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SUBJECT- DIRECT TAX

Test Code – FNJ 7301

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ANSWER : 1

1. C
2. C
3. D
4. D
5. A
6. C
7. C
8. D
9. B
10. B
11. A
12. C
13. D
14. C
15. D
16. D
17. D
18. A
19. B
20. C

ANSWER : 1

Computation of Total Income of M/s. Popular Cine Vision for the A.Y. 2019 – 20

Particulars	Amount	Amount
	(Rs.)	(Rs.)
Profits and Gains from Business or Profession		
Net Profit as per Profit & Loss A/c.		10,00,000
Add: Expenses disallowed or considered separately :		
Interest to partners in excess of 12% (Note 1)	3,00,000	
Disallowance under section 40A(3A) for aggregate cash payment exceeding Rs. 10,000 (FA 2017) in a single day (Note 5)	33,000	
Provision for gratuity (Note 8)	4,50,000	
Partners' Remuneration	30,00,000	
Royalty paid to Partner X (Note 4)	5,00,000	42,83,000
		52,83,000
Less : Interest on income – tax refund (Note 9)		1,20,000
Book Profit		51,63,000

Less : Partners' remuneration allowable under section 40(b)(v)			
(i) As per limit prescribed in section 40(b)			
On first Rs. 3,00,000	90%	2,70,000	
On the balance Rs. 48,63,000	60%	29,17,800	
		31,87,800	
(ii) Remuneration actually paid or payable			
(Rs. 1,00,000 × 10 months × 3 partners) + (Royalty Rs. 5 Lakhs)		35,00,000	
(i) or (ii) whichever is less, is deductible			31,87,800
			19,75,200
Capital Gain			
Short – term capital gain on transfer of land (Note 10)			6,00,000
Income from other sources			
Interest on income – tax refund			1,20,000
Gross Total income			26,95,200
Deductions under Chapter VI – A			NIL
Total Income			26,95,200

Notes :

- As per section 40(b), simple interest at 12% p.a. to partners relating to the period after the date of partnership deed is allowable. Excess interest @ 3% paid from 1st June, 2017 to 31st March, 2018 is to be disallowed. Excess interest of 3% being Rs. 15,00,000 × 3/15 = Rs. 3,00,000.
- Even though Z is a partner in a representative capacity, he is still a partner, Therefore, remuneration to Z should also be subject to the limits prescribed in section 40(b). This view finds support from the decision of the Supreme Court in the case of Rashik Lal & Co. v CIT (198) (SC).
- As per Explanation 1 to section 40(b), where an individual is a partner in a firm in representative capacity, the provisions of section 40(b), shall not apply to any interest payable by the firm to such individual in his personal capacity. Z represents his HUF in the firm. However, Z gave the loan in his individual capacity. Hence, assuming that the provisions of section 40A(2) do not get attracted in this case, such interest shall be allowed as deduction in full even though the interest rate is more than 12% p.a.
- It may be noted that the limits specified under section 40(b)(v) are applicable in case of payment of salary, bonus, commission, or remuneration, by whatever name called, to a working partner. From a plain reading of the section, it is clear that any remuneration, by whatever name called, paid to a working partner, is subject to the limits laid down in section 40(b)(v). Therefore, the royalty of Rs. 5 Lakhs paid to partner X would also be subject to the limits laid down in section 40(b)(v). Hence, the same has to be added back for computing book profits.

