

The Suggested Answers for Paper 7: Direct Taxes are based on the provisions applicable for A.Y.2004-05, which is the assessment year relevant for November 2004 exams.

PAPER – 7 : DIRECT TAXES

*Answer **all** questions*

Question 1

A & Co. Limited, engaged in the business of manufacturing, shows a net profit of Rs.65.00 lacs for the financial year ended 31-3-2004. A scrutiny of the Profit & Loss Account revealed the following:

- (i) Rent of Rs.2.40 lakhs from a commercial property owned by the company and let to a bank was included in the profit.*
- (ii) Loss of Rs.5 lakhs due to non-realisation of advances given to a wholly owned subsidiary Company engaged in the business of hire-purchase financing charged to Profit & Loss Account.*
- (iii) The Company used to include interest cost in valuation of its finished stock upto the financial year 2002-03. During the financial year 2003-04 the Company changed its accounting policy to adopt AS-2 (Valuation of Inventories) issued by the ICAI and excluded interest cost in valuation of finished stock. This has resulted in a decrease in the year's profit by Rs.15.40 lacs.*
- (iv) Municipal taxes on commercial property debited Rs.0.22 lacs, which were ultimately paid on 1-12-2004.*
- (v) The Company has received equity shares of AB Ltd. valued at Rs.1.25 lacs in exchange of equity shares of CD Ltd. in a scheme of amalgamation during the year. The shares in CD Ltd. were acquired in 1998-99 at a cost of Rs.0.40 lacs. The surplus has been credited to Profit & Loss account. Both AB and CD are Indian companies.*
- (vi) An executive, while on business trip abroad, died and gratuity paid voluntarily amounted to Rs.6.00 lacs.*
- (vii) As restructuring of its debt, the company has converted arrears of interest of Rs.5.00 lakhs on term loan into a new term loan with a revised repayment schedule. The company has paid Rs.0.50 lac towards such funded interest during the year.*
- (viii) Legal charges in connection with alteration of the Articles of Association Rs.1.50 lacs and for issue of bonus shares Rs.5.00 lacs.*
- (ix) The company has purchased scrap materials amounting to Rs.0.60 lacs, the payment for which was made in cash on 15th August, 2003.*
- (x) The profit, as shown above, includes Rs.5.00 lacs received from a Foreign Government for use of company's product. This was, however, not brought into India.*

Compute the net income of the company for the assessment year 2004-05 clearly indicating the basis of treatment of each item.
(16 marks)

Answer**Computation of net income of A & Co. Ltd. for the A.Y. 2004-2005**

Particulars	Rs. in lacs
I. Income from House Property (Working Note 1)	1.68
II. Profits and gains of business or profession (Working Note 2)	71.47
Gross Total Income	73.15
Less: Deduction under Chapter VI-A	-
Total Income	73.15

Working Note 1**Computation of income from house property**

Gross annual value (See Note 3 below)	2.40
Less: Municipal taxes are not allowable as deduction since they were not paid in the previous year.	-
Net Annual Value (NAV)	2.40
Less: 30% of NAV	0.72
Income from house property	1.68

Working Note 2**Computation of income under the head "Profits and gains of business or profession".**

Net profit as per profit and loss account	65.00
Add: Inadmissible expenditure	
(i) Loss on non-realization of advance to wholly owned subsidiary company does not arise in the normal course of business, since the wholly owned subsidiary company is engaged in providing finance to other borrowers. As far as A&Co. is concerned, its business is manufacturing and not financing. Hence, loss is to be disallowed.	5.00
(ii) Municipal taxes on commercial property is not allowable as deduction under this head of income.	0.22
(iii) Legal expenses of Rs 1.50 lacs for amendment of Articles of Association is an allowable expenditure. [Allahabad High Court in <i>CIT vs Modi Spinning & Weaving Mills Co Ltd. (1973) 89 ITR 304</i>].	-

However, the same paid in connection with the issue of bonus shares is a capital expenditure and hence not allowable. [*India Cements Ltd. vs CIT (1966) 60 ITR 52(SC)*]

	5.00	10.22
		75.22
Less: Admissible deductions and income not taxable/considered separately		
(i) Rent of commercial property let out on rent to a bank. This is taxable under the head "Income from House Property" and has been considered separately.	2.40	
(ii) Surplus on exchange of shares on amalgamation of companies – (See note 2 below)	0.85	
(iii) Interest on term loan should have been disallowed under section 43B in the earlier assessment years due to non-payment. Such interest has been converted into term loan. Since the company has paid Rs.0.50 lacs in the current year, the same is allowable as deduction in the light of the provisions of section 43B. It is assumed that the interest of Rs.5 lacs converted into term loan has not been debited in the profit and loss account.	0.50	3.75
Income under the head "Profits and gains from business or profession"		71.47

