claim deduction of the interest paid of Rs.20,000 for the assessment year 2006-07.

Question 4

- (a) *M/s. JKLM, a firm, consists of four partners namely, J, K, L and M. They shared profits and losses equally during the year ending 31.3.2005. The assessed business loss of the firm for the assessment year 2005-06 which it is entitled to carry forward amounts to Rs.3,60,000. A new deed of partnership was executed among J, K, L and M on 1.4.2005 in terms of which they agreed to share profits and losses in the ratio of 15:15:20:50 respectively.*

Compute the amount of business loss relating to the assessment year 2005-06, which the firm is entitled to set off against its business income for the assessment year 2006-07. The business income of the firm for the assessment year 2006-07 is Rs.3,30,000. Your answer should be supported by reasons. (3 Marks)

- (b) *The Income-tax Act, 1961 provides for taxation of a certain income earned by X. The Double Taxation Avoidance Agreement, which applies to X, excludes the income earned by X from the purview of tax. Is X liable to pay tax on the income earned by him? Discuss.* (4 Marks)

- (c) A co-operative society engaged in the business of banking seeks your opinion in the matter of eligibility of deduction u/s 80P on the following items of income earned by it during the year ending 31.3.2006:
- (i) Interest on investment in Government securities made out of statutory reserves
 - (ii) Hire charges of safe deposit lockers. (3 Marks)
- (d) The Assessing Officer found, during the course of assessment of a firm, that it had paid rent in respect of its business premises amounting to Rs.60,000, which was not debited in the books of account for the year ending 31.3.2005. The firm did not explain the source for payment of rent. The Assessing Officer proposes to make an addition of Rs.60,000 in the hands of the firm for the assessment year 2005-06. The firm claims that even if the addition is made, the sum of Rs.60,000 should be allowed as deduction while computing its business income since it has been expended for purposes of its business. Examine the claim of the firm. (2 Marks)

Answer

- (a) The firm is entitled to set off its brought forward business loss amounting to Rs.3,60,000 relating to the assessment year 2005-06 to the extent of Rs.3,30,000 against its business income of Rs.3,30,000 for the assessment year 2006-07 as per the provisions of section 72(1). Section 78(1), which deals with carry forward and set-off of losses in case of change of constitution of firm, is applicable to cases where a partner has retired or died. The section is not applicable to a case where there is a change in the ratio of sharing profits and losses amongst the existing partners. Therefore, section 78(1) is not applicable to the case of M/s. JKLM. The unabsorbed business loss of Rs.30,000 relating to the assessment year 2005-06 will be carried forward for set-off against the business income for the assessment year 2007-08.
- (b) Section 90(2) makes it clear that where the Central Government has entered into a Double Taxation Avoidance Agreement, then in respect of an assessee to whom such agreement applies, the provisions of the Act shall apply to the extent they are more beneficial to the assessee. This means that where tax liability is imposed by the Act, the Double Taxation Avoidance Agreement may be resorted to for reducing or avoiding the tax liability.
- The Supreme Court has held, in *CIT v. P.V.A.L. Kulandagan Chettiar (2004) 267 ITR 654*, that in case of any conflict between the provisions of the Double Taxation Avoidance Agreement and the Income-tax Act, 1961, the provisions of the Double Taxation Avoidance Agreement would prevail over those of the Income-tax Act. X is, therefore, not liable to pay tax on the income earned by him.
- (c) (i) Interest earned on investment in Government securities made out of statutory reserves by a co-operative society engaged in banking business is eligible for deduction under section 80P as per the decision of the Supreme Court in *CIT v. Karnataka State Co-operative Apex Bank (2001) 251 ITR 194*. In this case, it was held that the placement of such funds being imperative for the purpose of carrying

on banking business, the income therefrom would be income from the assessee's business and there is nothing in section 80P which restricts the exemption to only income derived from working or circulating capital.

- (ii) Provision of safe deposit lockers is part of the ordinary banking business. Income from hiring of such lockers is income from banking business and, therefore, eligible for deduction under section 80P. Therefore, the society is entitled to deduction under section 80P in respect of hire charges of safe deposit lockers.
- (d) The claim of the firm for deduction of the sum of Rs.60,000 in computing its business income is not tenable. The action of the Assessing Officer in making the addition of Rs.60,000, being the payment of rent not debited in the books of account (for which the firm failed to explain the source of payment) is correct in law since the same is an unexplained expenditure under section 69C. The proviso to section 69C states that such unexplained expenditure, which is deemed to be the income of the assessee, shall not be allowed as a deduction under any head of income. Therefore, the claim of the firm is not tenable.