5. Section 40A(3A) provides for disallowance of any expenditure which was allowed in the earlier year and the actual payment was made subsequently and where the aggregate payment so made is otherwise than by an account payee cheque or account payee bank draft in a single day to a person exceeding a sum of Rs. 10,000 **(FA 2017)**. Hence, the payments of Rs. 18,000 and Rs. 15,000 in cash on 1.2.2018 to Altaf, a hairdresser, shall be disallowed, since the aggregate payment of Rs. 33,000 exceeds the limit of Rs. 10,000 **(FA 2017)**.
6. The payment of bill of the assistant cameraman of Rs. 9,000 and Rs. 10,000 respectively on 1st February and 2nd February is not liable for disallowance under section 40A(3) since the aggregate payment in cash on a single day has not exceeded Rs. 10,000 (FA 2017).
7. As per section 40(a)(i), any sum payable to a non – resident shall not be allowed as deduction, if tax has not been deducted at source or after deduction, has not been paid on or before the due date specified under section 139(1). Tax deducted from the amount of remuneration credited to payee’s account on 31st March 2019 has to be deposited latest by 31st July 2019/30th September, 2019 (as the case may be). The firm has paid the tax on 3rd June, 2019 and hence, the remuneration shall be allowed. Since the same is already debited to profit and loss account, no further adjustment is made.
8. As per section 40A(7), any provision made for payment of gratuity to employees on their retirement or on termination of employment for any reason is disallowed. However, gratuity of Rs. 1.50 lakhs paid to retired employees is allowable as deduction. Hence, the balance provision of Rs. 4.50 lakhs (i.e., Rs. 6 lakhs – Rs. 1.50 lakhs) is to be disallowed.
9. Interest on income – tax refund is assessable under the head “Income from other sources”.
10. Distribution of a capital asset by a firm to its partner on dissolution or otherwise attracts capital gains tax liability as per the provisions of section 45(4) and the fair market value of the asset on the date of transfer is deemed to be the full value of consideration received or accruing as a result of the transfer. The words “or otherwise” includes within its scope, cases of distribution of capital assets on retirement of a partner also. Therefore, distribution of a plot of land on retirement of a partner would attract section 45(4).
11. Rs. 16 lakhs, being the fair market value of the plot on the date of transfer, is deemed to be the full value of consideration. Therefore, the capital gain would be Rs. 6 lakhs (i.e., Rs. 16 lakhs – Rs. 10 lakhs).

(14 MARKS)

ANSWER : 2

(A)

Particulars	Amount	Amount
(1) IFHP	£	
Rental Income (£ 12,500 p.m. × 12)	1,50,000	
(-) Municipal taxes paid	(10,000)	
NAV	1,40,000	
(-) Standard deduction @ 30%	(42,000)	
(-) Interest on borrowed capital	(13,000)	51,00,000
IFHP	85,000	
X TT Buying Rate on last day of PY	60	
(2) PGBP		
Indian business		

Gross receipts	Rs. 1.75 cr	
(-) Expenditure	(Rs. 1.25 cr)	
	Rs. 50,00,000	
UK Business		
Gross receipts	£ 30,000	
(-) Expenditure	(£12,500)	
	£ 17,500	
X TT buying rate	60	
	Rs. 10,50,000	60,50,000
(3) Dividend		
£ 2,500 × Rs. 62 (TTBR as on last day of previous month in which dividend is declared)		1,550,000
Total Income		1,13,05,000
Tax Liability		
Rs. 0 – Rs. 3 Lakh – Nil		
Rs. 3 Lakh – Rs. 5 Lakh – 5%	10,000	
Rs. 5 Lakh – Rs. 10 Lakh – 20%	1,00,000	
> Rs. 10 Lakh – 30%	30,91,500	32,01,500
Surcharge @ 15% as TI > Rs. 1 cr.		4,80,225
		36,81,725
Cess @ 4%		1,47,269
Tax liability		38,28,994
Average rate of tax (Rs. 38,28,994/1,13,05,000 * 100)		33.87%
Foreign Tax Credit u/s 90 r.w. Rule 128		
(a) Rental income - £ 85,000 × 20% × Rs. 62 (20% or 33.87% whichever is lower)	10,54,000	
(b) Business Income - £ 17,500 × 33.87 × Rs. 65 (40% or 33.87% whichever is lower)	3,85,275	
(c) Dividend Income - £ 2,500 × 10% × Rs. 62 (10% or 33.87% whichever is lower)	15,500	(14,54,775)
Note : Credit shall be determined by conversion of the currency of payment of foreign tax at the telegraphic transfer buying rate on the last day of the month immediately preceding the month in which such tax has been paid or deducted.		
Total tax liability		23,74,219

