

**Paper-7 Direct Taxation**

**Time Allowed: 3 hours**

**Full Marks: 100**

All the questions relate to the assessment year 2014-15, unless stated otherwise.

Working notes should form part of the answers.

**Section A**

[Question No.1 is compulsory and answer **any four** from Question No. 2 to 6]

**Question 1.**

**(a) Answer the following sub-divisions briefly in the light of the provisions of the Income-tax Act, 1961:**

- (i) The Head Office of a Hindu Undivided Family is in Burma. The family is managed by Mr. AP (since 1980) who is resident in India in only 4 out of 10 years preceding the Previous Year 2013-14 and he is present in India for more than 729 days during the last 7 years. Determine the residential status of the family for the Assessment Year 2014-15 if the affairs of the family's business are wholly controlled from Burma.**
- (ii) What will be the cost of acquisition of bonus shares u/s 55(2)(iia) if issued prior to 01.04.81.**
- (iii) Ms. Rinita, an individual paid medical insurance premium of ₹ 7,000 in cash for the financial year 2013-14. What is the deduction allowable u/s 80D?**
- (iv) If an employer provides conveyance facility to his employee to cover the journey between the office and his residence then what will be the tax liability on that perquisite?**
- (v) The normal date of retirement of Mr. Basu was 31.05.2013 and the gratuity would become due on that date. In an accident, Mr. Basu died on 20.06.2013 but before that he received the gratuity on 11.06.2013. Whether the gratuity is taxable in hands of Mr. Basu?**
- (vi) Brought forward unabsorbed speculation business loss can be set off against income of any head. — Discuss.**
- (vii) What will be the rate of TDS for dividend paid by a company to any person u/s 194?**
- (viii) Mr. X, a senior citizen has an income from house property. Whether he is liable to pay advance tax and why?**

**[8 × 1]**

**(b) Choose the most appropriate alternative:**

- (i) The amount of exemption for leave encashment in case of Government employee is —**
  - (A) Actual amount of leave encashment received.**
  - (B) fully exempted from tax**
  - (C) ₹ 3,00,000**
  - (D) 10 months average salary preceding the month of retirement**

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

---

- (ii) The basis of chargeability under the head income from house property is —
- (A) Annual Value
  - (B) Municipal Value
  - (C) Standard Rent
  - (D) Fair Rent
- (iii) The Cost Inflation Index as notified by the Central Government for the previous year 2013-14 is —
- (A) 852
  - (B) 711
  - (C) 939
  - (D) 100
- (iv) Which one of the following is not considered for deduction u/s 80C?
- (A) contribution by an employee to a recognised provident fund
  - (B) contribution by an employee to an approved superannuation fund
  - (C) medical insurance premium paid by any mode of payment other than cash
  - (D) subscription to any such security of the Central Government or any such deposit scheme as that Government may, by notification in the Official Gazette, specify in this behalf
- (v) Advance tax is payable by any person for the assessment year immediately following the financial year when the tax payable is —
- (A) ₹ 10,000 or more
  - (B) Less than ₹ 10,000
  - (C) ₹ 5,000 or more
  - (D) Less than ₹ 5,000

[5 × 1]

**Answer:**

(a) (i) As the affairs of the Hindu Undivided Family are controlled from a place outside India, the family will be non-resident. Accordingly, the said HUF is Non-resident for the Assessment Year 2014-15.

(ii) Where bonus shares are issued prior to 1.4.81, the cost of acquisition shall be the fair market value as on 1.4.81.

(iii) Deduction is allowed for any medical insurance premium paid by any mode of payment other than cash out of assessee's Taxable Income to General Insurance Corporation of India (GICI) or any other approved or notified insurer during the previous year, upto a maximum amount of ₹ 15,000. As she paid the amount in cash, she is not allowed for the said deduction.

(iv) If an employer provides conveyance facility to his employee to cover the journey between the office and his residence, then the perquisite exempt from tax in all cases and hence not includible for the purpose of tax deduction at source under section 192.

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

(v) The gratuity become due and paid during the lifetime of Mr. Basu, it is taxable in the hand of Mr. Basu. He can claim exemption under section 10(10).

(vi) Brought forward unabsorbed speculation business loss can be set off only against income under speculation business. The Carry forward and set off is permissible for 4 Assessment Years immediately succeeding the Assessment Year for which the loss was computed.

(vii) The rate of TDS for dividend paid by a company to any person u/s 194 will be —

- @10% if PAN is provided
- @20% if PAN is not provided

(viii) Section 207 provides that a senior citizen who has no income from business or profession will not be required to pay any Advance Tax. So, Mr. X is not liable to pay advance tax.