Note:-

1. Rs.5 lacs is received from a foreign Government for use of company's product. As the amount was not brought to India in convertible foreign exchange within the prescribed time, deduction u/s 80-O is not allowable.
2. Under section 47(vii) any transfer by a shareholder, in a scheme of amalgamation, of a capital asset, being shares held by him in the amalgamating company does not attract capital gains tax, if the transfer is made in consideration of the allotment of any shares in the amalgamated company and the amalgamated company is an Indian company.
3. Rent of commercial property has been taken as its gross annual value in the absence of other information.
4. A company can change its method of valuation of stock provided the change is made for *bona fide* reason and is followed consistently in future. The assessee changed its method of valuation of stock in line with the pronouncement of a professional body. Therefore, the genuineness of the change in method of valuation of stock cannot be questioned. Hence, even though the profit is lower by Rs.15.40 lacs, it would not have any impact on the computation of income.
5. Payment of gratuity Rs.6.00 lacs on account of death of an executive while on business trip is allowable as deduction. [*CIT vs. Laxmi Cement Distributors (P) Ltd. (1976) 104 ITR*]

711 (Gujarat)]. Since it has already been debited to the profit and loss account, no further adjustments are required.

6. Payment for scrap materials was made on 15th August, 2003, being the "Independence Day" on which banks are closed. Such payment is covered by Rule 6DD(k) of the Income-tax Rules. Therefore, the expenditure cannot be disallowed under section 40A(3).

Question 2

- (a) A private limited company has share capital in the form of equity share capital. The shares were held upto 31st March, 2002 by four members A, B, C and D equally. The company made losses/profits for the past three assessment years as follows:

Assessment Year	Business Loss Rs.	Unabsorbed Depreciation Rs.	Total Rs.
2000-2001	Nil	15,00,000	15,00,000
2001-2002	Nil	12,00,000	12,00,000
2002-2003	9,00,000	9,00,000	18,00,000
Total	9,00,000	36,00,000	45,00,000

The above figures have been accepted by the tax department.

During the previous year ended 31.3.2003, A sold his shares to Y and during the previous year ended 31.3.2004, B sold his shares to Z. The profits for the past two previous years are as follows:

31.3.2003 Rs.18,00,000 (before charging depreciation of Rs.9,00,000)

31.3.2004 Rs.45,00,000 (before charging depreciation of Rs.7,50,000)

Compute taxable income for A.Y.2004-05. Workings must form part of your answer.

(9 marks)

- (b) Given below is the summarized Profit and Loss Account of Sun and Sand Limited, engaged in the business of hotel approved by the prescribed authority:

	Rs. (in lacs)
Income	
Realised from services rendered to foreign tourists	75.00
Other business receipts	10.60
Capital Gains (short-term)	<u>3.50</u>
Total (A)	<u>89.10</u>
Expenses (Total)	37.50
Transfer to reserve under section 80HHD	<u>15.00</u>
Total (B)	<u>52.50</u>
Net Profit (A - B)	36.60

Following further information are given:

- (i) Expenses includes Rs.6.70 lacs being interest on term loan from bank. The amount remains unpaid as of date.
- (ii) Services rendered to foreign tourists include Rs.8.00 lacs received in convertible exchange after 30.9.2004 and Rs.1.00 lac by sale of articles from shops belonging to the company.
- (iii) Other business receipts includes Rs.4.00 lacs (INR) from an approved tour operator rendering services to foreigners.

Compute the amount of deduction that can be claimed by the company under section 80HHD. (5 marks)

Answer

- (a) A, B, C and D are the four shareholders of a private limited company. The shareholding pattern of the company as on 31.3.2002, 31.3.2003 and 31.3.2004 are as follows -

As on	A	B	C	D	Y	Z
	%	%	%	%	%	%
31.3.2002	25	25	25	25	-	-
31.3.2003	-	25	25	25	25	-
31.3.2004	-	-	25	25	25	25

Section 79 provides that, in case of a closely held company, no loss incurred in the previous year shall be carried forward and set off against the income of the subsequent previous year unless the shares carrying at least 51% of the voting power of the company are beneficially held on the last day of the previous year in which the loss is sought to be set off, by the same shareholders, who beneficially held the shares carrying at least 51% of the voting power on the last day of the previous year in which the loss was incurred.

Since shareholders holding at least 51% of the voting power are the same as on 31.3.2002 and 31.3.2003, the restriction imposed by section 79 is not applicable for A.Y.2003-04. Thus, the taxable income for the assessment year 2003-2004 would be:

Particulars	Rs.
Business profit	18,00,000
Less:- Current year's depreciation	9,00,000
	9,00,000
Less:- Brought forward business loss for the A.Y. 2002-2003	9,00,000
Taxable income	Nil

Unabsorbed depreciation for the last 3 assessment years can be carried forward to the next assessment year i.e. A.Y.2004-05. There is no brought forward business loss and section 79 is not applicable in case of carry forward of unabsorbed depreciation. Section 32 governs the carry forward and set off of depreciation for which the shareholding pattern is not relevant. Consequently, the income for A.Y.2004-05 will be determined as under -

Particulars	Rs.	Rs.
Business income		45,00,000
Less: Current year's depreciation		7,50,000
		37,50,000
Less: Unabsorbed depreciation:-		
Assessment year 2000-2001	15,00,000	
Assessment year 2001-2002	12,00,000	
Assessment year 2002-2003	9,00,000	36,00,000
Taxable Income for A.Y.2004-05		1,50,000

