

The Suggested Answers for Paper 7: - Direct Taxes are based on the provisions applicable for A.Y. 2005-06, which is the assessment year relevant for November, 2005 examinations.

PAPER – 7 : DIRECT TAXES

*Answer **all** questions*

Question 1

The net profits of XYZ Ltd. for the year ended 31st March, 2005, after debiting/crediting the following items, were Rs.9 lakhs:

- (a) The company had taken on lease an old building for the purposes of locating its business. Due to old age of the building, it was demolished and a new building put up, which was used for purposes of XYZ's business from September, 2004. The cost of the new building Rs.10 lakhs was written off as revenue expenditure. The lessor permitted the company to have an extension of the lease by another twenty years.*
- (b) Rs.1 lakh was paid as an annual fee for technical services to a foreign collaborator under an agreement approved by the Government.*
- (c) The company collected Rs.3 lakhs from its customers by way of sales tax in the year 1986-87 and had remitted it to the State Government in due time. On the levy being challenged in the High Court, the Court held the collection as illegal and the State Government in February, 2005 refunded the amount to the company.*
- (d) Land development charges of Rs.1.5 lakhs were paid to the State Industrial Development Corporation on allotment of a commercial plot.*
- (e) A criminal case was filed against a Director of the company, in his official capacity. The company spent legal expenses of Rs.50,000 defending him in the proceedings. The Director was acquitted of the charges at the end.*
- (f) The company issued in the year bonus shares to its shareholders and for that purpose had to enhance the authorised capital. Fees of Rs.1.5 lakhs were paid to the Registrar of Companies in this regard. These have been written off in the accounts as revenue expenses.*
- (g) The company paid Rs.70,000 as interest on deposits to some of the non-resident buyers on advances received from them. No tax at source was deducted on the payment.*
- (h) Overdraft interest of Rs.40,000 was paid to the company's bank to enable the company to pay its income tax dues.*
- (i) The opening and closing stocks of the year were Rs.90,000 and Rs.1,17,000 respectively and were undervalued by 10% on cost.*
- (j) Some investments were held by the company (not as stock in trade), which had to be depreciated by Rs.4.8 lakhs due to a directive from the Government.*

The balance on 1st April, 2004 to the Profit and Loss Account, shown separately in the Balance Sheet, was a debit of Rs.2 lakhs.

The company had the following claims brought forward from the prior years:

Business losses relating to

<i>Assessment year 1994-95</i>	<i>Rs.8 lakhs</i>
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<i>Assessment year 2002-03</i>	<i>Rs.4 lakhs</i>
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*Losses under the head capital gains -**Long-term*

<i>Assessment year 2003-04</i>	<i>Rs.3 lakhs</i>
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Unabsorbed depreciation

<i>(as per IT records as well as the books of the company)</i>	<i>Rs.12.50 lakhs</i>
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Required to :

- (a) Calculate the total income of XYZ Ltd. for the assessment year 2005-06 [Your answer should clearly indicate the reasons for the treatment of the individual items given above.]
- (b) Examine the applicability of section 115JB of the Income-tax Act to the company for the same assessment year. (16 Marks)

Answer**(a) Computation of total income of XYZ Ltd. for the A.Y.2005-06**

	Particulars	Rs.	Rs.
	Net profit as per profit and loss account		9,00,000
Add :	Cost of the new building written off is a capital expenditure – hence disallowed.	10,00,000	
	Land development charges paid to State Industrial Development Corporation is a capital expenditure – hence disallowed	1,50,000	
	Fees paid to ROC for increasing authorized capital is a capital expenditure – hence disallowed	1,50,000	
	Interest on deposit to non-resident buyers without deduction of tax at source – disallowed under section 40(a)(i)	70,000	
	Interest to bank on overdraft for payment of income-tax dues – disallowed as per Supreme Court's decision in <i>East India Pharmaceutical Works Ltd. v. CIT (1997) 224 ITR 627</i>	40,000	
	Depreciation on investments not held as stock-in-trade	4,80,000	
	Under valuation of stock $(1,17,000-90,000) \times 10/90$	3,000	18,93,000
			<u>27,93,000</u>
Less:	Depreciation on building @10% on Rs.10 lakhs (See Notes 1 & 2)		<u>1,00,000</u>

Business Income	26,93,000
<i>Less:</i> Set-off of business loss and unabsorbed depreciation	
Business loss of A.Y.1994-95 cannot be set-off against business income of the current year, since business loss can be carried forward for a maximum period of 8 years only.	-
Business loss of A.Y.2002-03	4,00,000
Long-term capital loss of A.Y.2003-04 cannot be set-off against business income since as per section 74, long-term capital loss can be set-off only against long-term capital gains.	
Unabsorbed depreciation	12,50,000
Total Income	16,50,000
	10,43,000