- (b) (i) (B) fully exempted from tax  
(ii) (A) Annual Value  
(iii) (C) 939  
(iv) (C) medical insurance premium paid by any mode of payment other than cash  
(v) (A) ₹ 10,000 or more

### Question 2.

(a) Mr. X and Mr. Y own the house property of H<sub>1</sub> and H<sub>2</sub> respectively. The details of which are as follows —

	H <sub>1</sub> ₹	H <sub>2</sub> ₹
<b>Municipal value (MV)</b>	1,20,000	1,20,000
<b>Fair rent (FR)</b>	1,30,000	1,30,000
<b>Standard rent under the Rent Control Act (SR)</b>	1,10,000	1,10,000
<b>Actual rent if property is let out throughout the previous year</b>	1,26,000	1,26,000
<b>Unrealised rent of the previous year 2013-14 as per Rule 4</b>	10,500	Nil
<b>Period when the property remains vacant (in number of month)</b>	1 month	Nil
<b>Loss due to vacancy</b>	10,500	Nil
<b>Municipal taxes—</b>		
<b>Tax of the year 2013-14</b>	18,000	18,000
<b>- Paid by X and Y during 2013-14</b>	16,000	9,000
<b>- Paid by X and Y after March 31, 2014</b>	2,000	1,000
<b>- Paid by tenants during 2013-14</b>	-	8,000

Find out the income from properties chargeable to tax for the assessment year 2014-15.

(b) What are the basic conditions for determination of residential status of an individual [u/s 6(1)]? Also specify the exceptions of it.

[8 + (2+3)]

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

**Answer:**

**(a) Computation of income under the head "Income from house property"**

	H <sub>1</sub> ₹	H <sub>2</sub> ₹
Gross annual value		
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]	1,10,000	1,10,000
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy	1,15,500	1,26,000
Step III - Amount computed in Step I or Step II, whichever is higher	1,15,500	1,26,000
Step IV - Loss due to vacancy	10,500	Nil
Step V - Gross annual value is Step III minus Step IV	1,05,000	1,26,000
Less: Municipal tax paid by X or Y during the previous year 2013-14	16,000	9,000
Net annual value	89,000	1,17,000
Less: Standard deduction under section 24(a) [30% of net annual value]	26,700	35,100
<b>Income from house property</b>	<b>62,300</b>	<b>81,900</b>

**(b) The basic conditions for determination of residential status of an individual [u/s 6(1)] —**

- (a) If the Individual stayed in India for a period of 182 days or more during the Relevant Previous Year (RPY), he is Resident of India;
- Or,
- (b) If he stayed in India for a period of 60 days or more during Relevant Previous Year (RPY) and 365 days or more during the four preceding Previous Years, he is Resident of India.

If the assessee fails to satisfy either of the above basic conditions, as applicable, then the assessee is a Non-Resident for that Relevant Previous Year.

**Special exceptional situations:**

For the following persons, condition mentioned in (a) above only shall apply to determine their Residential Status —

- (i) Individual, an Indian citizen, leaving India for employment outside India, or
- (ii) Indian Citizen being a crew member of an Indian ship leaving India, or
- (iii) Individual, an Indian citizen or a person of Indian origin, visiting India.

**Question 3.**

**(a) A & Co. (a firm with partners A and B) is engaged in the business of manufacturing (turnover of 2013-14 being ₹ 87,80,000). It wants to claim the following deduction —**

	₹
<b>Salary and interest to partners [as permitted by section 40(b)]</b>	<b>60,000</b>
<b>Salary to employees</b>	<b>4,90,000</b>
<b>Depreciation</b>	<b>2,70,000</b>
<b>Cost of material used</b>	<b>75,90,000</b>
<b>Other expenses</b>	<b>3,45,000</b>

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

<b>Total</b>	<b>87,55,000</b>
<b>Net profit (₹ 87,80,000 minus ₹ 87,55,000)</b>	<b>25,000</b>

Determine the total income of A & Co. for the assessment year 2014-15 assuming that long-term capital gain is ₹ 50,000 and the firm is eligible for a deduction of ₹ 5,000 under section 80G. The firm has a brought forward business loss of ₹ 2,40,000 (previous year 2010-11) of a trading business which has been discontinued.