(b) **Computation of deduction available under section 80HHD
for Sun & Sand Ltd. for A.Y.2004-05**

Particulars	Rs. in lacs
Amounts received in foreign exchange from foreign tourists	70.00
(Refer Working Note 1)	
Total business receipts (75.00+ 10.60)	85.60
Profits of the business (Refer Working Note 2)	54.80
Profits for the purpose of section 80HHD:- $54.80 \times 70.00/85.60$	44.81
Deduction-u/s 80HHD for the A.Y. 2004-2005:	
(i) 15% of eligible profit	6.72
(ii) Transfer to reserve (restricted to 15% of eligible profit)	6.72
Total deduction available under section 80HHD for A.Y.2004-05	13.44

Working Note 1**Amount received in foreign exchange from foreign tourists**

Amount realised from services rendered to foreign tourists		75.00
Less:- Amount received in convertible foreign exchange after 30.9.2004	8.00	
Amounts realized on sale of articles from shops	1.00	9.00
		66.00
Add:- Amount received from an approved tour operator rendering services to foreigners (It is assumed that the other tour operator has furnished the certificate in the prescribed form to Sun & Sand Ltd.)		4.00
		70.00

Working Note 2**Profits of the business**

Profit as per profit and loss account		36.60
Add:- Disallowance u/s 43B:-		
Interest on term loan remaining unpaid up to the date of filing the return	6.70	
Transfer to reserve u/s 80HHD	15.00	21.70
		58.30
Less:- Short term capital gain		3.50
		54.80

Question 3

- (a) R purchased equity shares in P Ltd., a constituent of BSE-500 index on Mumbai Stock Exchange on 1st March, 2003. He sold the shares on 4th March, 2004 at a loss of Rs.10,000. He wants to set off the loss against other long-term capital gain during the year. Examine whether such set off is permissible. Both purchase and sale transactions were entered into on a recognized stock exchange. (4 marks)
- (b) Dinesh, an individual engaged in the business of finance, advances Rs.5 lacs to his HUF on interest at 12% p.a., which is the prevailing market rate. The HUF invests the amount in its business and earns profit of Rs.2 lacs from this money. Can the assessing officer add a sum of Rs.1,40,000 (i.e. Rs.2,00,000-Rs.60,000) as income of Dinesh under

section 64(2) of the Income-tax Act? Will the position remain the same, if Dinesh does not charge any interest? (4 marks)

- (c) *A domestic company is liable to pay minimum alternate tax under section 115JB for the Assessment Year 2003-04. While computing book profit under section 115JB the company claims provision for deferred tax charged to Profit & Loss account in accordance with Accounting Standard-22 of the Institute of Chartered Accountants of India, which is sought to be disallowed by the Assessing Officer. On what grounds you can contest such disallowance?* (4 marks)

Answer

- (a) According to section 10(36) (inserted by the Finance Act 2003 with effect from assessment year 2004-05), any income arising from the transfer of long-term capital asset being an eligible equity share in a company purchased on or after 1st March, 2003 and before 1st March, 2004 and held for a period of 12 months or more is exempted from income tax. Eligible equity share includes any equity share in a company, which is a constituent of BSE-500 index of Mumbai Stock Exchange on 1st March, 2003 and the transactions of purchase and sale of such share are entered into on a recognized stock exchange in India.

In this case the assessee has suffered a loss of Rs.10,000 by selling eligible equity shares. It is settled principle that where income from a particular source is exempted under any provision of the Act, the loss arising from such source is not eligible for set off against income from a taxable source. In the case of *JCIT vs. Thyagarajan.S.S (1981) 129 ITR 115 (Mad)*, the Madras High Court held that loss incurred by an assessee from a source, income from which is exempted, cannot be set off against income from a taxable source. In view of the same, the set off in the instant case is not permissible.

- (b) Section 64(2) shall be applicable only where an individual member of HUF converts his property into the property of HUF or throws it into the common stock of the HUF without adequate consideration. In this case, Dinesh does not transfer money to his HUF but only lends an amount of Rs.5 lakhs to his HUF at an interest of 12%, which is the prevailing market rate. This is a transaction of loan, which pre-supposes re-payment. Dinesh continues to be the owner of the amount lent. Thus, there is no transfer of property from Dinesh to the HUF. Therefore, the Assessing Officer cannot add the profit arising to HUF in the total income of Dinesh by invoking section 64(2).

Even if no interest is charged by Dinesh, the nature of transaction does not change. It still remains a loan transaction. Therefore, the position will not change, even if Dinesh does not charge any interest.

- (c) The Supreme Court in the case of *Apollo Tyres Ltd vs. CIT (2002) 255 ITR 273* held that the Assessing Officer has the limited power of making addition and deduction to net profit as provided for in the Explanation to section 115J (now section 115JB). The Apex Court held that the Assessing Officer does not have any jurisdiction to go beyond the net profit shown in the profit and loss account except to the extent provided in the *Explanation* to section 115JB.