(b) Tax on total income as computed under the Income-tax Act	Rs.
Tax on total income of Rs.10.43 lakhs	3,65,050
Add: Surcharge @ 2.5%	9,126
	3,74,176
Add: Education cess @ 2%	7,484
Tax on total income	3,81,660

Computation of tax as per section 115JB

Net profit as per profit and loss account	9,00,000
<i>Less:</i> Business loss of Rs.2 lakhs, since it is lower than the unabsorbed depreciation of Rs.12.50 lakhs	2,00,000
Book Profit	7,00,000
7.5% of book profit	52,500
Add: Surcharge @ 2.5%	1,313
	53,813
Add: Education cess @ 2%	1,076
	54,889

Since the income-tax payable on the total income of the company computed under the Income-tax Act is not less than 7.5% of its book profit, section 115JB will not apply for A.Y.2005-06.

Notes:

1. As per *Explanation 1* to section 32(1), where an assessee carries on business or profession in a building which is not owned by him but in respect of which he holds a lease or other right of occupancy, depreciation is to be allowed on account of any capital expenditure incurred by the assessee on construction of any structure for improvement/renovation of the building as if the structure is a building owned by the assessee. Therefore, depreciation is allowable on the capital expenditure of Rs.10 lakhs incurred by XYZ Ltd. towards the cost of the new building put up after demolition of the old building.
2. The rate of depreciation on buildings is 10%. Since it is put to use for more than 182 days during the previous year 2004-05, full depreciation is allowable.
3. Payment of annual fees for technical services to a foreign collaborator is an allowable business expense and has been correctly charged to profit and loss account. Therefore, no adjustment is required.
4. Sales tax refund from the Government has to be treated as a revenue receipt. Since it has been correctly credited to profit and loss account, no adjustment is required.
5. Land development charges paid to SIDC on allotment of a commercial plot is a capital expenditure [*Jaswant Trading Co. v. CIT (1995) 212 ITR 293 (Raj)*]
6. Section 37(1) does not make any distinction between expenditure incurred in civil litigation and that incurred in criminal litigation. If the expenditure is *bona fide* incurred wholly and exclusively for the purpose of the business, it is allowable as deduction [*CIT v. Birla Cotton Spinning & Weaving Mills Ltd. (1971) 82 ITR 166 (SC)*]. Therefore, in this case, since legal expenses were incurred by the company for defending the Director in a criminal case filed against him in his official capacity, it is allowable as deduction.
7. Fees paid to Registrar of Companies for enhancement of authorised capital is a capital expenditure and not deductible under section 37(1) [*Punjab State Industrial Development Corporation Ltd. v. CIT 225 ITR 792 (SC)*].
8. Since no tax has been deducted at source on payment of interest to non-residents, interest paid will not be allowed as a deduction as per section 40(a)(i).
9. Interest paid to bank on overdraft for payment of income-tax dues is not an expenditure incurred wholly and exclusively for the purpose of business and is hence, not deductible under section 37(1) as per the Supreme Court's decision in *East India Pharmaceutical Works Ltd. v. CIT (1997) 224 ITR 627*.
10. The under valuation of both opening and closing stocks will have an impact on the profits for the year and accordingly, the difference in valuation of stock has to be credited to profit and loss account to the extent of 10% of cost.
11. Value of investment written down is on capital account and hence not allowed, even if such write down was on a directive from the Government.

Question 2

- (a) Can penalty under section 271(1)(c) of the Income-tax Act for concealment of income or particulars thereof be imposed on “intangible” additions to income made by the Assessing Officer.

Can these additions be utilised by the assessee to explain investments made in the subsequent years?

Is there any time limit for initiation of penalty proceedings in such cases? Discuss.

(5 Marks)

- (b) State the cases where the benefit of indexation of costs is not available for determination of capital gains.

(5 Marks)

- (c) A charitable trust, whose income can be exempt under section 11 of the Income-tax Act, was formed on 1st March, 2004. For the accounting year ended 31st March, 2005, it earned an income of Rs.60,000.

It filed with the Commissioner of Income-tax its application for registration on 30th March, 2005 explaining that for good and sufficient reasons, it was prevented from filing the application by the due date.

State:

- (i) *by which date the application for registration should have been filed;*
- (ii) *whether such an application could have been filed before the formation of the trust;*
- (iii) *in the absence of an order of registration from the Commissioner, can the trust be deemed to be registered;*
- (iv) *the steps to be taken by the trust to secure exemption from income-tax;*
- (v) *whether a certificate of registration once granted can be cancelled and if so, the conditions therefor.*

(5 Marks)

Answer

- (a) In many cases, the Assessing Officer makes additions to the returned income purely on account of certain technical reasons. For example, he calculates the total income of the assessee by assuming a certain rate of gross profit or yield, or he disallows a portion of certain expenses on estimated basis. These are called intangible additions. The Supreme Court, in *Anantharam Veerasighaiah and Co. v. CIT (1980) 123 ITR 457* observed that the secret profits or undisclosed income of an assessee earned in an earlier assessment year, commonly described as intangible additions, are also the real income of the assessee. Therefore, the assessee can explain the unexplained investment etc. of the current year to have been met out of intangible additions made in the past.

