



## FINAL – November 2017

### DIRECT TAXATION

Test Code –P25

Branch (MULTIPLE) (Date : 02.07.2017)

(50 Marks)

**Note: All questions are compulsory.**

#### Question 1(6 Marks)

A Ltd. is an eligible start-up, since –

- It is a company engaged in eligible business of innovation, development, deployment and commercialization of new processes driven by technology. It holds a certificate of eligible business from the notified IMBC.
- It is incorporated during the period 1.4.2016 to 31.3.2019.
- Its total turnover does not exceed Rs.25 crores in any previous year from P.Y.2016-17 to P.Y.2020-21.
- It holds a certificate of eligible business from the notified IMBC **(2 marks)**

Therefore, A Ltd., being an eligible start-up, is eligible for deduction under section 80-IAC of 100% of the profits and gains derived by it from an eligible business for any three consecutive assessment years out of five years beginning from the year in which the eligible start up is incorporated i.e. P.Y.2016 -17. **(2 marks)**

In the first two years i.e., P.Y.2016-17 and P.Y.2017-18, A Ltd. has incurred a loss. In the subsequent three years i.e., P.Y.2018-19, P.Y.2019-20 and P.Y.2020-21, A Ltd. has earned profits from eligible business and can hence, claim 100% of its profits as deduction under section 80-IAC from the P.Y.2018-19 to P.Y.2020-21. However, for P.Y.2018-19, the profits eligible for deduction would be the profits after set-off of brought forward losses of P.Y.2016- 17 and P.Y.2017-18. **(2 marks)**

#### Question 2(14 Marks)

Computation of Income of Pingu Trading Pvt.Ltd. chargeable to tax for the A.Y.2017-18

Particulars	Rs.
Net profit as per profit and loss account	33,90,000
<b>Add:</b> Difference in the value of stock detected on survey under section 133A on 31.03.2017 chargeable as income <b>(See Note 1) (2 marks)</b>	<u>3,75,000</u>
	37,65,000
<b>Less :</b> Income –tax refund credited in the profit and loss account out of which interest is to be considered separately under the head “Income from other sources” <b>(1 mark)</b>	<u>20,000</u>
	37,45,000
<b>Add:</b> Expenses either not allowable or to be considered separately but chargeable in the profit & loss account <b>(3 ½ marks)</b>	
- Repair expenses on rented premises where assessee is under no obligation to incur such expenses are not allowable as per section 30(a)(i). However , if such expenses are required for carrying on the business efficiently , the same are allowable under section 37.	
- Advertisement in the souvenir of political party not allowable as per section 37(2B) <b>(See Note 3)</b>	2,500
- Payment made to the wife of a director examined as per section 40A(2) and the excess payment made to be disallowed <b>(See Note 5)</b>	75,000

- Payment made to electoral trust by cheque (See Note 6)		1,00,000
- penalty levied by the sales tax department for delayed filing of returns not allowable as being paid for infraction of law(See Note 7)		5,300
- Depreciation as per books		71,500
- 30% of interest paid on loan without deduction of tax at source not allowable as per section 40(a)(ia)		24,000
		<b>4023,300</b>
<b>Less :Depreciation allowable as per Income tax Act,1961 (1/2 mark)</b>		65,000
		<b>39,58,300</b>
<b>Less: Income from specified business (warehousing charges) credited to profit and loss account, to be considered separately (See Note 8) (2 marks)</b>		15,00,000
<b>Income from business (other than specified business)</b>		<b>24,58,300</b>
<b>Computation of income /loss from specified business(See Note 8)(2 marks)</b>		
Income from specified business	Rs.15,00,000	
Less: Deduction under section 35AD @150% of Rs.25lakhs	Rs.37,50,000	
<b>Loss from specified business to be carried forward as per section 73A</b>	<b>(22,50,000)</b>	
<b>Income from Other Sources (1 mark)</b>		
Interest on income tax refund		4,570
	<b>Gross Total Income</b>	<b>24,62,870</b>
<b>Less :Deduction under section 80GGB (2 marks)</b>		
Contribution to political party (See Note 3)	Rs.2,500	
Contribution to an electoral trust (See Note 7)	Rs.1,00,000	<b>1,02,500</b>
Total Income		<b>23,60,370</b>

**Notes:**

- (1) The business premises were surveyed and differences in the figures of opening and closing stock and sales were found which have not been disputed and accepted by the assessee. Therefore, the trading account for the year is to be re-cat to arrive at the correct amount of the gross profit/net profit for the purpose of return of income to be filed for the previous year ended on 31.3.2017.