As per clause (a) of the *Explanation* to section 115JB, for the purpose of computing book profit, the net profit as shown in the profit and loss account for the relevant previous year shall be increased by the amount of income tax paid or payable and the provision therefor. Clause (a) of the *Explanation* to section 115JB essentially refers to current tax liability. Section 2(43) defines 'tax' as income-tax chargeable under the provisions of the Income-tax Act. Deferred tax is not income tax chargeable under the Income-tax Act. Moreover, deferred tax provision is not in the nature of provision for meeting any liability, which is not ascertained. Therefore, the deferred tax provision in the accounts is neither a liability for the purpose of clause (a) nor in the nature of provision for meeting any unascertained liability for the purpose of clause (c) of the *Explanation* to section 115JB. As such, it only represents a necessary accounting adjustment as per Accounting Standard 22 to fall in line with the matching principle of accounting.

Therefore, the provision for deferred tax charged to profit and loss account cannot be added back to the net profit by the Assessing Officer for computing book profit.

Question 4

- (a) *J filed a return of income for the Assessment Year 1999-2000, in due time disclosing a total income of Rs.4 lakhs. The taxes due on the income were covered by taxes deducted at source, advance tax and self-assessment tax.*

The return was taken for scrutiny by the assessing officer, who made large additions to the income disclosed by J. On appeal, the High Court set aside the order of assessment and directed a fresh assessment to be made after hearing the parties. The court order had become final since neither party had preferred an appeal against it.

The assessing officer did not make any fresh assessment with the result that the assessment became barred by time.

J has filed a petition that since no assessment of his income had been made by the assessing officer, the entire taxes paid, including the pre-assessment payments, must be refunded to him.

Is he justified in making this claim? Discuss.

(4 marks)

- (b) *An assessment was completed by the Assessing Officer under section 143(3) on the basis of return submitted and other information furnished by the assessee. The Assessing Officer accepted the cost of the land after waiting for a reasonable period for report of the valuation officer to whom a reference was made. Subsequent to receiving the report from the valuer, it revealed that there was a variation by about Rs.3.00 lacs. On the basis of this valuation report, the Commissioner issued notice under section 263 to set aside the completed assessment.*

Justify the action of the Commissioner.

(3 marks)

- (c) *M filed return of income for Assessment Year 2003-04 claiming a refund of Rs.45,000. The said refund was granted and paid to the assessee on 1st March, 2004 after processing the return under section 143(1). Later on, the case was taken up for regular assessment by issue of notice under section 143(2) and the said assessment was*

completed on 16th August, 2004 resulting in demand of Rs.2500. Is the assessee liable to pay interest on the amount of refund already granted to him and if so, what is the amount of such interest? (3 marks)

- (d) A search was initiated in the premises of an assessee on 11th November, 2003 and it was concluded on 14th November, 2003. What is the period of limitation for issue of notice for making assessment of preceding six assessment years? In case assessment under Section 143(3) for assessment year 2001-02 and appeal before CIT(A) for assessment year 1999-2000 are pending on 11th November, 2003, what would be the fate of such pending assessment and appeal? (4 marks)

Answer

- (a) The Gujarat High Court held, in *Saurashtra Cement and Chemical Industries Ltd. v. ITO* (1992) 194 ITR 659, that the liability to pay income-tax arose under section 4(1) of the Act and did not depend upon an assessment order being made by the Assessing Officer. It depends upon the enactment of the annual Finance Act laying down the rates of taxation for the relevant assessment year. Thus, as soon as the rates are prescribed, the liability to pay tax crystallizes.

On filing of return under section 139, the provisions of section 140A also get activated, since if any taxes over and above those paid by way of advance tax and tax deducted at source remain, payment has to be made under section 140A before a valid return of income could be filed by an assessee. Payment of pre-assessment taxes does not depend on an assessment being made by the Assessing Officer.

In the present case, J had paid taxes on the basis of his own declaration of income. J's primary liability under section 4 of the Act is not absolved merely due to absence of a formal assessment. As decided by the Supreme Court in *CIT v. Shelley Products* (2003) 261 ITR 367, pre-assessment taxes paid on the basis of admitted income do not become refundable in the absence of an assessment. Hence J's contention is incorrect.

- (b) As per the facts of the case, the Assessing Officer completed the assessment before the valuation report was received. The valuation report was received subsequent to completion of the assessment. However, it may be noted that the said report forms part of the 'record', which the Commissioner may call for and examine under section 263(1). A perusal of the valuation report revealed a variation of Rs.3 lakhs and to that extent it can be said that the order of the Assessing Officer was prejudicial to the interest of revenue and also erroneous. The Commissioner is absolutely justified in issuing notice u/s 263 since the term "record" used in the said section includes all the records available at the time of examination by the Commissioner even though such records may not have been available at the time of regular assessment. This view was upheld by the Supreme Court in *CIT v. Shree Manjunathesware Packing & Camphor Works* (1998) 231 ITR 335.
- (c) As per section 234D, inserted from 1st June 2003 by the Finance Act 2003, where any refund is granted to the assessee after processing the return u/s 143(1) and later on, in the regular assessment there is no refund due or the amount refunded exceeds the amount refundable, the assessee shall be liable to pay simple interest at $\frac{1}{2}\%$ for every

month or part of a month from the date of grant of refund to the date of such regular assessment on the whole or the excess amount so refunded.