Question 5

- (a) *S, an individual, filed his return of income for the assessment year 2005-06 erroneously offering for taxation, interest received from notified Relief Bonds exempt under section 10(15)(ii), in the said return. The Assessing Officer completed the assessment under section 143(3) on 20.4.2006 accepting the income returned by S. S had furnished complete particulars relating to the interest income in the return of income. S approaches you for advice regarding the steps to be taken to secure exemption of the income. Advise S about the various remedies available under the Income-tax Act, 1961 for the redressal of his grievance.* (6 Marks)
- (b) *D, a lady, received the following gifts during the year ending 31.3.2006:*
 - (i) *Rs.30,000 from her elder sister.*
 - (ii) *Rs.50,000 from the daughter of her elder sister.*
 - (iii) *Rs.1,25,000 from various friends on the occasion of her marriage.**Discuss the taxability or otherwise of these gifts in the hands of D.* (4 Marks)
- (c) *What is the circumstance in which it is not necessary for a non-resident Indian, whose total income is above the taxable limit, to file his return of income under section 139(1)?* (2 Marks)

Answer

- (a) S can file an appeal under section 246A, against the order of assessment, to the Commissioner (Appeals). The law is well settled that an appeal can be filed by an assessee even against inclusion in assessment, of such income erroneously included by him in the return of income. Reliance is place upon the decision of the Delhi High Court in *CIT v. Bharat General Reinsurance Co. Ltd. (1971) 81 ITR 303*.

If an assessee makes a mistake in submitting a return of income and submits to be assessed on a particular income before the assessing authority, he is not estopped or precluded by law from preferring an appeal and showing to the appellate authority that the income is, in fact, either wholly or partly, not exigible to tax. If such a contention is taken, it is the duty of the appellate authority to examine the matter and determine the proper tax leviable. There is no question of invoking the doctrine of estoppel in such a case [*Narsepalli Oil Mills v. State of Mysore* (1973) 32 STC 599 (Mys.)]

In the alternative, S can file a revision petition under section 264 with the Commissioner of Income-tax seeking exemption of interest from Relief Bonds, not claimed in the return of income and not allowed in the order of assessment.

The other course of action S could take is to file an application under section 154 with the Assessing Officer, seeking rectification of the order of assessment made. The consistent judicial view is that exemption not claimed by the assessee and not allowed by the Assessing Officer, though the material relating thereto was in the return of income, constitutes a mistake apparent from the record within the meaning of section 154 of the Act.

- (b) (i) Section 56(2)(v) provides for taxation of gifts exceeding Rs.25,000, received by an individual from any person, under the head "Income from other sources". The proviso thereto states that gifts of money received from any relative would not be so taxed. *Explanation* to section 56(2)(v) defines the term "relative". Sister of the individual is included in the said definition. Therefore, gift of Rs.30,000 received by D from her elder sister is not taxable.
- (ii) Daughter of the elder sister of an individual is not a "relative" within the definition of the term as contained in *Explanation* to section 56(2)(v). Since the amount received from the daughter of her elder sister exceeds Rs.25,000, the whole of the amount gifted shall be included in D's total income. Therefore, the entire sum of Rs.50,000 gifted is taxable in the hands of D.
- (iii) The proviso to section 56(2)(v) stipulates that gifts of money received by an individual on the occasion of the marriage of the individual is not taxable. Therefore, gifts amounting to Rs.1,25,000 received by D from her friends on the occasion of her marriage are not taxable.
- (c) Section 115G of the Income-tax Act, 1961 provides that it is not necessary for a non-resident Indian to furnish a return of income under section 139(1) if his total income consisted only of investment income or long-term capital gains or both and tax deductible at source under Chapter XVII-B has been deducted from such income.

Question 6

- (a) *State whether the following persons are liable to pay fringe benefit tax in respect of the fringe benefits provided to their employees:*
 - (i) *Hindu undivided family having 30 employees on its rolls in its textile business.*
 - (ii) *Charitable trust running a hospital registered under section 12AA.* (3 Marks)

- (b) *Examine the liability to fringe benefit tax in respect of the following items of expenditure incurred by a private limited company:*
- (i) *Transport allowance paid to employees exempt under section 10(14) read with rule 2BB.*
 - (ii) *Expenditure on conference of dealers.*
 - (iii) *Free medical samples distributed to doctors by its pharmaceutical manufacturing unit.* (3 Marks)
- (c) *X, an individual whose total sales in the business of food grains for the year ending 31.3.2005 was Rs.66 lakhs, did not maintain books of account. The Assessing Officer levied penalties under section 271A for non-maintenance of books of account and section 271B for not getting the books audited as required by section 44AB. Is the Assessing Officer justified in levying penalty under section 271B?* (3 Marks)
- (d) *An assessee sustained a loss under the head "Income from house property" in the previous year relevant to the assessment year 2005-06, which could not be set off against income from any other head in that assessment year. The assessee did not furnish the return of loss within the time allowed under section 139(1) in respect of the relevant assessment year. However, the assessee filed the return within the time allowed under section 139(4). Can the assessee carry forward such loss for set off against income from house property of the assessment year 2006-07?* (3 Marks)

