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CA FINAL MAY 2017 EXAM

DIRECT TAX LAW

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BRANCH - (MULTIPLE) (Date : 18.12.2016)

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

Tel : (022) 26836666

Answer-1 :

Computation of total income MNO Corporation LLP for the A.Y.2016-17

Particulars	Rs.
Profits and Gains from Business or 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	
(1) Interest on capital payable to partners in excess of 12% disallowed under section 40(b) (Rs. 100 lakhs × 3%)	3,00,000
(2) Working Partner's salary (to be considered separately)	36,00,000
(3) Depreciation as per books 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 exclusively 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]	<u>31,00,000</u>
Book Profit	78,75,000
Less: Remuneration to working partners [Subject to limits 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
	<u>48,15,000</u>
Restricted to actual remuneration paid	36,00,000
Income under the head Profits and gains of business or profession	42,75,000
	20,25,000
	22,50,000
Income from textile manufacturing business [See Notes 5 & 6]	
Income from specified business of operating a cold chain facility [Rs. 42,75,000 - Rs. 20,25,000]	<u>11,25,000</u>
	<u>11,25,000</u>
Less: Set-off of brought forward loss of specified business under section 73A [See Notes 1 to 4 below]	
Total Income	31,50,000

(10 Marks)

Notes:

- (1) **Computation of loss of specified business of setting up and operating a cold chain facility for P.Y.2014-15 relevant to Assessment Year 2015-16**

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] [See Notes 2 & 3]	<u>75,00,000</u>
Loss of specified business for P.Y.2014-15	<u>15,00,000</u>
Loss to be carried forward as per section 73A read with section 78 [Rs.15,00,000 × ¾] to be set-off against profits 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 1.4.2014, 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 1.4.2014 (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 31.3.2015, his share of loss (Rs. 3,75,000, being ¼th of Rs.15 lakh) for the previous year 2014-15 (A.Y.2015-16) cannot be carried forward to the previous year 2015-16 (A.Y.2016-17).

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

Particulars	Rs.
Profits 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 + Rs. 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)	<u>31,00,000</u>
	19,25,000
Add: Interest on capital of Rs. 3,00,000 disallowed [apportioned in the ratio of net profits of textile business and specified business as per profit and loss account (1:2)] [$\frac{1}{3} \times \text{Rs. } 3,00,000$] [See Note 6 below]	<u>1,00,000</u>
	<u>20,25,000</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 Rs. 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.2014-15 can be set-off against profits of specified business of the P.Y.2015-16.

For this purpose, while computing profits of textile manufacturing business included in the business income of Rs. 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 Rs. 10.25 lakhs pertaining to textile business, since the depreciation adjustments clearly relate to textile business.

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).

It is only the interest on capital amounting to Rs. 3 lakhs (which has been added back while computing business income) which has to be apportioned between textile manufacturing business and specified business.

The solution has been worked out apportioning the interest on capital in the ratio of 1:2 between textile manufacturing and specified business, being the ratio of the net profit of these two businesses as per profit and loss account. The solution can also be worked out by apportioning interest on capital on any other logical basis.

(6 x 1 = 6 Marks)

Answer-2 :

As per section 80AC, while computing the total income of an assessee of a previous year (P. Y. 2015-16, in this case) relevant to any assessment year (A . Y. 2016-17, in this case), any deduction is admissible, inter alia, under section 80-IA, such deduction shall not be allowed unless it furnishes a return of income for such assessment year on or before the due date specified in section 139(1).

Since the turnover of the partnership firm has exceeded Rs.100 lacs in the previous year 2015-16, it would be subject to audit under section 44AB, in which case the due date of filing its return of income for A.Y.2016-17 would be 30th September, 2016 as per section 139(1). (1.5 Marks)

Computation of total income and tax liability of M/s. Victory Polyfibres for A.Y.2016-17