(10 MARKS)

- (B)** Section 44BBA says for computing profits and gains of the business of operation of aircraft in the case of non – residents a sum equal to 5% of the aggregate of the amounts specified in sub – section (2) shall be the profits and gains chargeable to tax under the head “Profits and gains of business or profession”. Sub – section (2) specifies the following amounts –

- (a) the amount paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India ; and
- (b) the amount received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

Keeping in view the provisions of section 44BBA, the income of Mr. Q chargeable to tax in India under the head “Profits and gains of business or profession” is worked out hereunder –

Particulars	Amount (Rs.)
Amount received in India on account of carriage of passengers from Chennai	2,00,00,000
Amount received in India on account of carriage of goods from Chennai	1,00,00,000
Amount received in India on account of carriage of passengers from Singapore	3,00,00,000
Amount received in Singapore on account of carriage of passengers from Chennai	1,00,00,000
	7,00,00,000

Income from Business under section 44BBA at 5% of Rs. 7,00,00,000 is Rs. 35,00,000, which is the income of Mr. Q chargeable to tax in India under the head “Profits and gains of business or profession” for the A.Y. 2019 – 20.

In case the assessee is a foreign company, say, Q Airlines (P) Ltd, the answer would be the same since section 44BBA does not distinguish corporate and non – corporate taxpayers who operate aircraft provided their residential status is that of non – resident.

(4 MARKS)

ANSWER : 3

(A) Computation of Capital Gains

Particulars	Amount (Rs. In Lakhs)	Amount (Rs. In Lakhs)
For Land : (11/06/2014 - 01/01/ 2019) – (Note 1) Full Value Consideration (assuming greater than stamp duty value U/s 50C)	15,00,000	
(-) Indexed Cost of Acquisition (10L × (280/220))	12,72,727	
(-) Indexed Cost of Improvement (Note 3)	NIL	
Long Term Capital Gain on Land (A)		2,27,273
For Building : (11/06/2014 – 01/01/ 2019) – (Note 1) full Value consideration (assuming greater than stamp duty value U/s 50C)	12,00,000	
(-) Indexed Cost of Acquisition (8L × (280/220))	10,18,182	
Long Term Capital Gain on Building (B)		1,81,818
Total Long Term Capital Gain (A + B)		4,09,091
(-) Exemption U/s 54 – (Note 4)		1,81,818
TAXABLE LONG TERM CAPITAL GAIN		2,27,273

Note :

- (i) The Madras High Court in S.K. Jeyashankar case has held the right to the property flows from the date of agreement. That the property was registered in another date & the possession was given on the later date, does not take away the fact that the right was created at the time of the agreement. Hence in the present case the capital asset under consideration is a long term in nature.
- (ii) In Dr. D.R. Ramachandra Rao, it was held that both land and building are distinct capital assets and hence capital gains are computed separately.
- (iii) The Allahabad High Court in Smt. Rama Rani Kala case has held that conversion of the right of the lessee from leasehold to freehold is only by way of improvement of her rights over the property which he /she has enjoyed. Accordingly in determining the period of holding, the date from original acquisition of asset being the lessee shall be considered. The question does not provide the cost of the improvement (i.e. for conversion) and hence not considered.
- (iv) The Delhi High court in Kamal Wahal's case has held that Section 54 does not require purchase of a new residential house property in the name of the assessee himself. The section only requires to purchase or construction of a new house property. Hence, property purchased in the name of his wife will qualify for the exemption U/s 54/54F.