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

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

- (2) Bonus for the previous year 2015-16 paid after the due date for filing return for that year would have been disallowed under section 43B for the P.Y. 2015-16. However, when the same has been paid in December 2016, it should be allowed as deduction in the P.Y.2016-17 (A.Y.2017-18). Since it is already included in the figure of bonus to staff debited to profit and loss account of this year, no further adjustment is required.
- (3) The amount of ` 2,500 paid for advertisement in the souvenir issued by a political party attracts disallowance under section 37(2B). However, such expenditure falls within the meaning assigned to "contribute" under section 293A of the Companies Act, 1956, and is hence, eligible for deduction under section 80GGB. Any contribution to the political party or electoral trust made by way of cash is not allowed as deduction under section 80GGB. Since in the present case, the payment to the political party is made by way of an account payee cheque, it is allowed as deduction under section 80GGB.

- (4) The penalty of ` 15,000 paid for non-fulfillment of delivery conditions of a contract for reasons beyond control is not for the breach of law but was paid for breach of contract for obligations and therefore, is an allowable expense.
- (5) It has been assumed that ` 25,000 is the reasonable payment for the wife of Director, working as a junior lawyer, since junior advocates of High Courts normally charge only ` 25,000 for the same opinion and therefore, the balance ` 75,000 has been disallowed.
- (6) Payment to an electoral trust qualifies for deduction under section 80GGB since the payment is made by way of a cheque. However, since the amount has been debited to profit and loss account, the same has to be added back for computing business income.
- (7) The interest of ` 12,750 paid on the delayed deposit of sales tax is for breach of contract and hence, is allowable as deduction. However, penalty of ` 5,300 for delay in filing of returns is not allowable since it is for breach of law.
- (8) Weighted deduction @ 150% of the capital expenditure is available under section 35AD in respect of specified business of setting up and operating a warehouse facility for storage of agricultural produce which commences operation on or after 1.04.2012 . It is presumed that ` 25 lacs does not include expenditure on acquisition of any land.
- (9) The loss from specified business under section 35AD (warehousing) should be segregated from the income from other businesses, since, as per section 73A(1), any loss computed in respect of any specified business referred to in section 35AD shall not be set off except against profits and gains, if any, of any other specified business.
- (10) In view of the provisions of section 73A(1), the loss of ` 22.5 lacs from the specified business cannot be set-off against income from other businesses. Such loss has to be carried forward to be set-off against profit from specified business in the next assessment year. The return should be filed on or before the due date under section 139(1) for carry forward of such losses.