The assessee was granted refund on 1.3.2004 after processing the return u/s 143(1). The regular assessment u/s 143(3) was completed on 16.8.2004 and resulted in tax payable of Rs.2,500. Therefore, no refund was due on regular assessment. Accordingly, the assessee is liable to pay interest u/s. 234D on Rs.45,000 at $\frac{1}{2}\%$ for 6 months (i.e. from 1st March, 2004 to 16th August 2004; part of a month is to be considered as full month).

Interest payable by the assessee u/s 234D works out to Rs.1,350 (i.e. Rs. 45,000 $\times \frac{1}{2}\%$ $\times$ 6 months).

- (d) Under section 153A, where a search is initiated u/s 132 or books of accounts, other documents or any assets are requisitioned u/s 132A after 31.5.2003, the Assessing Officer shall issue notice to such person requiring him to furnish within such period as may be specified in the notice, the return of income in respect of six assessment years immediately preceding the assessment year relevant to the previous year in which such search is conducted or requisition is made. No time limit has been prescribed for the Assessing Officer to issue such notice to the person in whose case search is initiated u/s 132 or requisition is made u/s 132A. However, the Assessing Officer has to complete the assessment within a period of two years from the end of the financial year in which the last of the authorizations for search was executed. In the instant case, it would be 31st March, 2006.

The second proviso to section 153A provides that assessment or reassessment, if any relating to any assessment year falling within the above period of six assessment years, pending on the date of initiation of search u/s 132 or making of requisition u/s 132A shall abate. Therefore, if assessment for assessment year 2001-02 was pending on 11.11.2003, being the date of initiation of search u/s 132, the same shall abate.

Section 153A provides that the assessment or reassessment pending on the date of initiation of search shall abate. The section, however, does not deal with the appeals which are pending on the date of initiation of search. Hence, the appeal for assessment year 1999-2000 pending on 11.11.2003 shall not abate. The appeal proceedings shall continue as such proceedings do not get affected by the search assessment.

Question 5

- (a) *Explain the incidence of taxation on mutual concerns.* (4 marks)
- (b) *A company engaged in the manufacturing of pharmaceutical products, commenced its business on 1.4.2003. During the financial years 2000-01 to 2002-03 it had incurred Rs.2.00 lacs annually as expenditure on salaries and purchase of raw materials for the purpose of research connected with its business. During the previous year 2003-04, it incurred on scientific research, revenue expenditure of Rs.2.00 lacs and a capital expenditure of Rs.3.50 lacs on purchase of plant and machinery. Since the result of the research was unsuccessful, the company sold its plant and machinery on 31.12.2003*

for Rs.8.00 lacs and closed its research activity. Compute the admissible deduction under Section 35 for the assessment year 2004-05. (4 marks)

- (c) A company engaged in textile manufacturing, debited to its Profit & Loss Account a sum of Rs.60,000, being the interest on loan of Rs.6,00,000 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 Rs.6,000 was paid to a broker who arranged the loan. Discuss the admissibility or otherwise of the interest on borrowing. (4 marks)

Answer

- (a) The concept of “mutuality” means that the contributors and beneficiaries are identical. Since one cannot make profit by dealing with oneself, there is no taxable profit involved wherever such concept applies. A mutual concern or association stands on the same principle. All the contributors to the common fund are entitled to participate in the surplus and all the participants to the surplus are contributors in the case of a mutual concern. The excess of income over expenditure in a year shall supplement the common fund for future utilization to the benefit of the contributors and the excess of expenditure over income shall be absorbed by the common fund.

Generally the surplus derived by a mutual concern is not chargeable to tax. Therefore, a trade, professional or similar association which functions on the principle of mutuality concept is not chargeable to tax, if there is any surplus on account of subscriptions, membership fees, entrance fees etc., exceeding the expenditure.

However, the following additional points need to be taken into consideration-

- (i) Where a mutual concern carries on the business of insurance, the profits therefrom are chargeable to tax. Section 44 provides that the profits for this purpose have to be computed in accordance with the method prescribed in the Rules contained in the First Schedule.
 - (ii) In the case of trade, professional or similar associations, the income derived from specific services performed for its members is chargeable to tax u/s 28(iii). However, if there is a loss on account of expenditure exceeding the subscription etc. from members, such shortfall shall be absorbed by the income chargeable to tax u/s 28(iii). This set off as per section 44A cannot exceed 50% of the total income of such associations as computed before allowing the set off.
 - (iii) In the case of a mutual concern, if income is derived both from mutual activity as well as from non-mutual activity, the exemption applies only to the income from the mutual activity. The income attributable to the non-mutual activity will be liable to tax as was held by the Gujarat High Court in *Sports Club of Gujarat Ltd. vs CIT (1987) 171 ITR 504*.
- (b) The assessee is a company engaged in the business of manufacture of pharmaceutical products. Therefore, it is entitled to deduction u/s.35(2AB) in respect of current year expenditure on scientific research on in-house research and development facility

approved by the prescribed authority. Applying the provisions of section 35, the admissible deduction for A.Y.2004-05 is computed as under –