Answer

- (a) (i) Section 115W(a) defines the term "employer" to mean a company, firm, association of persons, body of individuals, local authority and artificial juridical person. Thus, individual and Hindu Undivided Family have not been included in the definition. Therefore, in the instant case, the Hindu Undivided Family having 30 employees on its rolls in its textile business is not liable to pay fringe benefit tax in respect of fringe benefits provided to its employees.
- (ii) Charitable trusts registered under section 12AA do not fall within the meaning of the term "employer" as defined in section 115W(a), since the proviso to section 115W(a) specifically provides that any person registered under section 12AA shall not be deemed to be an employer for the purposes of Chapter XIIH. Therefore, the charitable trust running a hospital registered under section 12AA is not liable to pay fringe benefit tax in respect of fringe benefits provided to its employees.
- (b) (i) Transport allowance falls within the meaning of "salary" as defined in section 17(1). Any expenditure incurred for the purposes of salary does not fall within the purview of fringe benefits. Therefore, transport allowance paid to the employees is not liable to fringe benefit tax.
- (ii) As per section 115WB(2)(C), expenditure incurred for the purpose of conference is liable to fringe benefit tax. It is immaterial whether the conference is of agents or dealers or any other persons. Therefore, expenditure incurred for the purpose of conference of dealers is liable to fringe benefit tax.

- (iii) The Supreme Court, in *Eskayef Ltd. v. CIT* 245 ITR 116, has held that expenditure on free medical samples distributed to doctors is in the nature of sales promotion. As such, expenditure on free medical samples distributed to doctors by the pharmaceutical manufacturing unit of the company would be liable to fringe benefit tax under section 115WB(2)(D).

Note – These clarifications on the above issues have been given by the CBDT in Circular No.8 dated 29.8.2005.

- (c) X has not maintained books of account though he was required under the Income-tax Act to do so since his gross sales exceeded Rs.40 lakhs. He is liable to pay penalty under section 271A for such default. Accordingly, the action of the Assessing Officer in levying penalty under section 271A is correct. However, where books of account have not been maintained, there cannot be a question of getting them audited. Audit of books of account presupposes maintenance of books of account. When admittedly X has not maintained books, he cannot obviously get the audit done. In *Surajmal Parsuram Todi v. CIT* (1996) 222 ITR 691, the Gauhati High Court has held that when a person commits an offence by not maintaining books of accounts as contemplated by section 44AA, the offence is complete and after that there can be no possibility of any offence as contemplated by section 44AB and, therefore, the imposition of penalty under section 271B is erroneous.

Therefore, in this case, the Assessing Officer is not justified in levying penalty under section 271B.

- (d) Section 139(3) stipulates that an assessee claiming carry forward of loss under the heads "Profits and gains of business or profession" or "Capital gains" should furnish the return of loss within the time stipulated under section 139(1). There is no reference to loss under the head "Income from house property" in section 139(3). The assessee, in the instant case, has filed the return showing loss from property within the time prescribed under section 139(4). The assessee is, therefore, entitled to carry forward such loss for set off against the income from house property of the assessment year 2006-07.

Question 7

- (a) A foreign company entered into contracts with several Indian companies for installation of mobile telephone system and made an application to the Authority for Advance Rulings for advance ruling on the rate of withholding tax on receipts from Indian companies. One of the Indian companies made an application to its Assessing Officer for determination of the rate at which tax is deductible on payment to the said foreign company. The Authority for Advance Rulings rejected the application of the foreign company on the ground that the question raised in the application is already pending before an income tax authority. Is the rejection of the application of the foreign company justified in law? (8 Marks)
- (b) Can an employee of a State Government claim exemption under section 10(10C) in respect of compensation received on voluntary retirement to the extent of Rs.5 lakhs and

relief under section 89(1) in respect of the amount of compensation in excess of Rs.5 lakhs? (4 Marks)

- (c) (i) J inherits a house property from his father, who had mortgaged it. J discharges the mortgage debt. J later sells the property. Can he claim the amount paid to the mortgagee as cost of improvement in computing the capital gain?
- (ii) L mortgaged his house property and utilized the mortgage amount to perform the marriage of his son. He paid the amount to the mortgagee later. Upon sale of the said property thereafter, he claims the mortgage debt discharged as forming part of the cost of acquisition. Can capital gain be computed accepting his claim? (4 Marks)

Answer

- (a) The matter relates to the admission or rejection of the application filed before the Advance Ruling Authority on the grounds specified in clause (i) of the first proviso to sub-section (2) of section 245R of the Income-tax Act, 1961.