**Question 3(10 Marks)**

**Computation of total income MNO Corporation LLP for the A.Y.2017-18**

Particulars		Rs.
Profit and Gains from Business of Profession		
Net profit as per profit and loss account (Rs. 10,25,000 +Rs. 20,50,000)		30,75,000
Add: Items debited to profit & loss account but not allowable as deduction /to be considered separately <b>(2 marks)</b>		
(1)	Interest on capital payable to partners in excess of 12% disallowed under section 40(b) (Rs.100 lakhs x 3%)	3,00,000
(2)	Working Partner's salary (to be considered separately )	36,00,000
(3)	Depreciation as per boks of account (Rs. 5 lakhs + Rs. 35 lakhs ) relating to textile business	40,00,000
(4)	Keyman Insurance premium paid (allowable as deduction , since it is incurred wholly and exclusive for the purpose of business –Circular No. 762 dated 18.2.1998	-
		<u>79,00,000</u>
		1,09,75,000
Less :Depreciation under section 32 of the Income tax Act ,1961 (relating to textile business ) [Rs. 27 lakhs +Rs. 4 lakhs] <b>(1 mark)</b>		<u>31,00,000</u>
<b>Book Profit</b>		<b>78,75,000</b>
Less :Remuneration to working partners [Subject to limit specified in section 40(b)]		
On first Rs.3,00,000 of book profit	90%of book profit or Rs.1,50,000, whichever is higher	2,70,000
On the balance of book Profit Rs. 75,75,000 [Rs.78,75,000 – Rs. 3,00,000]	60% of balance book profit	45,45,000
		48,15,000
Restricted to actual remuneration paid <b>(1 mark)</b>		<u>36,00,000</u>
<b>Income under the head Profit and gains of business or profession</b>		<b>42,75,000</b>
Income from textile manufacturing business [See Notes 5 & 6](2 marks)		19,25,000
Income from specified business of operating a cold chain facility [Rs. 42,75,000 –Rs. 19,25000](2 marks)		23,50,000
Less :Set –off of brought forward loss of specified business under section 73A[See Notes 1 to 4 below] (2 marks)		<u>11,25,000</u>
<b>Total income</b>		<b><u>31,50,000</u></b>

**Notes :**

**(1) Computation of loss of specified business of setting up and operating a cold chain facility for P.Y.2015-16 relevant to Assessment Year 2016-17**

Particulars	Rs.
Income from cold chain facility [before deduction under section 35AD]	60,00,000
Less : Deduction under section 35AD [150 of Rs. 50,00,000]	
<b>[See Notes 2&amp;3]</b>	<u>75,00,000</u>
Loss of specified business for P.Y.2015-16	<u>15,00,000</u>
Loss to be carried forward as per section 73A read with section 78 [Rs. 15,00,000 x <sup>3</sup> / <sub>4</sub> ] to be set-off against profit of any specified business of the subsequent years[See Note 4 below]	Rs.11,25,000

**(2) The specified business of setting up and operating a cold chain facility would be eligible for weighted deduction@150% of the capital expenditure, if the operations are commenced on or after 1.4.2012**

**[Section 35AD(1A)].** In this case, since the operations have commenced on 1.4.2015, the specified business qualifies for weighted deduction @ 150% of capital expenditure.

- (3) Expenditure of capital nature would, however, not include any expenditure incurred on acquisition of land **[Section 35AD(8)(f)]**. Therefore, in this case, only cost of Rs.50 lakhs on construction of building and machinery installed would qualify for deduction under section 35AD, assuming that such expenditure has been capitalized in the books of account as on 1.4.2015 (being the date of commencement of operations), since the same was incurred prior to commencement of operations **[Proviso to section 35AD(1)]**.
- (4) Section 78(1) does not permit carry forward of losses pertaining to the share of a retired or deceased partner. Therefore, in this case, since one of the four partners have retired on 31.3.2016, his share of loss ( 3,75,000, being ¼ th of `15 lakh) for the previous year 2015-16 (A.Y.2016-17) cannot be carried forward to the previous year 2016-17 (A.Y.2017-18).

**(5) Computation of profit from textile manufacturing business**

Particulars	Rs.
Profit and Gains from Business or Profession	
Net profit as per profit and loss account	10,25,000
Add: Depreciation as per books of account (Rs. 5 lakhs + 35 lakhs) Relating to textile business	<u>40,00,000</u>
	50,25,000
Less : Depreciation under section 32 of the Income –tax Act,1961(relating to textile business)	31,00,000
	<u>19,25,000</u>

- (6) Loss of specified business can be carried forward indefinitely for set-off only against profits of any specified business. Therefore, it becomes necessary to segregate the income of ` 42.75 lakhs computed under the head “Profits and gains of business or profession”, so that brought forward loss from specified business relating to P.Y.2015-16 can be set-off against profits of specified business of the P.Y.2016-17.
- (7) For this purpose, while computing profits of textile manufacturing business included in the business income of ` 42.75 lakhs, the depreciation as per books of account has to be added back and the depreciation as per the Income-tax Act, 1961 has to be reduced from the net profit of ` 10.25 lakhs pertaining to textile business, since the depreciation adjustments clearly relate to textile business.
- (8) There is no effect of adjustment of partners’ remuneration, since the entire remuneration which has been added back is allowable as the same is within the limits as per section 40(b)(v).