Particulars	Rs. in lacs
Expenditure incurred during the earlier three years on salaries and purchase of raw materials for the purpose of research connected with the business – fully allowed in the year of commencement of business by virtue of <i>Explanation</i> to section 35(1)(i) – [Rs.2 lacs × 3]	6.00
Revenue expenditure on scientific research incurred during the previous year 2003-04	2.00
Capital expenditure on scientific research incurred during the previous year 2003-04	3.50
Total	5.50
Weighted deduction @ 150% on Rs.5.50 lacs u/s 35(2AB) [See Note below]	8.25
Admissible deduction u/s 35 for the A.Y.2004-05	14.25

Note – In the case of an assessee engaged in the business of manufacturing of pharmaceutical products, current year scientific research expenditure qualifies for a weighted deduction of 150%. It is assumed that such expenditure is on scientific research on in-house research and development facility as approved by the prescribed authority being Secretary, Department of Scientific and Industrial Research.

- (c) Interest paid in respect of capital borrowed for the purposes of business or profession is admissible u/s 36(1)(iii). As per the proviso to section 36(1)(iii) inserted by the Finance Act, 2003, from assessment year 2004-05, 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 was not put to use till the end of the previous year. Therefore, interest of Rs.60,000 will not be allowed as deduction. However, the cost of the asset shall be increased by the amount of interest and depreciation shall be admissible on enhanced cost.

As regards the brokerage of Rs.6,000 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” u/s 2(28A) includes service fee or other charges in respect of monies borrowed, “brokerage” can be considered to fall under the scope of the term “other charges” and is therefore included under the definition

of interest. Hence, brokerage of Rs.6,000 for arranging the loan will be treated in the same way as interest.

The alternate view is based on the High Court decision in *C.Moolchand v. CIT (1956) 29 ITR 449 (Hyd.)*, where it has been held that brokerage or commission paid to an agent for arranging a loan for the purpose of business is not allowable as deduction u/s 36(1)(iii), but is allowable under section 37(1). As per this view, Rs.6,000 paid to a broker for arranging a loan is allowable as a deduction under section 37(1).

Question 6

- (a) *R & Co. is a partnership firm consisting of two partners R and S. The partners decide to dissolve the firm on 31.3.2004. The firm owns a land which was purchased 15 years back. One of the decisions taken in the scheme of dissolution was that the land, whose present market value was ascertained at Rs.15,00,000, would be given to S. A suggestion was made to the firm that instead of making an allotment at the time of dissolution, the firm can gift the land to S by making book entries. Discuss the pros and cons of the decision and advise the firm suitably in this context. (6 marks)*
- (b) *Redemption of preference shares amounts to "transfer" within the meaning of Section 2(47) of the Income Tax Act, 1961 in the hands of the shareholder. Discuss. (4 marks)*

Answer

- (a) The question involves consideration of the following two issues:
- (i) Can immovable property be transferred from the firm to a partner without any registration?
 - (ii) Is it better to transfer the land on dissolution to a partner or to make a gift of the land to the partner?

If any immovable property is transferred by a firm to its partner, registration of the transfer of document is required in order to effect such a transfer and enable the partner to get a perfect title. This view was upheld by the Mumbai High Court in *C.I.T vs J.M.Mehta & Bros (1992) 214 ITR 716*. According to this decision, transfer of an immovable property by mere book entries will not be valid. However, in the event of dissolution of a firm and distribution of assets, there is no need for registration as was decided by the Supreme Court in *S. V. Chandra Pandian & Others vs S. V. Sivalinga Nadar & Others (1993) 212 ITR 592*. The decision is based on the principle that a firm is not a distinct legal entity, apart from the partners constituting it. Each and every partner has an undefined interest in each and every property of the firm. Therefore, it can be concluded that if the land is gifted, registration will be required and if the land is distributed on dissolution, registration will not be required.

Section 47 lists out certain transactions which are not regarded as transfer and one such transaction is gift. Therefore, gift of immovable property does not attract capital gains tax. Further, the Gift-tax Act has been abolished in respect of gifts made on or after 1.10.98.

On the other hand, if the land is allotted to the partner at the time of dissolution instead of making a gift, the firm would be subjected to capital gains tax liability. The fair market value as on the date of distribution shall be deemed to be the full value of consideration for computation of capital gains. The indexed cost of acquisition should be reduced from the sale consideration to arrive at the capital gains. The capital gains so computed shall be charged to tax in accordance with the provisions of section 112.

Thus, taking into account the above considerations, it is advisable for the firm to gift the land to partner S instead of allotting the same to him at the time of dissolution which will attract capital gains tax.

- (b) The definition of the term "transfer" u/s 2(47) is not an exhaustive definition but an inclusive one. "Transfer" in relation to capital asset includes, *inter alia*, sale, exchange or relinquishment of capital asset.