Clause (i) of the first proviso of section 245R(2) provides that the Authority shall not allow the application where the question raised in the application is already pending before any income-tax authority or Appellate Tribunal or any court.

In the above case, no application had been filed or contention urged by the applicant (foreign company) before any income-tax authority/Appellate Tribunal/court, raising the question raised in the application filed with AAR. One of the Indian companies, however, had raised the question before the Assessing Officer, not on the applicant's behalf or with a view to benefit the applicant, but only to safeguard its own interest, as it had a statutory duty to deduct the proper amount of tax from payments made to a non-resident. Although the question raised pertains to one of the payments made or to be made to the non-resident applicant, it was not one pending determination before any income-tax authority in the applicant's case.

Therefore, as held by the AAR in *Ericsson Telephone Corporation of India AB v. CIT* (1997) 224 ITR 203, the application filed by the Indian company before the Assessing Officer cannot be treated to have been filed by the non-resident. Hence, it would not be proper to reject the application of the foreign company relying on clause (i) of the proviso to sub-section (2) of section 245R of the Income-tax Act. The application is, therefore, maintainable.

- (b) The Income-tax Act, 1961 does not contain any provision which prohibits an assessee from claiming both exemption under section 10(10C) and relief under section 89(1) in respect of compensation which has been offered for taxation in the same assessment year. Sections 10(10C) and 89(1) are independent provisions. There is no element of exemption being sought while claiming relief under section 89(1). Compensation constitutes profits in lieu of salary, which is included in the definition of salary under section 17(1). Voluntary retirement compensation upto Rs.5 lakhs is exempt under section 10(10C). The amount in excess of Rs.5 lakhs is taxable as salary, in respect of which relief has to be granted under section 89(1). The Madras High Court in *CIT v. G.V.*

Venugopal (2005) 273 ITR 0307 (Mad.) and Karnataka High Court in *CIT v. P. Surendra Prabhu (2005) 279 ITR 0402* have taken this view.

The employee of the State Government can, therefore, claim exemption under section 10(10C) in respect of compensation received on voluntary retirement to the extent of Rs.5 lakhs and relief under section 89(1) in respect of the amount of compensation in excess of Rs.5 lakhs.

- (c) (i) J inherited the house property with the liability to discharge the mortgage debt. He can, therefore, claim the amount paid to the mortgagee as cost of improvement while computing the capital gain on sale of the said property. The decision of the Supreme Court in *RM. Arunchalam v. CIT (1997) 227 ITR 222* supports this view.
- (ii) L has himself created the mortgage in respect of his house property. It is a self-created mortgage. Therefore, the debt discharged by L on the property under mortgage created by him does not form part of cost of acquisition. The decision of the Supreme Court in *V.S.M.R. Jagadish Chandran v. CIT (1997) 227 ITR 240* supports this view. Therefore, capital gain on sale of the property cannot be computed on the basis of the claim made by him.

Note – This question can also be answered with reference to the recent Bombay High Court ruling in *CIT v. Roshanbabu Mohammed Hussein Merchant (2005) 144 Taxman 720 / 275 ITR 0231*. This case highlights the difference in tax treatment in respect of allowability of the expenditure incurred on removing an encumbrance in two different cases, namely –

- (i) In a case where the mortgage is created by the previous owner and
- (ii) In a case where the mortgage is created by the assessee himself.

The Bombay High Court pointed out that there is a distinction between the obligation to discharge the mortgage debt created by the previous owner and the obligation to discharge the mortgage debt created by the assessee himself. Where the property acquired by the assessee is subject to the mortgage created by the previous owner, the assessee acquires absolute interest in that property only after the discharge of mortgage debt. In such a case, the expenditure incurred by the assessee to discharge the mortgage debt created by the previous owner to acquire absolute interest in the property is treated as 'cost of acquisition' and is deductible from the full value of consideration received by the assessee on transfer of that property. However, where the assessee acquires property which is unencumbered, the assessee gets absolute interest in that property on acquisition. When the assessee transfers that property, he is liable for capital gains tax on the full value realized, even if he has himself created an encumbrance on that property. The assessee is under an obligation to remove that encumbrance for effectively transferring the property. In other words, the expenditure incurred by the assessee to remove the encumbrance created by the assessee himself on the property (which was acquired by him without any encumbrance) is not an allowable deduction under section 48.