**Question 4(8 marks)**

**Computation of capital gains and business income of Harshita for A.Y. 2017-18**

Particulars	
<b>Capital Gains</b>	
Fair market value of land on the date of conversion deemed as the full value of consideration for the purposes of section 45(2)(1 mark)	2,10,00,000
Less: Indexed cost of acquisition [ $8,00,000 \times 711/109$ ] (1 mark)	52,18,349
	<u>1,57,81,651</u>
Proportionate capital gains arising during A.Y.2017-18 [ $1,57,81,651 \times 2/3$ ]	1,05,21,101
Less: Exemption under section 54EC(1 mark)	50,00,000
<b>Capital gains chargeable to tax for A.Y.2017-18(1 mark)</b>	<b><u>55,21,101</u></b>
<b>Business Income</b>	

Sale price of flats [10 × ` 30 lakhs] <b>(1 mark)</b>	3,00,00,000
<b>Less: Cost of flats(2 marks)</b>	
Fair market value of land on the date of conversion [ ` 210 lacs × 2/3]	1,40,00,000
Cost of construction of flats [10 × ` 10 lakhs]	1,00,00,000
<b>Business income chargeable to tax for A.Y.2017-18(1 mark)</b>	<b>60,00,000</b>

**Notes:**

- (1) The conversion of a capital asset into stock-in-trade is treated as a transfer under section 2(47). It would be treated as a transfer in the year in which the capital asset is converted into stock-in-trade.
- (2) However, as per section 45(2), the capital gains arising from the transfer by way of conversion of capital assets into stock-in-trade will be chargeable to tax only in the year in which the stock-in-trade is sold.
- (3) The indexation benefit for computing indexed cost of acquisition would, however, be available only up to the year of conversion of capital asset into stock-in-trade and not up to the year of sale of stock-in-trade.
- (4) For the purpose of computing capital gains in such cases, the fair market value of the capital asset on the date on which it was converted into stock-in-trade shall be deemed to be the full value of consideration received or accruing as a result of the transfer of the capital asset.  
In this case, since only 2/3rd of the stock-in-trade (10 flats out of 15 flats) is sold in the P.Y.2016-17, only proportionate capital gains (i.e., 2/3rd) would be chargeable to tax in the A.Y.2017-18.
- (5) On sale of such stock-in-trade, business income would arise. The business income chargeable to tax would be the difference between the price at which the stock-in-trade is sold and the fair market value on the date of conversion of the capital asset into stock-in-trade.
- (6) In case of conversion of capital asset into stock-in-trade and subsequent sale of stock-in-trade, the period of 6 months is to be reckoned from the date of sale of stock-in-trade for the purpose of exemption under section 54EC [ *CBDT Circular No.791 dated 2.6.2000*]. In this case, since the investment in bonds of NHAI/RECL has been made within 6 months of sale of flats, the same qualifies for exemption under section 54EC. With respect to long-term capital gains arising in any financial year, the maximum deduction under section 54EC would be ` 50 lakhs, whether the investment in bonds of NHAI or RECL are made in the same financial year or next financial year or partly in the same financial year and partly in the next financial year. Therefore, even though investment of ` 50 lakhs has been made in bonds of NHAI during the P.Y.2016-17 and investment of ` 50 lakhs has been made in bonds of RECL during the P.Y.2017-18, both within the stipulated six month period, the maximum deduction allowable for A.Y.2017-18, in respect of long-term capital gain arising on sale of long-term capital asset(s) during the P.Y.2016-17, is only ` 50 lakhs.