I. Where the firm files its return of income on 30th September 2016:

Particulars	Rs. in lacs
Gross Total Income	300.00
Less: Deduction under section 80-IA	<u>200.00</u>
Total Income	<u>100.00</u>
Tax liability@ 30%	30.00
Add: Education cess@2% and secondary and higher education cess@1%	<u>0.90</u>
Regular income-tax payable	<u>30.90</u>
Computation of Alternate Minimum Tax payable [Section 115JC]	
Total Income	100.00
Add: Deduction under section 80-IA	<u>200.00</u>
Adjusted Total Income	<u>300.00</u>
Alternate Minimum Tax (AMT) @ 18.5% on Rs. 300 lacs	55.50
Add: Surcharge@12% (Since adjusted total income > Rs. 1 crore)	<u>6.66</u>
	62.16
Add: Education cess@2% and SHEC@1%	<u>1.86</u>
Total tax payable (AMT)	64.02

(2.5 Marks)

Since the regular income-tax payable by the firm is less than the alternate minimum tax payable, the adjusted total income shall be deemed to be the total income of the firm for P. Y. 2015-16 and it shall be liable to pay income-tax on such total income@18.5% [Section 115JC(1)]. Therefore, the tax payable for the A.Y.2016-17 would be Rs. 64.02 lacs.

Tax credit for Alternate Minimum Tax [Section 115JD]	Rs. in lacs
Total tax payable for A.Y.2016-17 (Alternate Minimum Tax)	64.02
Less: Regular income-tax payable	<u>30.90</u>
To be carried forward for set-off against regular income-tax payable (upto a maximum of ten assessment years).	<u>33.12</u>

(1.5 Marks)

II. Where the firm files its return of income on 7th December 2016:

Where the firm files its return on 7-12-2016, it would be a belated return under section 139(4). Consequently, as per section 80AC, deduction under section 80-IA would not be available. In such circumstances, the gross total income of Rs. 300 lacs would be the total income of the firm.

Particulars	Rs. in lacs
Income-tax@30% of Rs. 300 lacs	90.000
Add: Surcharge@12% (since total income exceeds Rs. 100 lacs) _	<u>10.800</u>
Income-tax (plus surcharge)	100.800
Add: Education cess@2% and SHEC@1%	<u>3.024</u>
Total tax liability	103.824

(1.5 Marks)

Practical solution regarding obtaining clarifications

The practical solution regarding obtaining clarifications would be to file the return of income under section 139(1) on or before the due date 30.9.2016 and claim deduction under section 80-IA. In such a case, the firm can claim deduction of Rs. 200 lacs under section 80-IA. Thereafter, consequent to the clarifications obtained, if any change is required, it can file a revised return under section 139(5) within 31.3.2018 (i.e., within one year from the end of A.Y.2016-17) which would replace the original return filed under section 139(1). A return filed under section 139(1) [i.e., on or before the due date of filing return of income] can only be revised under section 139(5). A belated return filed under section 139(4) cannot be revised.

If the firm files the return of income under section 139(1) on or before 30.9.2016, its tax liability would stand reduced to Rs. 64.02 lacs, as against Rs. 103.824 lacs to be paid if return is furnished after due date. Further,

it would also be eligible for tax credit for alternate minimum tax under section 115JD to the extent of Rs. 33.12 lacs. Therefore, the firm is advised to file its return of income on or before 30.9.2016.

(3 Marks)

Answer-3 (a) :

Computation of total income of ILT Ltd. for the A.Y.2016-17

Particulars	Rs. (in lacs)
Profits and gains from business or profession	
Net profit as per profit and loss account	405.00
Add : Items debited to profit and loss account, but to be disallowed and items not considered in accounts but to be taxed	
Value of group free air ticket provided by a supplier is taxable as business income under section 28(iv), as the value of any benefit, whether convertible into money or not, arising from business is taxable as business income.	10
Amount waived by the supplier of raw materials is a deemed income under section 41(1), as the expenditure was allowed as deduction in the last year and there is a benefit by way of remission or cessation of a trading liability. The fact that effect was not given in the running account of supplier is not relevant.	2
Interest payable outside India to a foreign company is allowable (See Note 1 below)	-
Contribution to electoral trust is not an allowable expenditure while computing business income. Hence, the same has to be added back, since it is included in general expenses.	0.50
Salary paid to employee Sandeep is eligible for deduction. Disallowance under section 40A(3) will not apply – See Note 2 below	NIL
	<u>12.50</u>
	417.50
Less: Amount of deduction allowable	
Under section 43B, interest on loan due to any scheduled bank, etc. is allowed as deduction, if such interest is actually paid irrespective of the method of accounting followed by the assessee. Conversion of arrear interest into a fresh loan by a bank cannot be considered as actual payment of interest. However, the amount of funded interest (i.e. converted loan) actually paid is allowable as deduction. Hence, Rs. 1,60,000, being two installments of Rs. 80,000 each, actually paid is deductible.	<u>1060</u>
Business Income	<u>415.90</u>
Gross total income	415.90
Less: Deduction under Chapter VI-A	
Deduction under section 80GGB in respect of contribution by the assessee company to an electoral trust.	<u>0.50</u>
Total Income	<u>415.40</u>