Question 8

G, an individual, furnishes the following particulars of his assets and liabilities as on 31.3.2006:

Assets:	Rs. in lakhs
Residential house at New Delhi	25
Residential house at Agra	15
Plot of land comprising an area of 450 square meters at Mumbai	60
House at New Delhi exclusively used for carrying on his business	15
Commercial complex at Agra	20
Residential house at Chennai let out for 335 days during the relevant previous year	10
Motor cars used in business of running them on hire	20
Shares in private limited companies	25
Cash in hand	3
Gold jewellery	12
Liabilities:	
Loan borrowed for purchase of land at Mumbai	20
Loan borrowed for purchase of shares in private limited companies	10
Loan borrowed for purchase of gold jewellery	6

Amounts stated against assets, except cash in hand, are the values determined as per section 7 of the Wealth-tax Act, 1957 read with Schedule III thereto.

Compute the net wealth of G for the assessment year 2006-07.

State the reasons for inclusion or exclusion of the various items. (10 Marks)

Answer

Computation of net wealth of G for the A.Y. 2006-07

Particulars	Amount in Rs.
(a) Residential house at New Delhi is an asset	25,00,000
(b) Residential house at Agra is an asset	15,00,000
(c) Plot of land comprising an area of 450 square meters at Mumbai is an asset but exempt under section 5(vi)	Nil
(d) House at New Delhi exclusively used for carrying on his business is not an asset	Nil
(e) Commercial complex at Agra is not an asset	Nil
(f) Residential house at Chennai let out for 335 days during the relevant	Nil

	previous year is not an asset	
(g)	Motor cars used in the business of running them on hire is not an asset	Nil
(h)	Shares in private limited companies is not an asset	Nil
(i)	Cash in hand in excess of Rs.50,000 is not includible in net wealth	2,50,000
(j)	Gold jewellery is an asset	12,00,000
		54,50,000
	Less: Debts incurred in relation to assets	
(k)	Loan borrowed for purchase of land at Mumbai (not deductible since exemption under section 5(vi) has been claimed in respect of the said land)	Nil
(l)	Loan borrowed for purchase of shares in private limited companies (not deductible since shares are not included in net wealth)	Nil
(m)	Loan borrowed for purchase of gold jewellery	6,00,000
	Net Wealth	48,50,000

Reasons for inclusion or exclusion of the various items are furnished below:

- (a) Residential house at New Delhi is included, as residential house is an "asset" within the meaning of section 2(ea) of the Wealth Tax Act, 1957. Exemption under section 5(vi) is not claimed in respect of this house as it is more beneficial for the assessee to claim exemption in respect of plot of land at Mumbai whose value is higher.
- (b) Residential house at Agra is an asset u/s 2(ea) and, therefore, included in the net wealth.
- (c) Plot of land measuring 450 square metres at Mumbai is exempt under section 5(vi) and, therefore, does not form part of net wealth. One house or part thereof or a plot of land, not exceeding 500 square metres, belonging to an individual or a Hindu Undivided Family is exempt u/s 5(vi) without any monetary ceiling.
- (d) House at New Delhi, occupied for own business purposes, is excluded from net wealth as it is not an asset.
- (e) Commercial complex at Agra is excluded as it is not an asset.
- (f) Any residential property let out for a minimum period of 300 days in the previous year is not considered as an asset. Residential house at Chennai let out for more than 300 days is, therefore, excluded from net wealth.
- (g) Motor cars used in business of running them on hire are not assets as per section 2(ea)(ii) and, therefore, excluded from net wealth.
- (h) Shares in private limited companies are not assets and, therefore, excluded from net wealth.
- (i) Cash in hand, in excess of Rs.50,000, of individuals constitutes an asset. Therefore, Rs.2,50,000, being cash in hand in excess of Rs.50,000, is included in net wealth.

- (j) Gold jewellery constitutes an asset as per section 2(ea) and is includible in net wealth.
- (k) Debts incurred in relation to an exempted asset are not deductible in computing net wealth. Loan borrowed for purchase of land at Mumbai is not deductible as exemption under section 5(vi) has been claimed in respect of the said land.
- (l) Loan borrowed for purchase of shares in private limited companies is not deductible while computing net wealth as shares are not included in net wealth.
- (m) Gold jewellery, being an asset, has been included in the net wealth. Therefore, loan borrowed for purchase thereof is deductible in computing the net wealth.