Explanation 2 to section 271(1) enables the Assessing Officer to initiate penalty proceedings in respect of intangible additions made in the past which are claimed by the

assessee to be a source of any receipt, deposit or outgoing or investment in any subsequent year. The penalty proceedings shall be initiated for the assessment year in which such intangible additions were made and shall be leviable only on such intangible additions made in the past years which have been claimed to be a source of receipt, deposit, outgoing or investment of the subsequent year.

According to section 271(1A), where any penalty is imposable by virtue of *Explanation 2* to section 271(1), the proceedings for imposition of such penalty may be initiated at any time, even if assessment proceedings in the course of which such penalty could have been initiated have been completed.

(b) In the following cases, the benefit of indexation is not available for determination of capital gains on transfer of long-term capital assets –

1. Transfer of bonds/debentures other than capital indexed bonds issued by the Government (*Proviso 3* to section 48).
2. Transfer of shares or debentures acquired by a non-resident in foreign currency in an Indian company (*Proviso 1 and 2* to section 48).
3. Transfer of undertaking or division in a slump sale (Section 50B)
4. Transfer of units of Unit Trust of India or a Mutual Fund specified under section 10(23D) purchased in foreign currency by an overseas financial organisation referred to as offshore funds (Section 115AB)
5. Transfer of Global Depository Receipt purchased in foreign currency by an individual resident in India and employee of an Indian company or its subsidiary engaged in specified knowledge based industry or service (Section 115ACA).
6. Transfer of securities by Foreign Institutional Investors (Section 115AD).
7. Transfer of a foreign exchange asset by a non-resident Indian (Section 115D)

Further, indexation benefit is not available on capital gains arising on transfer of a depreciable asset since such capital gains would always be short-term capital gains.

(c) (i) The person in receipt of income of the trust should make an application for registration in the prescribed form and in the prescribed manner to the Commissioner of Income-tax before the expiry of a period of 1 year from the date of creation of the trust.

The last date for making an application for registration in this case is, therefore, 28th February, 2005.

The Commissioner may, however, condone the delay if he is satisfied, for reasons to be recorded in writing, that the person in receipt of income was prevented for sufficient reasons from making the application before the expiry of one year from the date of creation of trust.

(ii) No. The application for registration u/s 12A cannot be filed before the formation of the trust.

- (iii) As per section 12AA(2), every order granting or refusing registration should be passed before the expiry of 6 months from the end of the month in which the application was received under section 12A. However, the Act does not provide for deeming registration of a trust in the absence of an order of registration from the Commissioner.
- (iv) The following are the steps to be taken by the trust to secure exemption from income-tax -
 - (1) The trust should be registered with the Commissioner of Income-tax under section 12A.
 - (2) The accounts of the trust for the previous year must be audited by a Chartered Accountant if its total income exceeds Rs.50,000, without giving effect to the provisions of section 11 and section 12. The audit report in the prescribed form, duly signed and verified by the Chartered Accountant, should be furnished along with the return of income of the trust for the relevant assessment year.
 - (3) At least 85% of the income is required to be applied for the approved purposes.
 - (4) The unapplied income and the money accumulated or set apart should be invested or deposited in the specified forms or modes.
- (v) Yes, the certificate of registration can be cancelled by the Commissioner. According to section 12AA, if the Commissioner is satisfied that the activities of the trust are not genuine or are not being carried out in accordance with the objects of the trust, he shall, after giving the trust a reasonable opportunity of being heard, pass an order in writing canceling the registration of the trust.

Question 3

- (a) *Tarun Shipping Co. Ltd., having its registered office in Mumbai, plies two ocean-going vessels which it owns. The registered tonnage of the two vessels are 47,549 tonnes and 800 kgs and 25,759 tonnes and 400 kgs respectively. In the accounting year 2004-05, the first vessel was operated for 360 days and the second for 199 days.*

The accounts of the company reveal the following results :

- | | |
|--|----------------|
| (i) Profit from core shipping activity | Rs.60.50 lakhs |
| (ii) Profit from incidental activity | Rs.15,000 |

the tax payable by the company for the assessment year 2005-06, taking note of the new provisions of the law relating to taxation of income of shipping companies. Also indicate the specified conditions for the applicability of the new procedure. (6 Marks)

- (b) *M, an individual, was carrying on a business as sole proprietor. On his death, his legal heirs decide to continue the same business by forming a firm.*

At the time of death, M had a determined business loss of Rs.2 lakhs, under the

provisions of the Income-tax Act, to be carried forward.