- (b) Write to whom Alternate Minimum Tax shall not be applicable as per Section 115JEE (2).  
 (c) Delta Ltd., an infrastructure capital company, issued 1,00,000 Zero Coupon Bonds (Face Value ₹ 100) on 10th September, 2013 at a price of ₹ 75. The redemption date of the bonds is 22nd September, 2025. These bonds are notified by the Central Government as Zero Coupon Bond. You are required to compute the amount of discount allowable as deduction while computing business income of the Delta Ltd.

[6+2+5]

**Answer:**

(a) Assessee: A & Co.

Previous Year: 2013-14

Assessment Year: 2014-15

### Computation of Total Income

	₹
Income from business (8% of ₹ 87,80,000)	7,02,400
Less : Expenses	
Salary/interest paid to partners as permitted by section 40(b)	60,000
Other expenses [except salary/interest to partners in the case of a firm, no other expenditure is deductible]	Nil
Income from business	6,42,400
Less : Brought forward business loss adjusted	(-)2,40,000
Profits and gains from business or profession	4,02,400
Capital gains	50,000
Gross total income	4,52,400
Less : Deductions under sections 80C to 80U	5,000
Total income	4,47,400

- (b) The provisions of Alternate Minimum Tax under Chapter XII-BA shall not apply to-
- (i) an Individual; or
  - (ii) a Hindu Undivided Family; or
  - (iii) an Association of Persons or a Body of Individuals (whether incorporated or not) or
  - (iv) an Artificial Juridical Person referred to in section 2(31) (vii),
- if the Adjusted Total Income of such person does not exceed ₹ 20,00,000.

- (c) Discount on Zero Coupon Bond is allowable to Delta Ltd. on pro-rata basis.

Total Amount of Discount = (₹100 - ₹75) × ₹1,00,000 = ₹ 25,00,000

Date of issue: 10th September, 2013 [as it is less than 15 days, it shall be ignored and date of issue will be taken as 1<sup>st</sup> September, 2013]

Date of redemption: 22nd September, 2025 [if it is 15 days or more, it is taken as one month and so redemption date will be taken as 30<sup>th</sup> September, 2025]

## **Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1**

Total life of the bond: 1st September, 2013 to 30th September, 2025 i.e. 145 months.

Prorated discount for one month =  $25,00,000/145 = ₹17,241$

Amount of discount allowable for the Previous Year 2013-14 = ₹  $(17,241 \times 7) = ₹ 1,20,687$

Amount of discount allowable for the Previous Year 2014-15 to 2024-25 = ₹  $(17,241 \times 12) = ₹ 2,06,892$  per year

Amount of discount allowable for the Previous Year 2025-26 = ₹  $(17,241 \times 6) = ₹ 1,03,446$ .

### **Question 4.**

**(a) What do you mean by annexure less return? What is the manner of filing the return of income?**

**(b) Z Ltd., an Indian company, is engaged in the business of production of minerals since 1960. During the year ending March 31, 2013, it starts commercial exploitation of a new mine at Hazaribag. Compute the amount deductible under section 35E of Income-tax Act for the assessment years 2013-14 and 2014-15 from the given information —**

	Previous year 2012-13 ₹	Previous year 2013-14 ₹
<b>Income from mining (before section 35E deduction)</b>		
- from old mining	22,000	4,00,000
- from new mining at Hazaribag	25,000	75,000
<b>Other business income</b>	<b>4,00,000</b>	<b>3,90,000</b>

**Qualifying expenditure u/s 35E —**

	₹
<b>Expenses for the purpose of exploring and locating mineral incurred up to March 31, 2008</b>	<b>7,20,000</b>
<b>Expenses for the purpose of exploring and locating mineral from April 1, 2008 to March 31, 2013 (out of which ₹ 6,000 is met by the State Government)</b>	<b>9,36,000</b>
<b>Acquisition of site on June 30, 2008</b>	<b>4,00,000</b>
<b>Purchase of plant, machinery and building on July 31, 2009</b>	<b>6,00,000</b>

**(c) State whether assets having personal effects are also capital assets or not [as per section 2(14)(ii) of Income-tax Act]?**

**[4+7+2]**

**Answer:**

**(a)** The return of income required to be furnished in Form No. ITR-1, ITR-2, ITR-3, ITR-4, ITR-5, ITR-6 or ITR-7 shall not be accompanied by a statement showing the computation of the tax payable on the basis of the return, or proof of the tax, if any, claimed to have been deducted or collected at source or the advance tax or tax on self-assessment, if any, claimed to have been paid or any document or copy of any account or Form or report of audit required to be attached with the return of income under any of the provisions of the Act.

