# SUGGESTED SOLUTION

## FINAL MAY 2019 EXAM

**SUBJECT- DT**

## Test Code – FNJ 7103

**BRANCH - () (Date :)**

**Head Office : Shraddha, 3rd Floor, Near Chinai College, Andheri (E), Mumbai – 69.**

**Tel : (022) 26836666**

**Answer 1:**

**Computation of taxable income of Alpha Ltd. for the A.Y.2019-20**

| Particulars | Rs. |
|---|---|
| Net profit as per profit and loss account | 12,50,000 |
| ***Add:*** **Items debited to profit and loss A/c but not deductible or income to be taxed** | |
| 1. **Payment of advertisement expenditure of Rs.60,000** | |
| (i) Rs. 8,000, being the excess payment to a relative disallowed under section 40A(2) | 8,000 |
| (ii) As the payment is made in cash and since the remaining amount of Rs. 52,000 exceeds Rs. 10,000, 100% shall be disallowed under section 40A(3) | 52,000 |
| 2. Under section 31, expenditure relatable to current repairs regarding plant, machinery or furniture is allowed as deduction. The test to determine whether replacement of parts of machinery amounts to repair or renewal is whether the replacement is one which is in substance replacement of defective parts or replacement of the entire machinery or substantial part of the entire machinery [*CIT v. Darbhanga Sugar Co. Ltd. [1956] 29 ITR 21 (Pat)].* Here expenditure on repairs does not bring in any new asset into existence. Such replacement can only be considered as current repairs. Hence, no adjustment is required. Further, as per ICDS V on Tangible Fixed Assets, only an expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance has to be added to the actual cost. | |
| 3. Liability foregone by creditor chargeable as business income but not credited to profit and loss account [taxable under section 41(1)] | 6,000 |
| 4. Sale proceeds of import entitlements. The sale of the rights gives rise to profits or gains taxable under section 28(iiia). As the amount has already been credited to profit and loss account, no further adjustment is necessary. | - |
| ***Less:*** **Amount not debited to profit and loss account but allowable as deduction** | |
| 5. Expenditure on in-house research and development is entitled to a weighted deduction of 150% of the expenditure (both capital and revenue) so incurred under section 35(2AB)(1) = Rs.2 lacs x 150% = Rs.3 lacs. Expenditure of Rs. 2,00,000 has already been debited to Profit & Loss Account, therefore only additional deduction of Rs. 1 lacs further to be allowed | 1,00,000 |
| **Taxable Income** | **12,16,000** |

**(10 marks)**

**Answer 2:**

**Determination of net worth of Unit B of M/s. J.B. Opticals Ltd.**

| | **Rs. (in lacs)** |
|---|---|
| Written down value of fixed assets | 120 |

| | |
|---|---|
| Debtors | 75 |
| Stock-in-trade | 25 |
| | 220 |
| Less : Liabilities | 50 |
| Net worth | 170 |

**(3 marks)**

**Comparative calculation of chargeable capital gains**

| | Sale before 31.3.2019 | Sale after 31.03.2019 |
|---|---|---|
| Sale consideration | 2,25,00,000 | 2,25,00,000 |
| Less: Discount | 2,25,000 | Nil |
| Net sale consideration | 2,22,75,000 | 2,25,00,000 |
| Less: Net worth | 1,70,00,000 | 1,70,00,000 |
| Short term capital gain | 52,75,000 | N.A. |
| Long term capital gain | N.A. | 55,00,000 |
| Tax rate | 31.2% | 20.8% |
| Tax thereon | 16,45,800 | 11,44,000 |

**(3 marks)**

**Computation of Net Cash flow**

| | Sale before 31.3.2019 | Sale after 31.03.2019 |
|---|---|---|
| Net sale consideration | 2,22,75,000 | 2,25,00,000 |
| Less: Income-tax | 16,45,800 | 11,44,000 |
| Net Cash flow | 2,06,29,200 | 2,13,56,000 |

**(2 marks)**

Note: The assessee is advised to effect slump sale after 31.03.2019 as the tax liability arising out of long term capital gains is less than the tax liability arising on short term capital gains and the net cash flow is also higher, if Unit B is transferred after 31.03.2019. **(2 marks)**

**Answer 3:**

**(A)**

**i)** As stated in the Preamble, **ICDS is not meant for maintenance of books of accounts or preparing financial statements.** Persons are required to maintain books of accounts and prepare financial statements as per accounting policies applicable to them. For example, companies are required to maintain books of account and prepare financial statements as per requirements of Companies Act, 2013. The accounting policies mentioned in ICDS-I being fundamental in nature shall be applicable for computing income under the heads "Profits and gains of business or profession" or "Income from other sources".