(6 Marks)

Notes:

1. Since tax has been deducted on interest payable outside India to a foreign company during the previous year 2015-16 and the same has been deposited before the due date of filing return of income under section 139(1), disallowance under section 40(a)(i) is not attracted. Since the interest has already been debited to profit and loss account, no further adjustment is required.
2. In respect of payment of salary to sales executive in cash, no disallowance under section 40A(3) is to be made as the payments fall within the scope of Rule 6DD(i). Salary paid to him in cash is allowable as the executive was temporarily posted for a continuous period of more than 15 days in Bangalore which is not the place of his normal duty. Further tax was deducted from such salary under section 192 and he does not maintain any bank account in Bangalore. No disallowance under section 40A(3) is attracted in respect of such salary.

(2 Marks)

Answer-3 (b) :

Computation of depreciation allowable for the A.Y. 2016-17 in the hands of GP Ltd.

Particulars	Rs. (in lakhs)	
Total cost of plant and machinery	100.00	
Less: Used for Scientific Research (Note 1)	<u>10.00</u>	
	90.00	
Normal Depreciation @ 15% on Rs. 90 lakhs		13.50
Additional Depreciation:		
Cost of plant and machinery	100.00	
Less: Second hand plant and machinery (Note 2)	Rs. 20.00	
Plant and machinery used for scientific research, the whole of the actual cost of which is allowable as deduction under section 35(2)(ia) (Note 2)	<u>Rs. 10.00</u>	<u>30.00</u>
		70.00
Additional Depreciation@20%		<u>14.00</u>
Depreciation allowable for A.Y.2016-17		27.50

(2 Marks)

Notes:

- (1) As per section 35(2)(iv), no depreciation shall be allowed in respect of plant and machinery purchased for scientific research relating to assessee's business, since the entire expenditure is deductible under section 35.
- (2) As per section 32(1)(ia), additional depreciation is allowable in the case of any new machinery or plant acquired and installed after 31.3.2005 by an assessee engaged in the business of manufacture or production of any article or thing or engaged in the business of generation or generation and distribution of power, at the rate of 20% of the actual cost of such machinery or plant. However, additional depreciation shall not be allowed in respect of, inter alia, –
- (i) any machinery or plant which, before its installation by the assessee, was used either within or outside India by any other person;
- (ii) any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profit and gains of business or profession" of any one previous year.
- In view of the above provisions, additional depreciation cannot be claimed in respect of –
- (i) Second hand plant and machinery; and
- (ii) New plant and machinery purchased for scientific research relating to assessee's business in respect of which the whole of the capital expenditure can be claimed as deduction under section 35(1)(iv) read with section 35(2)(ia).

(2 Marks)

Answer-4 (a) :

As per *Explanation* to section 37(1), any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be given in respect of such expenditure.

(1.5 Marks)

As per the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002, no physician shall give, solicit, receive or offer to give, solicit or receive any gift, gratuity, commission or bonus in consideration for referring any patient for medical treatment.

(1.5 Marks)

The demand as well as payment of such referral fee is bad in law. It is not a fair practice and is opposed to public policy. Applying the rationale and considering the purpose of *Explanation* to section 37(1), the assessee would not be entitled to deduction of such payments made in contravention of law or opposed to public policy or have pernicious consequences to the society as a whole. This view has been expressed by the Punjab & Haryana High Court in *CIT vs. Kap Scan and Diagnostic Centre P Ltd. (2012) 344 ITR 476*.