Does the firm, consisting of all the legal heirs of M, get a right to have this loss adjusted against its current income? Discuss. (4 Marks)

- (c) X Ltd., is a company engaged in the business of growing, manufacturing and selling of tea.

For the accounting year ended 31st March, 2005, its composite business profits, before an adjustment under section 33AB of the Income-tax Act, were Rs.60 lakhs. In the year, it deposited Rs.25 lakhs with NABARD.

The company has a business loss of Rs.10 lakhs brought forward from the previous year.

The company withdrew in February, 2005 Rs.20 lakhs from the deposit account to buy a non-depreciable asset for Rs.18 lakhs and could not use the balance before the end of the accounting year. The withdrawal and the purchase were under a scheme approved by the Tea Board.

The non-depreciable asset was sold in November, 2005 for Rs.29 lakhs.

Indicate clearly the tax consequences of the above transactions and the total income for the relevant years. (5 Marks)

Answer

- (a) Computation of tax payable by Tarun Shipping Company Ltd. for the A.Y.2005-06

Particulars	Rs.	Rs.
Taxable income (See Working Note below)		59,35,040
Tax @ 35%		20,77,264
Add: Surcharge @ 2.5%		51,932
		21,29,196
Add: Education cess @ 2%		42,584
Total tax payable		21,71,780

Working Note – Computation of Tonnage Income [Section 115VG]

Particulars	Ship I Rs.	Ship 2 Rs.
First 1,000 tons (1000 x 46/100)	460	460
Next 9,000 tons (9,000 x 35/100)	3,150	3,150
Next 15,000 tons (15,000 x 28/100)	4,200	4,200
Balance [(22,500/800) x 19/100]	4,275	152
	12,085	7,962

Tonnage income -

Ship 1 (12,085 × 360)	43,50,600
Ship 2 (7,962 × 199)	15,84,438
	59,35,038
Taxable income (rounded off)	59,35,040

Note: Tonnage is to be rounded off to the nearest multiple of 100 tons. Hence, the first vessel will pay for 47,500 tons and the second for 25,800 tons.

As per section 115VF, the tonnage income computed under section 115VG would be deemed to be the profits chargeable under the head "Profits and gains of business or profession". This is, however, subject to fulfillment of the conditions mentioned below in the next paragraph. Then, the relevant shipping income referred to in section 115-VI(1), which includes the profit from core shipping activity (i.e. Rs.60.50 lakhs) and the profit from incidental activity (Rs.15,000), shall not be chargeable to tax.

The following are the conditions to be fulfilled by the company for applicability of the tonnage tax scheme -

- (i) An option to get assessed under Chapter XII-G has to be filed by the company.
 - (ii) The company is required to credit to a reserve account called Tonnage Tax Reserve Account, at least 20% of the book profits derived from its core and incidental activities to be utilized before the expiry of a period of 8 years for acquisition of a new ship for the purposes of the business of the company. Until the acquisition of a new ship, the amount can be utilized for the purposes of the business of operating qualifying ships. However, the amount should not be used for distribution of dividends or profits or for remittance outside India as profit or for creation of assets outside India.
- (b) Section 78(2) provides that where a person carrying on any business or profession has been succeeded in such capacity by another person, otherwise than by inheritance, then the successor is not entitled to carry forward and set-off the loss of the predecessor against his income. This implies that the only exception is when the business passes on to another by inheritance.

The Apex Court, in *CIT v. Madhukant M. Mehta (2001) 247 ITR 805*, has held that where the business is succeeded by inheritance, the legal heirs are entitled to the benefit of carry forward of the loss of the predecessor. Even if the legal heirs constitute themselves as a partnership firm, the benefit of carry forward and set off of the loss of the predecessor should be made available to the firm.

In this case, the business of M was continued by his legal heirs after his death by constituting a firm. Hence, the exception given in section 78(2) along with the decision of the Apex Court discussed above apply in this case. Therefore, the firm is entitled to carry forward the business loss of Rs.2 lakhs of M.