**Question 5(6 Marks)**

Switz Inc., the foreign company and Bharat Ltd., the Indian company are associated enterprises since Switz Inc. is the holding company of Bharat Ltd. Switz Inc. sells LEDs to Bharat Ltd. for resale in India. Switz Inc. also sells identical LEDs to Hindustan Ltd., which is not an associated enterprise. The price charged by Switz Inc. 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.**(1 mark)**

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 Switz Inc. and Bharat Ltd.) and uncontrolled transaction (i.e. transaction between Switz Inc. and Hindustan Ltd.) and the price so adjusted shall be the arm's length price for the international transaction. **(1 mark)**

For sale of LEDs by Hindustan Ltd., Switz Inc. is responsible for warranty for 4 months. The price charged by Switz Inc. to Hindustan Ltd. includes the charge for warranty for 4 months. Hence, arm's length price for LEDs being sold by Switz Inc. to Bharat Ltd. would be:

Particulars	No.	
Sale price charged by Switz Inc. to Hindustan Ltd.		18,000
Less: Cost of warranty included in the price charged to Hindustan Ltd. ( $\text{₹ } 2,400 \times 4 / 12$ )		800
<b>Arm's length price</b>		<b>17,200</b>
Actual price paid by Bharat Ltd. to Switz Inc.		21,000
<b>Difference per unit</b>		<b>3,800</b>
No. of units supplied by Switz Inc. to Bharat Ltd.	35,000	
Addition required to be made in the computation of total income of Bharat Ltd. ( $3,800 \times 35,000$ )		13,30,00,000

No deduction under Chapter VI-A would be allowable in respect of the enhanced income of ₹ 13.30 crores. **(4 marks)**

**Note:** It is assumed that Bharat Ltd. has not entered into an advance pricing agreement or opted to be subject to Safe Harbour Rules.

#### Question 6 (6 Marks)

- Section 192(1) requires any person responsible for paying any income chargeable under the head "Salaries" to deduct tax at source at the time of payment. If an employee receives income chargeable under a head other than "Salaries", section 192 does not get attracted at all. **(1 mark)**
- The issue under consideration is whether "tips" received by the hotel-company from its customers and distributed to the employees fell within the meaning of "Salaries" to attract tax deduction at source under section 192. **(1 mark)**
- This issue came up before the Supreme Court in *ITC Ltd. v. CIT (TDS) (2016) 384 ITR 14* wherein it was observed in respect of tips collected by the company from the customers and distributed to the employees, the person responsible for paying the employee was not the employer at all, but a third person, namely the customer. As income from tips would be chargeable in the hands of the employees as "Income from Other Sources", on account of such tips being received from customers and not from the employer, section 192 would not get attracted at all. **(1 mark)**
- The Supreme Court further observed that there was no vested right in the employee to claim any amount of tip from his employer. Tips are purely voluntary amounts that may or may not be paid by customers for services rendered to them, and hence, would not fall within the meaning and scope of section 15. Further, the amount of tips collected from the customers by the employer and paid to the employees has no reference to the contract of employment at all. Tips were received by the employer in a fiduciary capacity as trustee for payments that were received from customers which they disbursed to their employees for service rendered to the customer. There was, therefore, no reference to the contract of employment when these amounts were paid by the employer to the employee. **(1 mark)**

- e. Due to this reason the tips received by the employees could not be regarded as profits in lieu of salary in terms of section 17(3). The payments of collected tips included and paid by way of a credit card by a customer, would not be payments made “by or on behalf of” an employer. The contract of employment not being the proximate cause for the receipt of tips by the employee from a customer, such payments would be outside the scope of sections 15 and 17. **(1 mark)**
- f. Applying the rationale of the above Supreme Court ruling to the case on hand, the action of the Assessing Officer in treating Hotelia Ltd. as an assessee-in-default for non-deduction of tax at source on the amount of tips collected by it from the customers and distributed to its employees, is not correct. **(1 mark)**

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