(1.5 Marks)

Thus, the action of the Assessing Officer in disallowing the referral fee paid by X & Co. Diagnostic Centre P. Ltd. to doctors is correct. The fact that tax has been deducted under section 194H would not make any difference as regards the eligibility for deduction.

(1.5 Marks)

Answer-4 (b) :

As per the provisions of section 36(1)(vii), bad debts written off as irrecoverable by the assessee shall be allowed as deduction while computing income under the head "Profit and gains from business or profession" in case such debt has been taken into account in computing the income of the assessee in the previous year or in any earlier previous year.

However, as per the Supreme Courts ruling in *CIT v. T. Veerabhadra Rao, K.Koteswara Rao & Co (1985) 155 ITR 152*, a successor to a business will be entitled to claim an allowance for bad debt under section 36(1)(vii) even though the debt was not incurred by it (i.e., the successor) but was incurred by the predecessor before takeover of the business by the successor.

Therefore, the claim for bad debts will be allowed even if the relevant debt had been taken into account in computing the income of the predecessor only and not in computing the income of the successor.

However, it is important that the identity of the business after succession remains the same. Therefore in the present case, deduction under section 36(1)(vii) on account of bad debts of Rs. 5 lakh shall be allowed to Q. Limited in relation to a debt incurred by P. Limited for the engineering division transferred to Q. Limited, even though the same is not taken into account in computing the income of Q. Limited of the previous year or any earlier previous year, provided the identity of the business in the hands of Q Ltd remains the same.

(2 Marks)

Answer-4 (c) :

(A) (i) As per section 28(va), any sum received under an agreement for not carrying out any activity in relation to any business (i.e., non-compete fee) is chargeable to income-tax under the head "Profits and gains of business or profession".

Accordingly, Rs. 10 lakhs received by S Ltd. from K Ltd. for agreeing not to carry on any business relating to computer software in India for the next three years is chargeable to income-tax under the head "Profits and gains of business or profession".

The amount shall be allowed as deduction to K Ltd. provided tax has been deducted at source under section 194J on the payment so made to S Ltd. If tax is not deducted at source, 30% of the expenditure shall be disallowed under section 40(a)(ia).

(ii) Excise duty liability arises at the time of manufacture of goods and not on clearances. Therefore, it has to be included in the value of closing stock as per section 145A. Therefore, the closing stock has to be valued at Rs. 56 lakhs (i.e., including excise duty payable of Rs. 6 lakhs).

As per section 43B, deduction can be claimed for Rs. 4 lakhs, being the excise duty paid on or before the "due date" of filing the return under section 139(1).

(iii) A foreign agent of an Indian exporter operates in his own country and no part of his income accrues or arises in India. His commission is usually remitted directly to him and is, therefore, not received by him or on his behalf in India. The commission paid to the non-resident agent for services rendered outside India is, thus, not chargeable to tax in India.

Since commission income for booking orders by non-resident who remains outside India is not subject to tax in India, disallowance under section 40(a)(i) is not attracted in respect of payment of commission to such non-resident outside India even though tax has not been deducted at source. The amount of Rs. 50 lakhs remitted to Mr. Rodrigues outside India in foreign currency towards commission would not attract disallowance under section 40(a)(i) for non-deduction of tax at source.

(4 Marks)

(B) (i) For claiming deduction of any expense enumerated under section 43B, the requirement is, the actual payment and not deemed payment. Furnishing of bank guarantee cannot be equated with actual payment. Actual payment requires that money must flow from the

assessee to the public exchequer as specified in section 43B. Therefore, deduction of an expense covered under section 43B cannot be claimed by merely furnishing a bank guarantee [CIT v. McDowell & Co Ltd (2009) 314 ITR 167 (SC)]

- (ii) Interest payable to Sales tax department is part of sales tax.

Therefore, interest payable to sales tax department, which is not paid before the “due date” of filing of return of income, would attract disallowance under section 43B [Mewar Motors v. CIT (2003) 260 ITR 218 (Raj)].

(2 Marks)