(c) (i) **Computation of total income of X Ltd. for A.Y.2005-06**

Particulars	Rs.
Composite profits before allowing deduction under section 33AB	60,00,000
Less: Deduction u/s 33AB	
[Lower of 40% of Rs.60 lakhs (i.e. Rs.24 lakhs) or the actual amount deposited with NABARD (i.e. Rs.25 lakhs)]	24,00,000
	<u>36,00,000</u>
As per Rule 8 of Income-tax Rules, 40% of this sum is subject to income-tax and the balance 60% is treated as agricultural income. Hence, the business income is 40% of Rs.36 lakhs	14,40,000
Add: Non-utilisation of amount withdrawn: Rs.2 lakhs [i.e.(Rs.20 lakhs – Rs.18 lakhs)]	
40% is taxable as business income (the balance 60% is treated as agricultural income).	80,000
Business income	<u>15,20,000</u>
Less: Business loss brought forward from the previous year	<u>10,00,000</u>
Total income	<u>5,20,000</u>

(ii) **Computation of total income of X Ltd. for A.Y.2006-07**

Particulars	Rs.
Business income (See Note 2)	7,20,000
Capital gains (Short-term) (See Note 1)	11,00,000
Total Income	<u>18,20,000</u>

Note 1 - Computation of capital gains

Particulars	Rs.
Sale proceeds	29,00,000
Less: Cost of acquisition	<u>18,00,000</u>
Short term capital gains (since the period of holding is less than 36 months)	<u>11,00,000</u>

Note 2 - Computation of business income

Since the asset is sold within 8 years, the cost of the asset i.e. Rs. 18 lakhs should be treated as income since the same has been allowed as deduction in the F.Y.2004-05.

However, out of this Rs.18 lakhs, 60% would be agricultural income and the balance 40% i.e. Rs.7.2 lakhs would be business income of P.Y.2005-06. This is because deduction under section 33AB was allowed in P.Y.2004-05 before disintegration of income into agricultural income and non-agricultural income.

Question 4

- (a) *T and Q are individuals, who constitute an Association of persons, sharing profit and losses in the ratio of 2:1. For the accounting year ended 31st March, 2005, the Profit and Loss account of the business was as under:*

		Figures are in Rs. '000s	
Cost of goods sold	4,250	Sales	4,900
Remuneration to:		Dividend from companies	25
T	130	Capital gains -	
Q	170	Long-term	640
Employees	256		
Interest to:			
T	48.3		
Q	35.7		
Other expenses	111.7		
Sales-tax penalty due	39		
Net profit	524.3		
	5,565		5,565

Additional information furnished :

- (i) *Other expenses included :*
- entertainment expenses of Rs.35,000;*
 - wristwatches costing Rs.2,500 each were given to 12 dealers, who had exceeded the sales quota prescribed under a sales promotion scheme;*
 - employer's contribution of Rs.6,000 to the Provident Fund was paid on 14th January, 2005.*
 - Rs.30,000 was paid in cash to an advertising agency for publicity.*

- (ii) Outstanding sales tax penalty was paid on 15th October, 2005. The penalty was imposed by the Sales-tax Officer for non-filing of returns and statements by the due dates.

T and Q had, for this year, income from other sources of Rs.94,000 and Rs.32,000 respectively.

Required to :

- (i) Compute the total income of the AOP for the assessment year 2005-06;
 (ii) Ascertain the tax liability of the Association for that year; and
 (iii) Ascertain the tax liability for that year of the individual members. (8 Marks)
- (b) M, an individual, is 70 years of age. He is a sitting member of the State Assembly of Karnataka and for the financial year 2004-05 received the following amounts from the Assembly Secretariat :

- (i) Basic pay Rs.3,000 p.m.
 (ii) Constituency allowance Rs.8,000 p.m.
 (iii) Telephone allowance Rs.4,000 p.m.
 (iv) Electricity allowance Rs.3,000 p.m. [from June, 2004 onwards]

He owns a house in Delhi which has been let out at Rs.5,000 p.m. He received rent for 10 months only, the house having remained vacant for two months. Municipal taxes of Rs.1,200 were paid by the tenant. Interest of Rs.14,000 was paid by M on the amount borrowed by him to buy the house.

M has an agricultural income of Rs.55,000.

Compute his tax liability for the relevant assessment year. (7 Marks)

Answer

- (a) (i) **Computation of total income of the AOP for A.Y.2005-06**

Particulars	Rs.	Rs.
Profit & gains of business (See Working Note below)		2,88,300
Long term capital gain		6,40,000
Income from other sources[Dividend is exempt u/s 10(34), assuming that it is received from domestic companies]		-
Total income		9,28,300

Working Note -

Computation of profits and gains of business

Net profit as per profit & loss account	5,24,300
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Add: Inadmissible payments

Interest to members T & Q (Rs.48,300 + Rs.35,700)	84,000	
Advertising [Disallowance u/s 40A(3) (20% of Rs.30,000 being a cash payment)]	6,000	
Remuneration to members T & Q (Rs.1,30,000 + Rs.1,70,000)	3,00,000	
Sales tax penalty due (See Note 3 below)	39,000	4,29,000
		9,53,300