When shares are redeemed by a company, it only means that the concerned shareholder is giving up his or her ownership or claim with reference to the shares in favour of the company. The consideration received by the shareholder from the company is certainly for sale/relinquishment of the interest in the shares and therefore, the redemption of preference shares amounts to "transfer" and the gain arising therefrom, being the excess realization over the cost of acquisition, shall be charged to tax under the head "Capital Gains". This was upheld by the Supreme Court in *Anarkali Sarabhai vs CIT (1997) 224 ITR 422*. If the redemption is after a period of 12 months from the date of acquisition of shares by the shareholder, the long term capital gain shall be computed by deducting the indexed cost of acquisition. The resultant long term capital gain shall be charged to tax in accordance with the provisions of section 112.

Question 7

- (a) *S. Ltd. is engaged in export of goods manufactured by it and by others. During the year it has suffered loss in export of trading goods but earned good profit in export of manufactured goods. The company is of the view that it can claim deduction under Section 80HHC in respect of entire profit from export of manufactured goods ignoring the loss from export of trading goods, as Section 80HHC basically is an incentive provision. Discuss the correctness of the view.* (4 marks)
- (b) *US Ltd., a US company has a subsidiary, IND Ltd. in India. US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd. also sells computer monitors to CMI Ltd., another computer reseller. It sells 50,000 computer monitors to IND. Ltd. at Rs.11,000 per unit. The price fixed for CMI Ltd. is Rs.10,000 per unit. The warranty in case of sale of monitors by IND Ltd. is handled by IND Ltd. However, for sale of monitors by CMI Ltd., US Ltd. is responsible for the warranty for 3 months. Both US Ltd. and IND Ltd. offer extended warranty at a standard rate of Rs.1,000 per annum. On these facts, how is the assessment of IND Ltd. going to be affected?* (8 marks)

Answer

- (a) As per section 80HHC(1), where an assessee, being an Indian company, is engaged in the business of export of any goods or merchandise, there shall be allowed, in computing the total income of the assessee, a deduction to the extent of 30% of the profits derived by the assessee from the export of such goods or merchandise. Section 80HHC(3)(c) provides that for the purpose of sub-section (1), if the assessee is engaged in export of both self-manufactured and trading goods, the **profits derived from such export** shall -
- (i) in respect of goods manufactured by the assessee, be the amount which bears to the adjusted profits of the business, the same proportion as the adjusted export turnover in respect of such goods bears to the adjusted total turnover of the business; **and**
 - (ii) in respect of trading goods, be the export turnover in respect of such trading goods as reduced by the direct and indirect costs attributable to export of such trading goods.

The issue here is whether for the purpose of computing deduction, loss from export of trading goods should be adjusted against the profits from export of manufactured goods. The said issue has been settled by the Supreme Court decision in the case of *IPCA Laboratory Ltd. vs Dy. CIT (2004) 135 Taxman 594*. The Apex Court held that in the case of an assessee who is engaged in export of both trading goods and manufactured goods, the deduction u/s 80HHC shall be calculated on the net profit after adjusting the loss from one against the profit from the other. In case of such exporter, the amount of deduction is to be computed in accordance with clause (c) of sub-section (3) of section 80HHC. Clause (c) is divided into two sub-clauses (i) and (ii), which deal with computation of profit from export of manufactured goods and trading goods respectively. Between these two sub-clauses the word "and" appears which, joins the two sub-clauses. The Supreme Court held that the opening words "profit derived from such export" together with the word "and" indicates that profits have to be computed by considering both the manufacturing export and trading export. Accordingly if there is any loss in one, the same cannot be ignored.

Therefore, in the case of an assessee exporting both self-manufactured goods as well as trading goods, the aggregate of the profits/losses from both should be taken into consideration and only if there is a positive net profit after aggregation, should the deduction under section 80HHC be allowed.

Hence, the contention of the assessee is not correct.

- (b) US Ltd., the foreign company and IND Ltd., the Indian company are associated enterprises since US Ltd holds not less than 26% voting rights in IND Ltd. (being a subsidiary of US Ltd., more than 50% of its voting rights would be held by US Ltd.). US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd also sells identical computer monitors to CMI Ltd, which is not an associated enterprise. The price charged by US Ltd. for a similar product transferred in comparable uncontrolled transaction is,

therefore, identifiable. Therefore, Comparable Uncontrolled Price (CUP) method for determining arm's length price can be applied.

While applying CUP method, the price in comparable uncontrolled transaction needs to be adjusted to account for difference, if any, between the international transaction (i.e. transaction between US Ltd. and IND Ltd.) and uncontrolled transaction (i.e. transaction between US Ltd. and CMI Ltd.) and the price so adjusted shall be the arm's length price for the international transaction.

For sale of monitors by CMI Ltd., US Ltd. is responsible for warranty for 3 months. The price charged by US Ltd. to CMI Ltd. includes the charge for warranty for 3 months. Hence arm's length price for computer monitors being sold by US Ltd. to IND Ltd. would be:

Particulars	No.	Rs.
Sale price charged by US Ltd. to CMI Ltd.		10,000
Less: Cost of warranty included in the price charged to CMI Ltd. (Rs.1,000 x 3 /12)		250
Arm's length price		9,750
Actual price paid by IND Ltd. to US Ltd.		11,000
Difference per unit		1,250
No. of units supplied by US Ltd. to IND Ltd.	50,000	
Addition required to be made in the computation of total income of IND Ltd. (1,250 x 50,000)		6,25,00,000

Exemption under section 10A/10B and deduction under chapter VI-A will not be available in respect of increased income of Rs.6.25 crores.