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

Manner of filling the return: The return of income referred to in sub-rule (1) may be furnished in any of the following manners, namely:-

- (ii) Furnishing the return in a paper form;
- (iii) Furnishing the return electronically under digital signature;
- (iv) Transmitting the data in the return electronically and thereafter submitting the verification of the return in Form ITR-V;
- (v) Furnishing a bar-coded return in paper form.

### (b) Computation of qualifying expenditure u/s 35E —

	₹
1. ₹ 7,20,000 incurred prior to April 1, 2008 is not part of qualifying expenditure (expenditure incurred during 2012-13 and earlier 4 years will be considered)	---
2. Out of ₹ 9,36,000, ₹ 6,000 is met by the State Government; only ₹ 9,30,000 shall be included	9,30,000
3. Expenditure on acquisition of site is not qualifying amount	---
4. Building, plant and machinery are qualified for depreciation ; deduction under section 35E is not available	---
Qualifying expenditure	9,30,000
Amount deductible during 10 years : assessment years 2013-14 to 2022-23	93,000
Assessment year 2013-14	
Income from mining (old and new)	47,000
Less : Deduction under section 35E (i.e., ₹ 47,000 or ₹ 93,000 whichever is less)	47,000
Mining income	Nil
Other income	4,00,000
Net income	4,00,000

Note: The amount of unabsorbed deduction under section 35E of ₹ 46,000 (i.e., ₹ 93,000 - ₹ 47,000) become a part of deduction for the next year.

Assessment year 2014-15

	₹
Mining income (old and new)	4,75,000
Less : Deduction under section 35E [i.e., ₹ 93,000 + ₹ 46,000, subject to a maximum of mining income)	1,39,000
Balance	3,36,000
Other business income	3,90,000
Net income	7,26,000

### (c) Assets having personal effects are not capital assets under section 2(14)(ii) of Income-tax Act, if the following conditions are satisfied:

1. It should be movable property (including wearing apparel and furniture).
2. It should be held for personal use by the assessee or any member of his family dependent on him.
3. It should not be jewellery, archaeological collections, drawings, paintings, sculptures, or any work of art.

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

---

### Question 5.

(a) State the taxability of the following five incomes —

- (i) Dividend
- (ii) Bonus
- (iii) Winning from lotteries etc.
- (iv) Fees and commission
- (v) Gift

(b) Mr. Dey sells a residential house property at a long-term capital gain of ₹ 75,000. He invests ₹ 80,000 within 3 years in construction of the first floor and barsati (to be used for residence) to another house owned by him since 1949. Is ₹ 75,000 exempt from tax under section 54? (Specify in details)

[10+3]

### Answer:

(a) (i) Dividend is defined by section 2(22). Dividend from an Indian company is not taxable in the hands of shareholders. However, deemed dividend under section 2(22)(e) from an Indian company or any dividend from a foreign company is taxable in the hands of shareholders under the head "Income from other sources".

(ii) It is taxable in the year of receipt if it has not been taxed earlier on due basis. While contractual bonus is regarded as salary, gratuitous bonus is taxable as perquisite. If bonus is received in arrears, the assessee can claim relief in terms of section 89.

(iii) It includes any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever. These receipts are chargeable to tax under the head "Income from other sources".

(iv) Fees and commission are taxable as salary irrespective of the fact that they are paid in addition to or in lieu of salary. However, if fees and commission is paid to a person (other than an employee), it is not taxable as salary income. For instance, commission paid to a director (not being an employee) for his giving guarantee for repayment of loan, etc. is taxable under the head "Income from other sources".

(v) If any sum of money or property is received during a previous year without consideration by an individual or a Hindu undivided family from any person or persons exceeds ₹ 50,000, the whole of such amount is taxable in the hands of the recipient as income from other sources.

(b) The words "house property" in section 54 does not mean an independent and completed house. They have the same meaning as the concept of house property in sections 22 to 27 and it includes an independent unit such as the first floor of house. In fact, there can be no doubt that the section takes into account all independent residential units, particularly in the days when multi-storied flats are becoming the order of the day. The amount of capital gain is invested by Mr. Dey in the construction of a house property within the meaning of section



## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

54, which is completed within a period of 3 years after the date of the sale. Further, the house property so constructed is admittedly used for the purpose of residence. Hence, Mr. Dey is entitled to the exemption under section 54.

### Question 6.

(a) Ravi purchases the following movable and immovable properties from persons who are not his relatives. State the tax liability in the hands of Ravi.