Less: Income not taxable under this head

Dividend from companies	25,000	
Long term capital gain	6,40,000	6,65,000

Profits and gains of business **2,88,300**

(ii) Computation of tax liability of the AOP for A.Y.2005-06

Particulars	Rs.	Rs.
Long-term capital gain (Rs.6,40,000@20%)		1,28,000
Other income (Rs.2,88,300@30%)		86,490
Tax on total income		2,14,490
Add: Surcharge @10%		21,449
		2,35,939
Add: Education cess @2%		4,719
Total tax due		2,40,658

Notes –

- Since one of the members has individual income more than the basic exemption limit, the AOP will be assessed at the maximum marginal rate. The maximum marginal rate includes the surcharge applicable in relation to the highest slab of income in case of an individual and as such surcharge shall be chargeable at the rate of 10%.
Since the AOP is taxed at maximum marginal rate, share income of the members are not taxable in their hands individually.
- Since the employer's contribution to PF has been paid during the previous year 2004-05 itself, it is allowable as deduction.
- Penalty imposed for delay in filing sales tax return is not deductible since it is on account of infraction of the law requiring filing of the return within the

specified period. – *CIT v. Ratanchand Bholanath (S.S) (1986) 160 ITR 500 (M.P.)*

(iii) **Computation of tax liability of members T & Q for the A.Y.2005-06**

	T.		Q
Tax on Rs.94,000	Rs.7,800	Tax on Rs.32,000	Nil
Less: Rebate u/s 88D	<u>Rs.7,800</u>		
Net tax payable	<u>Nil</u>		

Note – While calculating tax liability of member T, rebate under section 88D has to be allowed since his total income does not exceed Rs.1 lakh. Section 88D provides a rebate of the entire amount of income-tax payable by a resident individual having total income not exceeding Rs.1 lakh. It is logical to assume that T is a resident.

(b) **Computation of total income of Mr.M for A.Y.2005-06**

Particulars	Rs.	Rs.
Income from house property		
Gross Annual Value (GAV) [See Note 1 below]	50,000	
Municipal taxes (not allowed since it is borne by tenant)	-	
Net annual value (NAV)	50,000	
Less: Deduction u/s 24		
(a) 30% of NAV	15,000	
(b) Interest on borrowed capital	<u>14,000</u>	
	29,000	21,000
Income from Other Sources [See Note 2 below]		
Basic Pay	36,000	
Constituency allowance (Rs.8,000 x 12)	96,000	
Electricity allowance (Rs.3,000 x 10)	30,000	
Telephone allowance (Rs.4,000 x 12)	48,000	
	<u>1,74,000</u>	
Less: Exempt u/s 10(17)[Rs.2000 p.m.]	24,000	1,50,000
Total Income		<u>2,07,000</u>

Note – 1. In the absence of other information, rent received has been taken as the Gross Annual Value.

2. The pay and allowances of a member of the State Assembly would be taxable under the head "Income from other sources", since there is no employer-employee relationship in this case.

Computation of tax liability of Mr. M for A.Y. 2005-06

Particulars	Rs.	Rs.
Tax on agricultural income plus non-agricultural income i.e. on Rs.2,62,000 (being Rs.55,000 + Rs.2,07,000)	52,600	
Less: Tax on agricultural income plus basic exemption limit i.e. on Rs.1,05,000 (being Rs.55,000 + Rs.50,000)	10,000	
Tax on non-agricultural income		42,600
Less: Rebate under section 88B (tax payable subject to a maximum of Rs.20,000)		20,000
Tax Payable		22,600
Add: Education cess @2%		452
Total tax payable		23,052

Question 5

- (a) 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 CEGAT and where the matter has been taken up in further appeal to the Court by the Central Excise Department. (4 Marks)
- (b) Does the Settlement Commission have the power to reduce or waive interest levied under sections 234A, 234B and 234C of the Income-tax Act? Discuss. (6 Marks)
- (c) In the course of search operations under section 132, a tax payer makes a declaration under section 132(4) on the earning of income not disclosed. Can that State save the tax payer from a levy of penalty under section 271(1)(c)? (4 Marks)

Answer

- (a) 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 an 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 a 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 CEGAT 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.

- (b) The Supreme Court in the case of *CIT v Anjum M H Ghaswala [2001] 252 ITR 1* has held that the Settlement Commission, while passing the final order under section 245D, does not have the power to reduce or waive interest statutorily payable under sections 234A, 234B and 234C except to the extent of granting relief in accordance with the norms laid down in the circulars issued by the CBDT under section 119, eg. Circular/Order No.400/234/95-IT(B) dated 23rd May, 1996. While the Settlement Commission arrives at the taxable income of the assessee on the basis of the records available before it, it has to levy the mandatorily chargeable tax and wherever interest is due under mandatory provisions like sections 234A, 234B and 234C, it has to include that interest also in the settlement.