(8 MARKS)**(B)**

**Determination of Gross Margin of Comparable
Uncontrolled transaction i.e., of SAK Ltd.**

Particulars	Amount in USD
Direct Cost (USD 100 × 8 hours × 15 days)	12,000
Indirect Cost (USD 200 × 8 hours × 15 days)	24,000
Total Direct and Indirect Cost	36,000
Billing per month	70,000
Gross Margin being gross profit	34,000
Gross Margin to cost (%) [34,000 × 100/36,000]	94.44%
Adjustment for functional difference on account of cost of warranty	
Total Direct and Indirect Cost	36,000
Add : Cost of Warranty [1% of direct cost of USD 12,000]	120
Total Cost	36,120
Billing per month	70,000
Margin after cost of warranty being profit margin [70,000 – 36,120]	33,880
Profit margin to cost (%) [after considering functional difference on account of cost of warranty [33,880 × 100/36,120]	93.80

Computation of Arm's Length Price by Applying Cost Plus Method

	ABC Inc (USD)
Direct cost (USD 100 × 9 hours × 15 days)	13,500
Indirect Cost (USD 200 × 9 hours × 15 days)	27,000
Total Direct and Indirect Cost	40,500

Add : Interest on loan of USD 1,00,000 borrowed for purchase of hardware [USD 3,000 (i.e., USD 1,00,000 @ 3%)/12]	250
Total Cost	40,750
Profit margin by applying the margin of 93.80% of total cost of USD 40,750	38,224
Arm's Length Price of billing per month	78,974
Arm's Length Price (in Rs.) (USD 78,974 × 64) = Rs. 50,54,336 Actual Billing per month	85,000

In the present case, since actual billing of USD 85,000 per month to the ABC Inc, an AE, is higher than the Arm's Length price of USD 78,974 determined by applying cost plus method, no adjustment is to be made to the income of Amar P Ltd.

(6 MARKS)

ANSWER : 4

- (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 employee Q which is not paid.

If salary has been paid during the year to Q, then, MNO Ltd has to obtain from Q, the evidence/ proof / particulars of prescribed claims (including claim for set – off of loss) under the provisions of the Act in such form and manner as may be prescribed.

If Q has not furnished any information about his income /loss under any other head or proof of investments /expenditure qualifying for deduction under section 80C, then, the employer has to deduct tax without considering any claim for any expenditure or set – off of losses or deduction under section 80C.

- (ii)** An individual who is liable for tax audit under section 44AB in the immediately preceding financial year is liable to deduct tax at source under section 194C for the financial year 2018 – 19 in respect of the payment made to contractor exceeding Rs. 30,000 in a single contract and Rs. 1,00,000 in aggregate of contracts during the financial year. Turnover of the individual T is Rs. 2.20 crores in the financial year 2017 – 18. Therefore, T is liable to get his account for that year audited under section 44AB. As the payment during financial year 2018 – 19 to the contractor has exceeded the limits prescribed in section 194C, tax has to be deducted under section 194C.
- (iii)** The limit of Rs. 30,000 for non – deduction of tax under section 194J would apply separately 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 fee for each category does not exceed Rs. 30,000 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. 30,000. 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.

(5 MARKS)

- (B)** If any expenditure is required by an assessee in any financial year in respect of which he is not able to offer explanation about the source of such expenditure or the explanation offered by him is not satisfactory in the opinion of the assessing officer, then the amount of

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

Therefore, in this case since the assessing officer is not satisfied with the explanation offered by Mr. Rajiv, the expenditure of Rs. 30 lakhs incurred by him in the financial year 2018-19 in hosting a grand cruise party may be deemed as his income for P.Y. 2018-19 as per section 69C.

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

Where the total income of Mr. Rajiv includes such unexplained expenditure of Rs. 30 lakh, which is deemed as his income under section 69C, such deemed income would be taxed at the rate of 60% as per section 115BBE plus surcharge @25% and cess @4%. The effective rate of tax would be 78%.

Further no basic exemption or allowance or expenditure shall be allowed to him under any provision of the Income Tax Act, 1961 in computing such deemed income. No set off of loss is permissible against such deemed income.

New section 271AAC has been inserted with effect from 1st April, 2018 in the Income Tax Act, 1961 to provide for levy of penalty @10% of tax payable under section 115BBE, in a case where income determined includes any income referred to in sections 68, 69A to 69D for any previous year. However, no such penalty would be levied on such income to the extent the same has been included by the assessee in return of income furnished under section 139 and tax in accordance with section 115BBE has been paid on or before the end of the relevant previous year.