Date of purchase	Property	Purchase price ₹	Stamp duty value ₹	Fair market value ₹
April 22, 2013	House I	21 lakh	21.5 lakh	----
June 27, 2013	Plot of land	30 lakh	30.5 lakh	----
August 22, 2013	Gold ring	5 lakh	----	5.5 lakh
October 23, 2013	Shares	8 lakh	----	8.5 lakh

(b) Write down the steps for calculation of tax in case of agricultural income.

[7+6]

### Answer:

(a) Section 56(2)(vii)(b) has been amended with effect from assessment year 2014-15 to cover the case of receipt of receipt of immovable property with inadequate consideration. The amended provision is applicable only when an individual or HUF has received an immovable property for a consideration which less than the stamp duty value of the property by an amount exceeding ₹ 50,000.

**House I** - House I is purchased for less than stamp duty value. The difference is ₹ 50,000. The amended provision is applicable only if stamp duty value is more than purchase price and the difference is more than ₹ 50,000. Consequently, nothing is taxable in the hands of Ravi on purchase of House I. However, in the hands of the transferor, stamp duty value of ₹ 21.5 lakh will be taken as sale consideration under section 50C or 43CA.

**Plot of land** - Plot of land is purchased for ₹ 30 lakh. Stamp duty value is ₹ 30.5 lakh. The inadequacy of consideration is ₹ 50,000. Since it is not more than ₹ 50,000, the amended provision is not applicable. Consequently, nothing is taxable in the hands of Ravi under section 56. It may be noted that inadequacy of consideration of ₹ 50,000 of House I and inadequacy of consideration of plot of land of ₹ 50,000 cannot be clubbed (such clubbing is required in the case of recipient of movable properties). In the hands of the transferor, ₹ 30.5 lakh is taken as full value of consideration by virtue of section 50C or 43CA.

**Gold ring and shares** - Gold ring is purchased for less than fair market value. Likewise, shares are purchased for less than fair market value. The two assets come within the definition of "movable property" under section 56. The aggregate inadequacy of consideration is more than ₹ 50,000 (i.e., ₹ 5.5 lakh - ₹ 5 lakh + ₹ 8.5 lakh - ₹ 8 lakh = ₹ 1 lakh). Consequently, ₹ 1 lakh is taxable under section 56(2). In the hands of the transferors of gold ring and shares, ₹ 5 lakh

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

---

and ₹ 8 lakh, respectively, will be taken as sale consideration. Section 50C or section 43CA is not applicable on transfer of movable properties.

### (b) The steps for calculation of tax in case of agricultural income:

**Step 1:** Add non-agricultural income with net agricultural income. Compute tax on the aggregate amount.

**Step 2:** Add net agricultural income and the maximum exemption limit available to the assessee (e.g. ₹ 2,00,000/ ₹ 2,50,000 / ₹ 5,00,000, etc. as applicable). Compute tax on the aggregate amount.

**Step 3:** Deduct the amount of income tax calculated in step 2 from the income tax calculated in step 1 i.e. Step 1 – Step 2.

**Step 4:** Deduct any applicable rebate from the amount of tax obtained in step 3.

**Step 5:** Add surcharge, if applicable, to the amount obtained in step 4 above.

**Step 6:** The sum so arrived at shall be increased by education and higher secondary cess.

These steps are applicable whenever tax liability is to be worked out e.g. self-assessment tax, advance tax, tax on regular assessment.

### Section B

[Answer **all** the questions]

#### Question 7.

State whether the following statements are correct or not with brief reasons:

- (i) **Wealth tax can be levied on any political party.**
- (ii) **Cash in hand in excess of ₹ 50,000 is an 'asset' in case of individual.**
- (iii) **Property held under a trust is chargeable under wealth tax.**
- (iv) **Gold Deposit Bonds are also assets as jewellery.**
- (v) **Yachts, boats and aircrafts used for non-commercial purposes are treated as 'assets'.**

[5 × 1]

#### Answer:

- (i) No, wealth tax cannot be levied on the net wealth of any political party as per section 45 of the Wealth Tax Act.
- (ii) Yes, in case of individual cash in hand on the last moment of the valuation date in excess of ₹ 50,000 is an 'asset'.
- (iii) No, as per Section 5(i) of the Wealth Tax Act any property held by an assessee under a trust in India is totally exempt from tax.
- (iv) No, Jewellery does not include Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999 notified by the Central Government. So these are not assets.
- (v) Yes, as per section 2(ea)(iv) of the Wealth Tax Act Yachts, boats and aircrafts if used for non-commercial purposes then treated as 'assets'.