Question 8

(a) *X Limited is engaged in the construction of residential flats. For the valuation date 31.3.2004, it furnishes the following data and requests you to compute the taxable wealth:*

- (i) *Land in urban area (Construction is not permitted as per Municipal Laws in force) Rs.35,00,000*
- (ii) *Motor-cars (used on hire by the company) Rs.7,00,000*
- (iii) *Jewellery (Investment) Rs.15,00,000. Loan taken for purchasing the same Rs.10,00,000*
- (iv) *Cash Balance (as per books) Rs.1,75,000*
- (v) *Bank Balances Rs.2,50,000*
- (vi) *Guest House (situated in a place which is 30 kms away from the local limits of the municipality) Rs.6,00,000*

(vii) Residential flats occupied by the Managing Director Rs.10,00,000. The managing director is on whole time appointment and is drawing remuneration of Rs.2,00,000 per month.

(viii) Residential house let out on hire for 200 days Rs.8,00,000

The computation should be supported with proper reasoning for inclusion or exclusion.

(6 marks)

(b) What are the various circumstances under which an assessee will be deemed to have concealed the particulars of his net wealth or furnished inaccurate particulars thereof?

(4 marks)

Answer

(a) **Computation of taxable wealth of X Limited as on 31.3.2004:**

	Particulars	Note No.	Rs. in lacs
(i)	Land in urban area	(1)	Nil
(ii)	Motor-cars used on hire	(2)	Nil
(iii)	Jewellery	(3)	15
(iv)	Cash balance	(4)	Nil
(v)	Bank balance	(5)	Nil
(vi)	Guest house	(6)	6
(vii)	Residential flat occupied by the Managing Director	(7)	10
(viii)	Residential house let out for 200 days	(8)	8
	Total wealth		39
	Less: Debts: Loan obtained for purchasing jewellery	(9)	10
	Taxable wealth as on 31.3.2004		29

Notes:

- (1) Land in urban area on which the construction is not permitted as per municipal laws in force is not an asset with in the meaning of "asset" as defined u/s 2(ea) and as such excluded from taxability.
- (2) Motor car held as stock in trade or used on hire is not taxable. It is taxable only if it is used for business purposes or personal purposes.
- (3) Jewellery is always taxable unless the same is held as stock in trade.
- (4) Cash on hand in excess of Rs.50000 as on the valuation date is taxable in the case of an individual or HUF. In other cases it is not taxable to the extent reflected in the books of account. In this case, since cash balance of Rs.1,75,000 is as per books of X Ltd., it is not taxable.

- (5) Bank balance is not an asset within the meaning of "asset" as defined in section 2(ea).
 - (6) Guest house situated 30 kms away from the local limits of the municipality is an asset and is therefore taxable. Taxability does not arise only in the case of a farm house situated beyond 25 kms from the local limits of any municipality.
 - (7) Residential flat which is allotted by a company to an employee or an officer or a director who is in whole time employment, having gross annual salary of Rs.5 lacs or more is an asset within the meaning of "asset" as defined in section 2(ea) of the Act. Accordingly, the residential flat occupied by the managing director is taxable since his annual remuneration is Rs.24 lacs.
 - (8) Any residential property which is let out for a minimum period of 300 days in the previous year is not an asset. In the given case, the residential house is taxable since it has been let out for only 200 days i.e. less than 300 days during the previous year.
 - (9) Debts incurred in relation to assets chargeable to wealth tax shall be allowed as deduction in the computation of net wealth. Accordingly loan obtained for purchase of jewellery shall be allowed as deduction since jewellery is assessable to wealth tax.
- (b) The circumstances under which an assessee will be deemed to have concealed the particulars of his net wealth or furnished inaccurate particulars thereof are follows:
- (i) Where a person fails to offer an explanation or offers an explanation which is found to be false in respect of any facts material to the computation of net wealth, he will be deemed to have concealed the particulars. Further, where such person offers an explanation which he is unable to substantiate and fails to prove that such explanation is bonafide and that all the facts relating to same and material to the computation of his net wealth have been disclosed by him, he will be deemed to have concealed the particulars - *Explanation 2* to section 18.
 - (ii) Where a person not previously assessed to wealth tax, fails, without reasonable cause, to furnish within the due date, a return of his net wealth which he is required to furnish and the Assessing Officer is satisfied that the person has assessable wealth, he shall be deemed to have concealed the particulars of his assets - *Explanation 3* to section 18.
 - (iii) Where the value of any asset returned by any person is less than 70% of the value of such asset as determined in an assessment u/s 16 or 17, such person shall be deemed to have furnished inaccurate particulars.
 - (iv) Where in the course of search u/s 37A, the assessee is found to be the owner of any money, bullion, jewellery or other valuable article or thing and such assets have been neither declared in the return of wealth nor recorded in the books of account, he shall be deemed to have concealed the particulars of such assets or furnished inaccurate particulars of such assets.