(5 MARKS)

- (C)** MFN clause is present under protocols to some DTAA's. MFN clause is as follows :
"In respect of Articles 10 (Dividends), 11(interest) and 12 (royalties and fees for technical services) if under any Convention, Agreement or Protocol between India and a third State which is a member of the OECD, India limits its taxation at source on dividends, interest, royalties, or fees for technical services to a rate lower or a scope more restricted than the rate of scope provided for in this Convention on the said items of income, the same rate or scope as provided for in that Convention, Agreement or Protocol on the said items of income shall also apply under this Convention."

MFN clause is a provision in DTAA by which one State agrees to accord to the other State a treatment that is no less favorable than that which it accords to a third State.

India has an MFN clause with following countries – Sweden, Swiss Confederation, France, Israel, Philippines, Belgium, Netherlands, Kazakhstan, Hungary, Spain.

India – Sweden DTAA has no restrictive definition of FTS i.e. there is no make available clause present in the DTAA. Accordingly, whenever some technical service is provided by resident of Sweden to India it would get classified as FTS even though the resident of Sweden has not made available the know how to recipient in India. Under India – Portugal DTAA, FTS would be taxable in India only if service provider makes available his knowledge to the service recipient. However, India has inserted the MFN clause in the India – Sweden DTAA. Consequently, a resident of Sweden can invoke MFN clause and import the “make available condition” and get the same treatment as that given to resident of Portugal. The clause shall apply mutatis mutandis to resident of Sweden as to the resident of Portugal. That is to say, FTS would be taxable for resident of Sweden only if “make available” test is satisfied.

Thus, MFN clause can be used in a treaty signed between first and second state to import either restrictive definition or lower rate from the treaty signed between the first and third state.

(4 MARKS)

ANSWER : 5

(A)

Computation of gross total income of Ms. Janaki for A.Y. 2019 - 20

Particulars		Amounts (Rs.)	
Salaries :			
	Salary as computed		48,000
Income from House property :			
	- House 1 Income	37,000	
	- House 2 Loss	(27,000)	10,000
Profits and gains of business or profession			
(i)	Textile business loss	(20,000)	
(ii)	Chemical business – Bad debts recovered taxable u/s 41(4)	40,000	
	Less : Set off of brought forward Loss of P.Y. 2016 – 17 u/s 72	(25,000)	15,000
			(5,000)
(iii)	Leather business income	62,000	
(iv)	Interest on securities held as stock – in trade	10,000	72,000
		67,000	
	Less : b/f loss of business Rs. 80,000 restricted to Rs. 67,000 (Note I)	(67,000)	Nil
	Total		58,000
	Less : Unabsorbed depreciation loss of Rs. 15,000 restricted to Rs. 10,000 (Note II)		(10,000)
	Gross total income		48,000

Note :

- (i) The unabsorbed loss of Rs. 13,000 (Rs. 80,000 – Rs. 67,000) of Textile business can be carried forward to A.Y. 2020 – 21 for set off u/s 72, even though the business is discontinued. It is eligible to be carried forward up to A.Y. 2024 – 25.
- (ii) The unabsorbed depreciation of Rs. 15,000 is eligible for set off against any Income other than salary income. Accordingly, a sum of Rs. 10,000 is adjusted against Income from house property. The balance Rs. 5,000 is eligible for carry forward and set off to A.Y. 2020 – 21 for indefinite period of time.
- (iii) Recovery of bad debts earlier allowed as deduction is taxable in the previous year in which it is recovered even if the business is discontinued. Further, as per section 41(5) where the business is no longer existing and there is Income chargeable to tax under section 41 in respect of that business, any loss not being speculative loss, which arose in that business during the previous year in which it ceased to exist (unabsorbed), shall be set off against the income chargeable to section 41(4), as aforesaid.