**ii)** As a principle, interest accrues on time basis and royalty accrues on the basis of contractual terms. Subsequent non-recovery in either cases can be claimed as deduction in view of amendment to section 36(1)(vii). Further, **the provision of the Act (e.g. Section 43D) shall prevail over the provisions of ICDS.** **(3 marks x 2 = 6 marks)**

**(B)**

The Supreme Court in **Rajesh Kumar & Ors. v. DCIT** (2006) 287 ITR 91 observed that the order under section 142(2A) is a quasi judicial order. Therefore, the **principles of natural justice have**

**to be applied** and the assessee has to be given an **opportunity of being heard before directing the special audit.** The principles of natural justice are based on two principles, namely, (i) nobody shall be condemned unheard; (ii) nobody shall be a judge of his own cause. Once it is held that the assessee suffers civil consequences and any order passed would be prejudicial to him, the principles of natural justice must be held to be implicit. If the principles of natural justice were to be excluded, the Parliament could have said so expressly.

Accordingly, to give effect to the observation of the Supreme Court, it has been provided that the Assessing Officer is required to give the assessee an opportunity of being heard before issuing directions for special audit under section 142(2A).

Therefore, on the basis of above discussion we can conclude that The contention of Mr. Abhishek is tenable under law. **(4 marks)**

**Answer 4:**

**(A)**

As per section 153A(1), issuance of notice and assessment or reassessment under the said section can also be made for an assessment year preceding the assessment year relevant to the previous year in which search is conducted or requisition is made which falls **beyond six assessment years** but **not beyond ten assessment years** from the assessment year relevant to the previous year in which search is conducted or requisition is made, provided that -

the Assessing Officer has in his possession books of account or other documents or evidence which reveal that the income which has escaped assessment amounts to or is likely to amount to **fifty lakh rupees or more in one year or in aggregate in the relevant assessment years;**

(ii) such income escaping assessment is represented in the form of asset which shall include immovable property being land or building or both, shares and securities, deposits in bank account, loans and advances;

(iii) the income escaping assessment or part thereof relates to such year or years; and

(iv) search under section 132 is initiated or requisition under section 132A is made on or after 1-4-2017. **(3 marks)**

In the light of the above amended provision, the Assessing Officer can issue the notice u/s 153A beyond six assessment years but not beyond ten assessment years from the assessment year relevant to the previous year in which search is conducted or requisition is made. Thus, in the given case, the Assessing Officer can issue notice under section 153A upto A.Y.2008-09 as she,

a. has in his possession, documents or evidence which reveals the escaped assessment amounts to Rs. 55 lacs in aggregate during the relevant four assessment years i.e. from A.Y. 2008-09 to A.Y. 2011-12

b. such income escaping assessment represents in the form of assets which includes Rs. 40 lacs being Shares purchased in P.Y. 2009-10 and P.Y. 2010-11 plus Rs. 15 lacs being payment to contractor for construction of residential house in P.Y. 2007-08 (payment of Rs. 10 lacs relevant to P.Y. 2006-07 cannot be included as it is beyond ten assessment years)

c. search was conducted after 01.04.2017.

Hence, the contention of Miss. Priyanka Ravi that the Assessing Officer cannot issue the notice under section 153A beyond six assessment years immediately preceding the assessment year relevant to the previous year in which the search was conducted under section 132 is incorrect.

The action of Assessing Officer is partly correct as it is possible to him to issue notice beyond six assessment years but not beyond ten assessment years from the assessment year relevant to the previous year in which search is conducted or requisition is made. Thus, he cannot issue the

notice under section 153A for the A.Y.2007-08. **(3 marks)**

> ***Note –*** *It may be noted that as per section 153A(1), the notice can be issued beyond six assessment years in respect of income escaping assessment which is represented in the form of asset which shall include immovable property being land or building or both, shares and securities, deposits in bank account, loans and advances. It means, the list of assets is exhaustive. If the income escaping assessment is in the form of any other assets like jewellery, bullion, etc. then no notice can be issued even if other conditions are fulfilled.*

**(B)**

**The cost of inherited property to Mr. Abraham shall be the cost to the previous owner as per provisions of section 49(1)(iiia)** and therefore, Rs. 5 lacs, being the cost to his father (amount paid by his father on 26.5.2001 for acquiring the property) shall be the cost to Mr. Abraham, who is the new owner. **Payment of outstanding loan of the predecessor by the successor for obtaining a clear title of the property by release of Mortgage Deed shall be the cost of acquisition of the successor** under section 48 read with section 55(2) of the Act as held by the Apex Court in case of *RM. Arunachalam v. CIT [1997] 227 ITR 222.* **(2 marks)**

**Computation of Taxable Capital Gain for the A.Y. 2019-20** **(2 marks)**

| Particulars | | Rs. |
|---|---|---|
| Sale consideration of house property | | 50,00,000 |
| *Less:* **Indexed cost of acquisition (See Note below)** | | |
| (i) Cost to previous owner (Rs. 5,00,000 × 280/ 137) | 10,21,898 | |
| (ii) Loan amount paid by Mr. Abraham | | |
| (Benefit of CII is available since the loan amount was paid in the financial year 2008-09) (Rs. 15,00,000 × 280/137) | 30,65,693 | 40,87,591 |
| **Capital gains** | | **9,12,409** |

**Note:** Since the property was acquired by Mr. Abraham through inheritance, the cost of acquisition will be cost to the previous owner.