Under Circular/Order no. 400/234/95-IT(B), dated 23rd May, 1996, the Board has empowered the Chief Commissioner and the Director-General to waive or reduce interest chargeable under sections 234A, 234B and 234C in the class of cases or class of incomes specified therein for the period and on conditions enumerated therein. Since this is a beneficial circular, the benefit can also be conferred on those assesseees who approach the Settlement Commission under section 245C on such terms and conditions as are specified in the circular. Section 245F empowers the Settlement Commission to exercise the powers of an income-tax authority. While exercising the power under this circular, the Settlement Commission will be enforcing the relaxed provisions for the benefit of the assessee in the process of settlement.

Thus, the Settlement Commission can waive/reduce the interest leviable under sections 234A, 234B or 234C only to the extent it can be waived by the Chief Commissioner/Director General as permitted by such circular.

- (c) As per *Explanation 5* to section 271(1)(c), the assessee shall not be deemed to have concealed income where, in the course of search under section 132, he makes a statement under section 132(4) that any money, bullion, jewellery or other valuable article or thing found in his possession or under his control, has been acquired out of his income which has not been disclosed so far in his return of income to be furnished before the expiry of the time specified in section 139(1), and also specifies in the statement the manner in which such income has been derived and pays the tax, together with interest, if any, in respect of such income. In such a case, the State can save the tax payer from levy of penalty under section 271(1)(c).

Question 6

- (a) State whether the information regarding possession of unexplained assets and income received from the Central Bureau of Investigation, a Government agency, can constitute “information” for action under section 132 of the Act. Discuss. (5 Marks)

- (b) In the course of an assessment proceeding, the Assessing Officer enhanced the value of the closing stock and added the difference to the total income.

In the assessment year subsequent to this, the assessee wants the Assessing Officer to enhance, by the same amount, the value of the opening stock of that year.

Discuss the validity of the claim. (5 Marks)

- (c) A foreign company, ST, has entered into an agreement with an Indian Company KN for supply of know-how and the agreement is within the Industrial Policy conditions laid down by the Central Government. In the year 2004-05, Rs.50 lakhs is paid, under the agreement, to ST by KN.

ST claims to have spent Rs.14 lakhs as expenses in India to be recognized as a deduction.

In the following situations, what will be your decision on the tax liability of the parties:

- (i) The agreement having been entered into before 1st June, 2002 and approved by the Government, KN pays to the Indian income-tax authorities the tax payable by ST;
- (ii) There is no agreement as to KN bearing the tax liability; the royalty payable is decided to be Rs.59 lakhs net of taxes. (5 Marks)

Answer

- (a) As per section 132(1)(c), authorization for search and seizure can take place if the authority, in consequence of *information in his possession*, has *reason to believe* that any person is in possession of money, bullion, jewellery or other valuable article or thing and these assets represent, either wholly or partly, income or property which has not been, or would not be disclosed by such person for the purposes of this Act. In the absence of such information, a search cannot be validly authorized.

The Apex Court in *UOI v Ajit Jain [2003] 260 ITR 80* has held that mere intimation by the CBI that money was found in the possession of the assessee, which according to the CBI was undisclosed, without something more, does not constitute “information” within the meaning of section 132, on the basis of which a search warrant could be issued. Consequently, the Supreme Court held that the search conducted on this basis and the block assessment made pursuant to such search was not valid.

- (b) The Supreme Court, in *Mahendra Mills Ltd.v PB Desai, AAC [1975] 099 ITR 135*, has held that since the closing stock of one assessment year furnishes the figure of the opening stock for the succeeding year, therefore, to the extent of ascertaining the closing stock and opening stock positions, the assessments for the two years telescope into each other. The record showing the closing stock of one assessment year formed a part of the evidence relevant to the assessment for the next assessment year. Therefore, the

value of the closing stock of the preceding year must be the value of the opening stock of the succeeding year. Hence, if the value of closing stock at the end of a year is enhanced, the enhanced value should be taken as the value of the opening stock of the next year for the purpose of income tax.

The claim of the assessee in this case is, therefore, valid.

- (c) (i) As per section 10(6A), in the case of a foreign company deriving income by way of royalty or fees for technical services from the Government or an Indian concern under the terms of an agreement entered into before 1.6.2002 relating to a matter included in the industrial policy of the Central Government, the tax paid by the Government or an Indian concern on such income would not be included in the total income of the foreign company. Hence, such tax paid would be exempt in the hands of the foreign company.

Therefore, in the present problem, in the first case, the tax paid by KN will be exempt from tax in the hands of ST. In this case, section 195A is not applicable and consequently, the royalty of Rs.50 lakhs should not be grossed up. As per section 44D, where a foreign company receives income by way of royalty from an Indian concern in pursuance of an agreement made on or after 1st April, 1976 but before 1st April, 2003, no deduction is allowable in respect of any expense or allowance under sections 28 to 44C in computing such income.