## **Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1**

---

**Question 8.**

**Either**

**(a) Discuss in respect of the following items, the manner of treatment for Mrs. P's wealth-tax assessment for the assessment year 2014-15.**

- 1. Mrs. P has two cars for her personal use each being of value of ₹ 95,000.**
- 2. She has another house property at Nainital given to her as a gift by her father on January 1, 1971 on the occasion of her birthday. This house is also used by her as her own residence where she lives during summer vacations only. The value of the house on March 31, 2014 was ₹ 25,00,000.**
- 3. Jewellery received from her father at the time of her marriage in 1956 was of the value of ₹ 1,20,000 on March 31, 2014.**

**(b) What will be the consequence if an asset transferred to son's wife of an individual?**

**[4+1]**

**Or**

**Compute the taxable net wealth and wealth tax payable by X Ltd. from the following particulars:**

- (i) Land in urban area (Construction is not permitted as per Municipal Laws in force) ₹ 50,00,000.**
- (ii) Cash Balance (as per books) ₹ 2,75,000.**
- (iii) Guest House (situated in a place which is 30 kms away from the local limits of the municipality) ₹ 35,00,000.**

**[5]**

**Answer:**

**Either**

**(a) 1. ₹1,90,000 (₹ 95,000 × 2) is chargeable to wealth-tax.**

2. Value of the house is to be included in the net wealth of Mrs. P. She can, however, claim exemption under section 5(vi) of Wealth-tax Act.

3. Jewellery received in 1956 is outside the purview of section 4. Therefore, it will be included in the net wealth of Mrs. P.

**(b) As per Section 4(1)(a)(v) of the Wealth Tax Act, if an asset transferred by an individual after May 31, 1973, to son's wife, directly or indirectly, without adequate consideration and the asset may be held by the transferee on the relevant valuation date in the same form in which it was transferred or otherwise, will be 'deemed asset' of transferor.**

**Or,**

# Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

Assessee: X Ltd.

Valuation Date: 31.3.2014

Assessment Year: 2014-15

## Computation of Taxable Net Wealth and Wealth Tax Payable

Nature of Assets		Reasons
Land in Urban Area	Nil	Land in which construction is not permitted as per municipal law is not an asset u/s 2(ea) of Wealth-tax Act
Cash Balance	Nil	Cash as per books - Not an asset u/s 2(ea) of Wealth-tax Act
Guest House	35,00,000	Asset u/s 2(ea) of Wealth-tax Act
Net Wealth	35,00,000	
Less: Basic Exemption	30,00,000	
Taxable Net Wealth	5,00,000	
<b>Tax Payable @1%</b>	<b>5,000</b>	

### Section C

(All questions in this section relate to the transfer pricing provisions under the Income-tax Act, 1961)

#### Question 9.

- State the purpose of APA (Advance Pricing Agreement)?
- What are the provisions to consider a transaction as deemed international transaction?
- Define the term 'Permanent Establishment'.
- What is meant by uncontrolled conditions in the context of arm's length price?
- Write about role of market forces in determining the "Arm's Length Price" in case of independent enterprises.

[5 × 1]

#### Answer:

- APA shall include determination of the arm's length price or specify the manner in which arm's length price shall be determined, in relation to an international transactions to be entered into, by that person.
- Section 92B(2) provides that transactions between an enterprise and another person is deemed as transactions entered into between two associated enterprises if either of the following exists:
  - There is a prior agreement in relation to the relevant transaction between such other and the associated enterprise; or
  - The terms of the relevant transaction are determined in substance between such other person and the associated enterprise.
- Permanent Establishment is defined in Sec. 92F (iiia), which includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.
- For the computation of Arm's Length Price, Conditions which are not controlled or suppressed or moulded for achievement of pre-determined results are said to be uncontrolled conditions.
- In case of transactions between independent enterprises, the conditions of their commercial and financial relations (eg. The price of goods transferred or services provided and the conditions of the transfer or provision) are, ordinarily, determined by the market force.

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

---

Question 10.

Either

- (a) State the types of issues which are dealt in transfer pricing in relation to the intangibles?
- (b) Apollo Ltd. is an Indian company which is a 100% subsidiary of Zorrelto Ltd., a foreign company. Zorrelto Ltd. sells its products to Apollo Ltd. at \$50 per unit. At the same time, it sells its products to another company Yatchilo Ltd. in India at \$70 per unit. Total income of Apollo Ltd. is ₹ 14,00,000 after making payment for 200 units @ \$50 (\$1 = ₹ 45). Apollo Ltd. has deducted tax at source while making payment to Zorrelto Ltd. Compute 'arm's length price' and 'taxable income' of Apollo Ltd. and Zorrelto Ltd. assuming that Yatchilo Ltd. has purchased 100 units @ \$70 (\$1 = ₹ 45).
- (c) Explain the concept and validity of 'Treaty shopping'.
- (d) What are the applications of Cost Plus method in computation of arm's length price?
- (e) What is the underlying idea behind Double Taxation Avoidance Agreement (DTAA)?