As per the definition of indexation cost of acquisition under clause (iii) of *Explanation* below section 48, indexation benefit will be available only from the previous year in which Abraham first held the asset i.e. P.Y. 2008-09.

However, as per the view expressed by Bombay High Court, in the case of *CIT v. Manjula J. Shah (2013) 355 ITR 474,* in case the cost of acquisition of the capital asset in the hands of the assessee is taken to be cost of such asset in the hands of the previous owner, the indexation benefit would be available from the year in which the capital asset is acquired by the previous owner. If this view is considered, the indexed cost of acquisition would be Rs. 44,65,693 and long term capital gain would be Rs. 5,34,307.

**Answer 5:**

**(A)**

**(i) If the amount was paid for transfer of business/ profession to partnership**

As per section 45(3), the profits and gains arising from the transfer of a capital asset by a person to the firm in which he becomes a partner shall be chargeable to tax as the income of the previous year which such transfer takes place. The amount recorded in the books of account of the firm would be deemed to be the full value of consideration received or accruing as a result of transfer of the capital asset.

Since in this case, consideration of Rs. 5 lacs **is received for such transfer**, profit or gain accrues to the transferor for the purposes of section 45. The amount of Rs. 5 lacs would be the full value of consideration received as a result of transfer and the capital gains resulting from this transfer would be chargeable to tax. **(3 marks)**

**(ii) If the amount is paid by the incoming partner for Goodwill**

The Supreme Court, in CIT v. B.C. Srinivasa Setty (1981) 128 ITR 294, observed that the income chargeable to capital gains tax is to be computed by deducting from the full value of consideration "the cost of acquisition of the capital asset". If it is not possible to ascertain the cost of acquisition, then, transfer of such asset is not chargeable to tax.

Section 55(2)(a) provides that the cost of acquisition of certain self-generated assets, including goodwill of a business, is Nil. Therefore, in respect of these self-generated assets covered under section 55(2)(a), the decision of the Supreme Court in B.C. Srinivasa Setty's case would not apply. However, in respect of other self-generated assets, including goodwill of profession, the decision of the Supreme Court in B.C. Srinivasa Setty's case, would continue to be applicable.

In effect, in case of self-generated assets not covered under section 55(2)(a), since the cost is not ascertainable, there would be no capital gains tax liability.

Therefore, in this case, since the consideration of Rs. 5 lakhs is paid towards goodwill of a profession, whose cost is **NOT** to be taken as 'Nil' since it is not covered under section 55(2)(a), the liability to capital gains tax will not arise. **(3 marks)**

**(B)**

The issue under consideration is whether, in a case where debentures are issued with maturity at the end of five years, and the debenture holders are given an option of upfront payment of interest in the first year itself, can the entire upfront interest paid, be claimed as deduction by the company in the first year or should the same be deferred over a period of five years; and would the treatment of such interest as deferred revenue expenditure in the books of account have any impact on the tax treatment.

The facts of the case are similar to the facts in **<u>Taparia Tools Ltd. v. JCIT</u>** (2015) 372 ITR 605, wherein the above issue came up before the Supreme Court. In that case, it was observed that under section 36(1)(iii), the amount of interest paid in respect of capital borrowed for the purposes of business or profession, is allowable as deduction.

The moment the option for upfront payment was exercised by the subscriber, the liability of X Ltd. to make the payment in that year had arisen. Not only had the liability arisen in the previous year in question, it was even quantified and discharged as well in that very year.

As per the rationale of the **<u>Supreme Court</u>** ruling in Taparia Tools Ltd.'s case, when the deduction

of entire upfront payment of interest is allowable as per the Income-tax Act, 1961, **the fact that a different treatment was given in the books of account could not be a factor which would bar the company from claiming the entire expenditure as a deduction.**

Accordingly, the **action of the Assessing Officer** in spreading the upfront interest paid over the five year term of debentures and restricting the deduction in the P.Y.2018-19 to one-fifth of the upfront interest paid is **not correct.** The company is eligible to claim the entire amount of interest paid upfront as deduction under section 36(1)(iii) in the P.Y.2018-19. **(4 marks)**