Total income of ST is	50,00,000
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Tax payable @ 20.91% (See Note below)

(20% + surcharge@2.5% + education cess@2%)	10,45,500
Less: Tax liability of ST paid by KN	<u>10,45,500</u>
Net tax payable	<u>Nil</u>

Note – The rate of tax is 20% as per section 115A(1)(b)(A), since the royalty is received in pursuance of an agreement made after 31.5.1997 but before 1.6.2005.

- (ii) In the second case, since there is no agreement as to KN bearing the tax liability, the benefit under section 10(6A) is not available. However, KN has to deduct tax at source on royalty payment to ST, a foreign company, as per section 195. Since in this case, KN has to pay the royalty of Rs.59 lakhs 'net of taxes' to ST, therefore, the royalty has to be grossed up.

The tax liability of ST has to be computed as under:

Net royalty income	59,00,000
Gross royalty income (59,00,000 x 100/79.09)	74,59,856
Tax on royalty of 74,59,856 @ 20.91 %	15,59,856

KN has to deduct this tax of Rs.15,59,856 at source under section 195.

Question 7

New Era Construction Ltd. furnishes the following particulars of its wealth for the valuation date of 31st March, 2005. Compute its net wealth and the wealth tax payable by it for the Assessment Year 2005-06:

	Rs.	Rs.
<i>Land in rural area (within 5 kms of Aligarh – purchased in 1990, construction on which is permissible) (Rs.90 lakhs)</i>		90,00,000
<i>Land in urban area (for construction of Mall)</i>		20,00,000
<i>Land in urban area (held as stock-in-trade since 1990)</i>		50,00,000
<i>Motor car (including one imported car worth Rs.6 lakhs)</i>		11,00,000
<i>Jewellery (held as stock-in-trade)</i>		18,00,000
<i>Aircraft for use of directors and auditors</i>		1,58,00,000
<i>Bank balance</i>		5,00,000
<i>Cash in hand as per cash book</i>		2,70,000
<i>Guest house and land appurtenant thereto in rural area</i>		8,00,000
<i>Residential flats of identical size provided to six employees for their use near factory in rural areas (salaries of two such employees exceed Rs.5,00,000 p.a.)</i>		15,00,000
<i>Residence provided to managing director (salary exceeds Rs.5,00,000 p.a.)</i>		10,00,000
<i>Flats constructed remaining unsold (not held as stock)</i>		30,00,000
<i>Residence provided to whole time director (salary Rs.15,000 p.m.)</i>		17,00,000
<i>The company has taken the following loans :</i>		
<i>(a) for purchase of jewellery</i>	6,00,000	
<i>(b) for purchase of aircraft</i>	7,00,000	
<i>(c) for flats constructed remaining unsold</i>	2,00,000	
<i>(d) for residence provided to whole time director</i>	90,000	

(10 Marks)

Answer

Computation of net wealth and wealth-tax payable by New Era Construction Ltd. for the A.Y.2005-06

Particulars	Rs.	Rs.
1. Land in rural area within 5 kms. of Aligarh (within the prescribed limit)		90,00,000

2.	Land in urban area (for construction of mall) [It has been assumed that the land has not been held as stock-in-trade]	20,00,000
3.	Land in urban area (held for more than 10 years as stock in trade – hence taxable)	50,00,000
4.	Motor car (including imported car)	11,00,000
5.	Jewellery (held as stock in trade – hence, not taxable)	Nil
6.	Aircraft for use of directors and auditors	1,58,00,000
7.	Bank balance - not an asset under section 2(ea)	Nil
8.	Cash in hand as per cash book - not an asset as per section 2(ea)	Nil
9.	Guest house in rural area	8,00,000
10.	(a) Four residential flats given to employees, whose salary does not exceed Rs.5,00,000 p.a. - exempt	Nil
	(b) Two residential flats given to employees, whose salary exceed Rs.5,00,000 p.a. - taxable	5,00,000
11.	Residential house given to Managing Director whose salary exceeds Rs.5,00,000 p.a.	10,00,000
12.	Unsold flats	30,00,000
13.	Residence given to whole time director (not taxable, since salary does not exceed Rs.5,00,000 p.a.)	Nil

Gross Wealth	3,82,00,000
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Less: Debts

1.	Loan for purchasing jewellery – Not deductible since jewellery held as stock in trade is exempt from wealth-tax	Nil
2.	Loan for purchasing aircraft	7,00,000
3.	Loan for flats constructed remaining unsold	2,00,000
4.	Loan for residential house provided to the whole time director – not deductible as the house is exempt from wealth-tax	Nil
		9,00,000

Net Wealth	3,73,00,000
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Computation of wealth tax payable for A.Y.2005-06

On Net Wealth up to Rs.15,00,000	-
On the balance wealth of Rs.3,58,00,000 @ 1%	3,58,000
Wealth Tax Liability	3,58,000