(9 MARKS)

- (B) (a)** Whether to pay dividend to its shareholder, or buy back its shares or issue bonus shares out of the accumulated reserves is a business choice of a company. Further, at what point of time a company, makes such a choice is its strategic policy decision. Such decisions cannot be questioned under GAAR.
- (b)** Payment of dividend to its shareholder or buy back of its shares or issuing bonus shares out of the accumulated reserves is a business choice of a company, which a company is entitled to exercise at any point of time. It should be interpreted as incidental that the shareholder is entitled to a treaty benefit which exempts capital gains, but it is subject to SAAR (i.e. Limitation of Benefit clause). The decision of X Ltd. cannot be questioned under GAAR.

(5 MARKS)

ANSWER : 6

(A)

Deduction available to Mr. M for AY 2019 – 20

Section	Particulars	Amount	Amount
		Rs.	Rs.
80C	Deposit in PPF	1,20,000	
	Life insurance premium paid Rs. 15,000 (deduction restricted to Rs. 12,000, being 10% of Rs. 1,20,000 as the policy was taken after 1.4.2012)	12,000	
	5yr term deposit with bank	30,000	
	Total	1,62,000	
	Restricted		1,50,000
80CCD (1)	Contribution to NPS of central govt. Rs. 1,30,000 (Rs. 1,80,000 – Rs. 50,000, being deduction u/s 80CCD (1B)), restricted to 10% of salary [1,80,000* 10/15] Note 1		1,20,000
	Total		2,70,000
80CCE	Aggregate deduction restricted to		1,50,000

80CCD (1B)	Rs. 50,000 would be eligible for deduction i.r.t. contribution to NPS		50,000
80CCD(2)	Employer contribution to NPS, restricted to 10% of salary.		1,20,000
	Total Deduction available under chap VI A		3,20,000

Note :

1. The deduction u/s 80CCD (1B) is not subject to overall limit of Rs. 1.5L u/s 80CCE. Therefore, it is more beneficial for Mr. M to claim deduction u/s 80CCD(1B) first and then remaining u/s 80CCD (1).
2. If the contribution towards NPS is Rs. 1,20,000, here again, it is beneficial for Mr. M to first claim deduction u/s 80CCD(1B) is over & above the aggregate limit of Rs. 1,50,000 u/s 80CCE.
In any case, the aggregate deduction of Rs. 2,20,000 [i.e. Rs. 1,50,000 u/s 80C + Rs. 70,000 u/s 80CCD(1)] cannot exceed overall limit of Rs. 1,50,000 u/s 80CCE. Total deduction would remain same.
3. The deduction u/s 80CCD(2) in respect of employer's contribution to the Notified Pension Scheme is over & above the aggregate limit specified u/s 80CCE.

(8 MARKS)

(B) Movable Property [Rules 38 & 39 of Schedule II to the Income – tax Act, 1961]

Where the Tax Recovery Officer orders sale of movable property, he should issue a proclamation in the language of the district, of the intended sale, specifying the time and place of sale and whether the sale is subject to confirmation or not.

The proclamation should be made by beat of drum or other customary mode, -

- (a) In the case of property attached by actual seizure –
 - (i) In the village in which the property was seized, or, if the property was seized in a town or city, then, in the locality in which it was seized; and
 - (ii) At such other places as the Tax Recovery Officer may direct ;
- (b) In the case of property attached otherwise than by actual seizure, in such places, if any, as the Tax Recovery Officer may direct.

A copy of the proclamation should also be affixed in a conspicuous part of the office of the Tax Recovery Officer.

Immovable Property [Rule 54 of Schedule II to the Income – tax Act, 1961]

The Tax Recovery Officer shall make a proclamation for sale of immovable property at some place on or near such property by beat of drum or other customary mode. A copy of the proclamation shall be affixed on a conspicuous part of the property and also upon a conspicuous part of the office of the Tax Recovery Officer.

Where the Tax Recovery Officer directs, such proclamation shall also be published in the Official Gazette or in a local newspaper or in both, and the cost of such publication shall be deemed to be cost of the sale.

Where the property to be sold is divided into lots for the purpose of being sold separately, then it is not necessary to make a separate proclamation for each lot of property, unless in the opinion of the Tax Recovery Officer, proper notice of sale cannot otherwise be given.

(6 MARKS)