[4+6+5+4+1]

Or

- (a) What is the object of introducing Transfer Pricing?
- (b) Write a note on income by way of royalties, etc., in case of non-residents.
- (c) Mcnil Inc. of France and Robot Ltd. of India are associated enterprises. Robot Ltd. imports 2,000 compressors for Air Conditioners from Mcnil Inc. at ₹ 7,500 per unit and these are sold to Happy Cooling Solutions Ltd at a price of ₹11,000 per unit. Robot Ltd. had also imported similar products from Thunder Inc. Poland and sold outside at a Gross Profit of 20% on Sales.

Mcnil Inc. offered a quantity discount of ₹1,500 per unit. Thunder Inc. could offer only ₹500 per unit as Quantity Discount. The freight and customs duty paid for imports from Thunder Inc. Poland had cost Robot Ltd. ₹ 1,200 per piece. In respect of purchase from Thunder Inc., Robot Ltd. had to pay ₹200 only as freight charges.

Determine the Arm's Length Price and the amount of increase in Total Income of Robot Ltd.

- (d) What are the objectives of Profit Split Method (PSM)?

[2+7+6+5]

Answer:

Either

- (a) Transfer pricing of intangibles is well known as a difficult area of taxation practice. However, the pace of growth of the intangible economy has opened new challenges to the arm's length principle. Seventy five percent of all private R&D expenditure worldwide is accounted for by MNEs.

The transactions involving intangible assets are difficult to evaluate because of the following reasons:

- (ii) Intangibles are seldom traded in the external market and it is very difficult to find comparables in the public domain.
- (iii) Intangibles are often transferred bundled along with tangible assets.
- (iv) They are difficult to be detected.

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

---

A number of difficulties arise while dealing with intangibles. Some of the key issues revolve around determination of arm's length price of rate of royalties, allocation of cost of development of market and brand in a new country, remuneration for development of marketing, Research and Development intangibles and their use, transfer pricing of cobranding etc.

- (b)** Both Apollo Ltd. and Zorrelto Ltd. are associated enterprises since Apollo Ltd. is wholly owned subsidiary of Zorrelto Ltd. Therefore, the transaction between Apollo Ltd. and Zorrelto Ltd. is an international transaction and its taxation will be governed by transfer pricing law.

As per Section 92, the provisions of transfer pricing will not apply where adoption of arm's length price results in reduction of taxable income or increase in loss computed as per books of account for previous year in which international transaction was entered.

In the given case, if ALP of US\$ 70 per unit charged for sales made to Yatchilo Ltd. in India (a comparable uncontrolled transaction) is adopted, then it will result in reduction in taxable income of Apollo Ltd., hence, the arm's length price will not be adopted. Accordingly, the taxable income of M/s. Apollo Ltd. = 14 lakh (as already computed).

It appears that no part of the income of Zorrelto Ltd. accrues or arises in India, as merely by having subsidiary company in India (viz. Apollo Ltd.), no business connection cannot be said to exist, more so, when the transactions between Zorrelto Ltd. and Apollo Ltd. relate only to purchase or sale of goods. Hence, its taxable income in India = NIL. It can claim refund of tax deducted at source.

- (c) Treaty shopping:** If a resident of a third country takes unintended advantage of tax treaty between two countries, it is known as treaty shopping. For taking such unintended advantage, an entity is formed or incorporated in another country having regard to tax treaty available with the other country and whose laws make it a suitable base for such international investment.

**For example:** In Mauritius there is no capital gains tax. As per Indo-Mauritius DTAA, residents of Mauritius will be taxed only by Mauritius government in respect of capital gains arising from movable properties in India.

To take unintended advantage of such treaty, persons of other countries incorporates a company in Mauritius and make their investments in India through that company, thus avoiding capital gains tax liability from investments in India.

**Validity of Treaty Shopping :** The Supreme Court in UOI v. Azadi Bachao Andolan [2003] 132 Taxman 373 (SC) observed that many developed countries tolerate or encourage 'treaty shopping' for other non-tax reasons even if it is unintended, improper or unjustified, unless it leads to a significant loss of tax revenue. The Supreme Court recognized that the treaties are negotiated and entered into at political level and have several considerations as their bases. This is an important principle to be kept in mind in the interpretation of the provisions of an international treaty. The Court observed that if it was intended that a resident of a third state should be precluded from the benefits of a DTAA, then a suitable limitation to that effect

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

---

must find place in the DTAA itself. In the absence of a limitation specifically provided in the DTAA, treaty shopping cannot be held to be invalid.

**(d)** The Cost Plus method is ordinarily used where:

- 1) Semi finished goods are sold between related parties;
- 2) Contract/Toll Manufacturing arrangements;
- 3) Long-term buy — and supply arrangements have been entered; and
- 4) Services are provided.

**(e)** The underlying idea behind Double Taxation Avoidance Agreement (DTAA) entered between two countries is relieving the tax payers from the burden of paying tax twice on the same income in two different countries and to promote mutual economic relations.

Or

**(a)** The existence of different tax rates in different countries offers multinational enterprises to fix up their prices for goods and services and allocate profits among the enterprises within the group in such a way that there may be either no profit or negligible profit in the jurisdiction which taxes such profits and substantial profit in the jurisdiction which is tax haven or where the tax liability is minimum. This may adversely affect a country's share of due revenue and which may lead to erosion of tax revenue. Therefore, transfer pricing provisions have been brought with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises.

**(b)** Income by way of royalties, etc., in case of non-residents [Section 44DA]:

**(A) Section applies to:** This section applies if the following conditions are fulfilled -

- (i) The assessee is a non-resident (not being a company) or a foreign company;
- (ii) He is in receipt of income by way of royalty or fees for technical services from Government or an Indian concern;
- (iii) Such income is received in pursuance of an agreement made by the assessee with Government or the Indian concern after 31-3-2003;
- (iv) Assessee carries on business in India through a permanent establishment situated in India, or performs professional services from a fixed place of profession situated in India; and
- (v) The right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment/fixed place of profession.

**(B) Computation of income:** The income of such assessee shall be computed under the head "Profits and gains of business or profession" in accordance with the provisions of this Act.

However, no deduction is allowed in respect of -

- (i) Any expenditure or allowance which is not wholly and exclusively incurred for the business of such permanent establishment or fixed place of profession in India; or

## Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1

- (ii) Amounts paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to its head office or to any of its other offices.

### (C) Accounts and audit: The assessee shall -

- (i) Keep and maintain books of account and other documents as per Section 44AA;  
(ii) Get his accounts audited by a Chartered Accountant; and  
(iii) Furnish along with the return of income the report of such audit in prescribed form duly signed and verified by such Chartered Accountant.

**(D) Provisions of Section 44BB not to apply:** The provisions of Section 44BB shall not apply in respect of the income referred to in this section. Hence, even if royalty/fees for technical services received by non-resident relates to exploration activity, the provisions of Section 44BB won't apply. Section 44BB would apply only in a case where consideration is for services and other facilities relating to exploration activity which are not in the nature of royalty/technical services.

### (c) Computation of Arm's Length Price of Products bought from Mcnil Inc., France by Robot Ltd, India

Particulars	Amount (₹)
Resale Price of Goods Purchased from Mcnil Inc.	11,000
<b>Less:</b> Adjustment for Differences –	
a) Normal Gross Profit Margin at 20% of Sale Price [20% x ₹ 11,000]	2,200
b) Incremental Quantity Discount by Megabyte Inc. [₹ 1,500 - ₹ 500]	1,000
c) Difference in Purchase related Expenses [₹ 1,200 - ₹ 200]	1,000
Arms Length Price	6,800

### Computation of Increase in Total Income of Robot Ltd

Particulars	Amount (₹)
Price at which actually bought from Mcnil Inc. of France	7,500
Less: Arms Length Price per unit under Resale Price Method	(6,800)
Decrease in Purchase Price per unit	700
No. of units purchased from Mcnil Inc.	3,000 units
Increase in Total Income (2,000 units x ₹ 700)	₹ 14,00,000

### (d) The objectives of Profit Split Method (PSM) —

- 1) To determine the relative value of each controlled taxpayer's contribution;
- 2) To assess the impact of the controlled taxpayer's contribution on the success of the relevant business activity;



## **Answer to PTP\_Intermediate\_Syllabus 2012\_Jun2014\_Set 1**

---

- 3) To identify and evaluate the impact of the controlled taxpayer's contribution that reflects the functions performed, risks assumed, and resources employed.
- 4) To eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.
- 5) To identify the profit to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged.