

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) Ms. Damietti, an Italian national has income from house property in Italy, remitted by tenant to her in India through State Bank of India for ₹ 3,20,000 in the previous year 2013-14. What will be the incidence of tax if she is Non-resident in India during the said previous year?
- (ii) If Municipal Value (MV), Fair Rent (FR) and Standard Rent of a house property are ₹ 50,000, ₹ 56,000 and ₹ 45,000 respectively for the previous year 2013-14, then what will be its reasonable expected rent?
- (iii) Whether unabsorbed depreciation can be set off only against income under "Profits and Gains of Business or Profession" or not?
- (iv) A, an individual, gets ₹ 65,000 as a birthday gift from his Grandfather. Is the receipt taxable under the Income Tax Act?
- (v) "The provision of Alternate Minimum Tax shall apply to an individual" — critically examine.
- (vi) Does tax planning include compliance within law? Clarify.
- (vii) Nayanika is employed as resident engineer in WLB Ltd. on a basic salary of ₹ 75,000 per month. A sweeper and a watchman are engaged to look after her bungalow. They are the employees of the company on a salary of ₹ 300 per month each. Nayanika had no shares in the company and she is not related to any of the directors. Discuss the tax treatment in the hands of Nayanika.
- (viii) State the deductibility of the expenses in case of profits and gains from business or profession — Initial expenditure incurred on installation of fluorescent tube lights.

[8 × 1]

(b) Choose the correct alternative:

- (i) An individual can avail the benefit of Leave Travel Assistance offered by his employer —
 - (A) twice in a block of two years;
 - (B) twice in a block of four years;
 - (C) once in a block of four years;
 - (D) once in a block of two years.

- (ii) How many installments of prior period interest of a house property will be allowed as deduction from the year in which the property was acquired or construction was completed?
 - (A) five;
 - (B) ten;

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- (C) six;
(D) four.
- (iii) As per section 80GG of the Income-tax Act, which one of the following is one of the criteria for claiming deduction in respect of rents paid—
(A) 50% of Adjusted Total Income;
(B) 100% of Adjusted Total Income;
(C) 10% of Adjusted Total Income;
(D) 25% of Adjusted Total Income.
- (iv) As per section 139A of the Income-tax Act, Permanent Account Number (PAN) comprises of —
(A) 10 alphanumeric characters;
(B) 12 alphanumeric characters;
(C) 10 numeric characters;
(D) 12 numeric characters.
- (v) As per section 71B of the Income-tax Act, the permissible limit to carry forward and set off Brought forward loss from House Property is —
(A) 4 Assessment Years immediately succeeding the Assessment Year for which such loss was computed;
(B) Any number of year until it is fully set off;
(C) 8 Assessment Years immediately succeeding the Assessment Year for which such loss was computed;
(D) None of the above.

[5 × 1]

Answer to Question 1(a):

- (i) Although Ms. Damietti is non-resident in India during the previous year 2013-14, as the income of ₹ 3,20,000 is received in India it will be taxable in India for that previous year.
- (ii) The reasonable expected rent will be the higher of Municipal Value and Fair Rent of the house property but subject to the Standard Rent. In this situation reasonable expected rent will be ₹45,000.
- (iii) Unabsorbed depreciation shall be treated as part of the current year depreciation. Such unabsorbed depreciation can be set off not only against income under "Profits and Gains of Business or Profession" but also against income under any other head.
- (iv) A has received the gift from his grandfather. Grandfather is a relative. Hence, the receipt is not taxable.
- (v) The provision of Alternate Minimum Tax shall not apply to an individual if the Adjusted Total Income of such person does not exceed ₹ 20,00,000.
- (vi) Yes. Timely filing of returns, payment of advance tax, finally tax deduction at source, etc., are all important to avoid penal interest, penalty, prosecution, etc.
- (vii) Basic salary of ₹ 9,00,000 is taxable. The benefit of providing free sweeper and watchman is taxable. ₹ 7,200 (being expenditure incurred by employer) is chargeable to tax.
- (viii) Initial expenditure on installation of fluorescent tube lights is a capital expenditure, not deductible [Section 37(1)].

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Answer to Question 1(b):

- (i) (B) twice in a block of four years
- (ii) (A) five
- (iii) (D) 25% of Adjusted Total Income
- (iv) (A) 10 alphanumeric characters
- (v) (C) 8 Assessment Years immediately succeeding the Assessment Year for which such loss was computed.

Question 2.

(a) The travelling allowance of ₹ 35,000 is given to Mr. Y by his employer for official purpose during the previous year 2013-14. The amount actually spent by Mr. Y for this purpose is ₹ 32,000. State the taxability of the said item.

(b) Z retires on 30th June, 2013. He submits the following information –

Basic salary (since January 2013): ₹ 20,000 per month, dearness allowance: ₹ 6,000 per month (1/3 of which is part of salary for retirement benefits), employer's contribution towards provident fund : ₹ 3,000 per month (Z makes a matching contribution); interest credited at the rate of 15 per cent on April 30, 2013 : ₹ 7,500; pension after retirement : ₹ 10,000 per month, and payment of provident fund at the time of retirement : ₹ 7,60,000 (out of which employer's contribution: ₹ 3,30,000, interest thereon : ₹ 44,000, Z's contributions : ₹ 3,50,000, interest thereon : ₹ 46,000). Salary and pension become due on the last day of each month. Z has deposited the entire provident fund payment with a company (rate of interest: 9 per cent per annum).

Find out the income of Z for the assessment year 2014-15 on the assumption that the provident fund is (i) statutory provident fund, (ii) recognized provident fund, or (iii) unrecognized provident fund.

(c) What is the due date of filling of return of income in case of a non-working partner of a firm whose accounts are not liable to be audited?

[2+(3+3+3)+2]

Answer:

(a) In the given case, the amount chargeable to tax is ₹ 3,000 (₹ 35,000 - ₹ 32,000). The travelling allowance is exempt u/s 10(14) of the Income-tax Act to the extent the amount is utilised for the specified purpose for which the allowance is received.

(b) **Computation of Income of Z**

Particulars	Statutory provident fund ₹	Recognised provident fund ₹	Unrecognised provident fund ₹
Basic salary (₹ 20,000 x 3)	60,000	60,000	60,000
Dearness allowance	18,000	18,000	18,000

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PF Contribution by the employer [₹ 3,000 x 3 – 12% of (₹ 60,000 + 1/3 of ₹ 18,000)]	---	1,080	---
Interest credited in PF account in excess of 9.5% [₹ 7,500 x 5.5/15]	---	2,750	---
Pension (₹ 10,000 x 9)	90,000	90,000	90,000
Payment for provident fund account	---	---	3,30,000
- Employer's contribution	---	---	44,000
- Interest thereon	1,68,000	1,71,830	5,42,000
Gross salary	---	---	---
Less: Deductions	1,68,000	1,71,830	5,42,000
Income from salary	---	---	---
Income from other sources	---	---	46,000
- Interest on Z's contribution to provident fund	---	---	---
- Interest on company deposits (i.e., 9% per annum on ₹ 7,60,000 from July 1, 2013 to March 31, 2014)	51,300	51,300	51,300
Gross total income	2,19,300	2,23,130	6,39,300
Less: Deduction under section 80C	9,000	9,000	Nil
Net income	2,10,300	2,14,130	6,39,300

Note: In the case of recognized provident fund, it is assumed that Z has retired after rendering service of 5 years.

- (c) A working partner for the above purpose shall mean an individual who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner and is drawing remuneration from the firm.

Due date of furnishing return of income in case of non-working partner shall be 31st July of the Assessment Year whether the accounts of the firm are required to be audited or not.

Question 3.

- (a) Kavita owns a house property which is given on rent. For the previous year 2011-12, she claims a deduction of ₹ 78,000 on account of unrealised rent, out of which the Assessing Officer allows only ₹ 62,000 as deduction. What are the tax consequences if Kavita recovers on June 25, 2013 from the defaulting tenant (i) ₹ 10,000, (ii) ₹ 16,000 or (iii) ₹ 35,000 as full and final payment?

- (b) What is the difference between exemption and deduction?

- (c) Can assessee follow different method of accounting for different businesses?

- (d) During his 195 days' stay in India in the previous year 2013-14, Aman, a citizen of U.K. is all the time moving from one place to another. He claims that he is non-resident in India for the assessment year 2014-15 on the following grounds:

1. He had never visited India before April 1, 2013.
2. During 2013-14, though he is in India for 195 days, he could not spend two consecutive nights at any one place.
3. For the assessment year 2014-15, he is resident in U.K. according to the English Income-tax Act. He insists that he cannot be resident of two countries for the same assessment year. Do you agree with him?

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[5+2+2+4]

Answer:

(a)

Amount recovered during 2013-14 (₹)	Amount of bad debt (i.e., ₹ 78,000 minus the amount of recovery (₹))	Deduction allowed in 2012-13 (₹)	Balance
(i) 10,000	68,000	62,000	Loss of ₹ 6,000
(ii) 16,000	62,000	62,000	Nil
(iii) 35,000	43,000	62,000	Income of ₹ 19,000

In situation (iii), the excess recovery of ₹ 19,000 is chargeable to tax under the head "Income from house property" for the previous year 2013-14 (i.e., assessment year 2014-15).

It may be noted that:

- expenditure on recovery is not taken into consideration ; and
- the tax treatment will remain the same, even if the house property is not owned by Kavita during 2013-14.

(b) If an income is exempt from tax, it is not included in the computation of income. Exemption can never exceed the amount of income. Deduction is generally given from income chargeable to tax. Deduction can be less than or equal to or more than amount of income. If an amount deductible is more than the amount of income, the resulting amount will be taken as loss.

(c) If an assessee is carrying on more than one business, he can follow cash system of accounting for one business and mercantile system (accrual system) of accounting for other business. Similarly, if he had more than one sources of income under the head Income from Other Sources, he can follow accrual system for one source of income under the head Income from Other Sources, and cash system for other sources of income.

(d) The claim of Aman is not tenable, as he is in India for 195 days during the previous year 2013-14. He satisfies one of the two basic conditions (namely, presence of 182 days or more during the previous year 2013-14) and none of the additional conditions. He is, therefore, resident but not ordinarily resident in India for the assessment year 2014-15. The fact that he could not spend two consecutive nights at any one place is immaterial. Moreover, a person who is resident in India may become resident of any other country according to the tax laws of that country for the same or a different assessment year.

Question 4.

(a) A purchases a house property in 1995. It is compulsorily acquired by the Government on 20th April, 2012 (indexed cost of acquisition is ₹ 40,000). Compensation paid by the Government on 6th May, 2013: ₹ 6,00,000. The Delhi High Court increases the compensation from ₹ 6,00,000 to ₹ 9,30,000 on the appeal filed by A (legal expenditure incurred by A: ₹ 10,000). The

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Government on 10th June, 2014 pays the additional compensation of ₹ 3,30,000. Compute the capital gains.

- (b) An assessee filed a return of income on 31.8.2014 in respect of Assessment Year 2014-15 disclosing an income of ₹ 6 lakhs from business. It was not accompanied by proof of payment of tax due on self-assessment. Discuss the validity of such a return.
- (c) Name few of the property incomes which are exempted from tax.
- (d) How the cost of acquisition of Bonus Shares is determined in computation of capital gain?

[4+3+4+2]

Answer:

(a) Computation of Capital Gains

	₹
Assessment year 2014-15	
Sale consideration (being the original compensation)	6,00,000
Less : Indexed cost of acquisition	40,000
Long-term capital gains	5,60,000
Assessment year 2015-16	
Sale consideration (being the additional compensation awarded by Delhi High Court)	3,30,000
Less : Indexed cost of acquisition	Nil
Less : Expenses on transfer	10,000
Long-term capital gain	3,20,000

- (b) As per Explanation to sub-section (9) of section 139 of Income-tax Act a return is regarded as defective unless it is accompanied by proof of tax deducted at source, advance tax and tax on self-assessment, if any, claimed to have been paid. Therefore, the return is prima facie defective. It is not invalid at that stage. On receipt of the return, the Assessing Officer has to intimate the defect to the assessee and give him an opportunity to rectify the defect within a period of 15 days from the date of such intimation or within such further period which, on application by the assessee, he may, in his discretion, allow. If the defect is not rectified within the said period, the return will be treated as an invalid return and the provisions of the Income-tax Act shall apply, as if the assessee has failed to furnish the return.

Also, it may be noted that section 140A(3) of Income-tax Act says that if an assessee fails to pay tax or interest on self assessment he shall be deemed to be an assessee in default in respect of the tax or interest or both remaining unpaid and all the provisions of the Act shall apply accordingly.

- (c) Property income is exempt from tax in the following cases:
- (i) income from farm house [sec. 2(1A)(c) of the Income-tax Act with sec. 10(1) of the Income-tax Act] ;
 - (ii) annual value of any one palace of an ex-ruler [sec. 10(19A) of the Income-tax Act];
 - (iii) property income of a political party [sec. 13A of the Income-tax Act];
 - (iv) property income of a local authority [sec. 10(20) of the Income-tax Act] ;
 - (v) property income of a trade union [sec. 10(24) of the Income-tax Act]
 - (vi) one self-occupied property [sec. 23(2) of the Income-tax Act].

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(d) The cost of acquisition of Bonus Shares u/s 55(2)(iii) of Income-tax Act is determined as follows —

- 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.
- Where such bonus shares are issued on or after 1.4.81, the cost of acquisition shall be taken as Nil.

Question 5.

(a) Merry International Ltd. incurs an expenditure of ₹ 255 crores for acquiring the right to operate telecommunication services for Assam & Sikkim. The payment was made in November 2011 and the licence to operate the services was valid for 15 years. In December 2012, the company transfers part of the licence, in respect of Assam, to Banerjee International Ltd. for a sum of ₹ 56 crores and continue to operate the licence in Sikkim. What is the deduction allowable u/s 35ABB of the Income-tax Act to Merry International Ltd. for the Assessment Year 2014-15?

(b) Y, a resident individual, submits the following information for the assessment year 2014-15:

	₹
Business A	
Loss of the year 2013-14	(-)48,000
Brought forward loss of the year 2012-13	(-)39,000
Business B	
Profit of year 2013-14	1,56,000
Business C (previous year ends on 31st March, business discontinued on 10th April, 2013)	
Profit of the period from 1 st April, 2013 to 10 th April, 2013	Nil
Brought forward loss of 2012-13	(-)39,700
Business D (previous year ends on 31st March, business discontinued on 31st March, 2012)	
Brought forward loss of 2012-13	(-)40,000
Income from other sources	
Loss from the activity of owning and maintaining camels for races	(-)9,000
Dividend on units of UTI held as investment	75,000
Interest on debentures held as investments	99,000
Long-term capital loss on sale of shares	(-) 14,900
Income from house property	57,600

Determine the net income of Y for the assessment year 2014-15. Also calculate the amount of loss which can be carried forward for being set off in the next assessment year.

(c) What is the amount of deduction in respect of royalty of authors allowed as per section 80QQB of the Income-tax Act?

[4+7+2]

Answer:

(a) Assessee: Merry International Ltd. Previous Year: 2013-14 Assessment Year: 2014-15

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U/s 35ABB of the Income-tax Act, where part of the Telecom Licence is transferred and net consideration received on such transfer, is less than the expenditure remaining unallowed, the amount of deduction shall be computed as follows:

(i) Unallowed amount as on 01.04.2012	= Total Expenditure Less Deduction for Financial Year 2011-12 = ₹ 255 crores Less (₹ 255 crores/licence period of 15 years) = ₹ 255 crores less ₹ 17 crores = ₹ 238 crores.
(ii) Net Consideration received	= ₹ 56 crores
(iii) Remaining period of licence	= 14 years (including current Previous Year)
(iv) Deduction u/s 35ABB	= ₹ (238 crores less 56 crores)/14 years = ₹ 13 crores.

(b) Computation of Net Income

	₹
Business income/loss for the assessment year 2014-15	
Loss of business A for the year 2013-14	(-)48,000
Profit of business B for the year 2013-14	1,56,000
Profit of business C for the period April 1, 2013 to April 10, 2013	Nil
Loss from the activity of owning and maintaining camels for races	(-) 9,000
Current business profit	99,000
Less : Brought forward loss of Business A, Business C and Business D [i.e., (₹ 39,000 + ₹ 39,700 + ₹ 40,000) subject to the maximum of ₹ 99,000]	99,000
Business income	Nil
Computation of net income for the assessment year 2014-15	
Income from house property	57,600
Profits and gains of business or profession	Nil
Income from other sources	
Interest on debentures	99,000
Dividend on units of UTI	Nil
Gross total income	1,56,600
Less : Deduction	Nil
Net income	1,56,600

Notes:

1. Though business D was not in existence during the previous year 2013-14, yet the brought forward business loss of year 2012-13 can be set off against the income of the assessment year 2014-15.
2. Loss under the head "Capital gains" can be carried forward to the next year for set off against long-term capital gain.
3. The unadjusted brought forward business loss (i.e., ₹ 19,700) can be carried forward.

(c) The amount of deduction in respect of royalty of authors is allowed as per section 80QQB of the Income-tax Act as under:

- 100% of the royalty income etc. subject to a maximum of ₹ 3,00,000.
- In case of royalty or copyright fees, not in lump sum consideration, deduction shall be restricted to 15% of the value of books sold during the Previous Year.

Question 6.

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(a) On receipt of assessment order for the assessment year 2014-15 of MP Ltd., the chief accountant of that company finds that the following deductions claimed by it in the return of total income have not been allowed:

1. Expenditure of ₹ 17,000 incurred on accommodation maintained, at the place where the factory is located, for the directors and other employees of the company, who visit the factory for the purposes of the company's business.
2. A sum of ₹ 17,500 incurred for lunch at a five-star hotel where seven representatives of a prominent raw material supplier were taken for lunch and the purchase manager of the assessee had accompanied them.
3. Claim for deduction of a sum of ₹ 4,50,000 being the amount of liability for gratuity for the calendar year 1991 calculated on actuarial basis for which no provision was made in the books of account. The company does not maintain any gratuity fund. It maintains its accounts on mercantile basis. So far as gratuity liability is concerned, it has made provision for the same in the book of account for the previous year ended December 31, 1976. Thereafter, it stopped making provision for gratuity liability in the books of account. However, actual payments are debited to the Profit and Loss Account.
4. Expenditure of ₹ 12,000 incurred for drilling a tube-well in the factory. The drilling operations were given up as the water was hard and not suitable for use. The expenditure thus became infructuous.
5. Annual preference dividend liability of ₹ 1,00,000 on the company's 10 per cent cumulative redeemable preference shares which are not entitled to any further rights to participate in profits or surplus assets. These shares are redeemable on December 1, 2013 according to the terms of issue.
6. The Assessing Officer has also added a sum of ₹ 8,000 pertaining to unclaimed wages for the year 1992 which was transferred to the Profit and Loss Account of the year 2013-14 since the claim has become time barred. The assessee had claimed that the same was not liable to be included in the total income.

The company seeks your advice on the correctness or otherwise of the disallowances.

(b) Write a short note on return of loss [section 139(3) of Income-tax Act].

[9+4]

Answer:

(a)

1. Disallowance of expenses of ₹ 17,000 is not justified in view of the amendment made by the Finance Act, 1997. Now guest house maintenance expenses are deductible under section 37(1) of Income-tax Act.
2. Expenditure of ₹ 17,500 on lunch for representatives of raw material supplier is deductible under section 37(1) of Income-tax Act.
3. In view of the provision of section 40A(7) of Income-tax Act, the opinion of the Assessing Officer is justified — People's Engg. & Motor Works Ltd. v. CIT [1981] 6 Taxman 53 (Cal.).
4. Since the expenditure of ₹ 12,000 for drilling a tube-well in the factory is incurred wholly and exclusively for the purpose of the business of the assessee, the same is allowable under section 37(1) of Income-tax Act.
5. Provision for dividend is not an expenditure.
6. The amount of unclaimed wages, transferred to the Profit and Loss Account is taxable under section 41(1) of Income-tax Act.

(b) Return of Loss [Section 139(3) of the Income-tax Act]

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- (1) This section requires the assessee to file a return of loss in the same manner as in the case of return of income within the time allowed under section 139(1) of the Income-tax Act.
- (2) Under section 80 of the Income-tax Act, an assessee cannot carry forward or set off his loss against income in the same or subsequent year unless he has filed a return of loss in accordance with the provisions of section 139(3) of the Income-tax Act.
- (3) A return of loss has to be filed by the assessee in his own interest and the non-receipt of a notice from the Assessing Officer requiring him to file the return cannot be a valid excuse under any circumstances for the non-filing of such return.
- (4) In particular, a return of loss must be filed by an assessee who has incurred a loss under the heads "Profits and Gains from Business or Profession", "Capital Gains", and income from the activity of owning and maintaining race horses taxable under the head "Income from Other Sources".
- (5) However, loss under the head "Income from House Property" under section 71B of the Income-tax Act and unabsorbed depreciation under section 32 of the Income-tax Act can be carried forward for set-off even though return of loss has not been filed before the due date.

Section B

[Answer **all** the questions]

Question 7.

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

- (i) **A farm house situated within 30 kilometres from the local limits of any municipality is asset.**
- (ii) **Coparcenary interest in a Hindu undivided family is exempt from wealth-tax.**
- (iii) **Net wealth in excess of ₹ 30,00,000 is chargeable to wealth tax.**
- (iv) **The return of net wealth is to be filed in form ITR-1.**
- (v) **Motor car used by the assessee in the business of running them on hire, is an asset.**

[5 × 1]

Answer:

- (i) Not correct. A farm house situated within 25 kilometres from the local limits of any municipality (whether known as a municipality, municipal corporation or by any other name) or a cantonment board is asset.
- (ii) Correct. If the assessee is a member of a Hindu undivided family, his interest in the family property is totally exempt from wealth tax.
- (iii) Correct. Net wealth in excess of ₹ 30,00,000 is chargeable to wealth tax at the rate of 1 per cent.
- (iv) Not correct. The return of net wealth is to be filed in form BA.
- (v) Not correct. Motor car is an "asset", but a motor car used by the assessee in the business of running them on hire is not an asset.

Question 8.

Either

(a) Which entities are outside the purview of wealth tax?

(b) What is the basis of valuation of assets of business in the context of wealth tax?

[3+2]

Or

A, an Indian citizen, was ordinarily residing in Canada. He comes to India every year during August for 3 weeks. He comes to India permanently on July 9, 2013. He owns the following assets:

- 1. A residential house (not being let out) at Bombay gifted by his father-in-law.**
- 2. A house at Bangalore purchased out of money remitted from Canada on August 3, 2012.**
- 3. Two kilograms gold brought at the time of transfer of residence on July 9, 2013.**
- 4. Out of money brought into India at the time of return and out of his Non-resident (External) Account, he acquires the following during July-September 2013:
two cars, air-conditioners and shares in companies.**
- 5. On December 10, 2013, after selling one kilogram of gold, he purchases a boat.**

Discuss the taxability of the above items under the purview of Wealth-tax Act.

[5]

Answer:

Either

(a) The following entities are outside the purview of wealth tax:

- (i) any company registered under section 25 of the Companies Act, 1956
- (ii) any co-operative society
- (iii) any social club
- (iv) any political party
- (v) a Mutual fund specified under section 10(23D) of the Income-tax Act
- (vi) the Reserve Bank of India.

(b) If the assessee is carrying on a business for which accounts are maintained by him regularly, the net value of the assets of the business as a whole, having regard to the balance sheet of such business on the valuation date, is taken as value of such assets.

Or

1. House at Bombay is chargeable to tax.
2. As the house at Bangalore is purchased after July 9, 2012, it is not taxable for the assessment years 2014-15 to 2020-21 (exemption is not available for the assessment year 2013-14).
3. One kilogram gold (which he has not sold) is not chargeable to tax for the assessment years 2014-15 to 2020-21.
4. Air conditioners and shares are not "assets" and not chargeable to tax. Two cars purchased out of moneys brought into India are not taxable for the assessment years 2014-15 to 2020-21.
5. Boat purchased out of sale proceeds of gold is exempt under section 5(v). Exemption is available in respect of asset purchased out of money remitted into India or out of money standing to his credit in a Non-resident (External) Account.
Even if assessee has converted assets, which were brought by him from outside India, into money, and has used that money for acquisition of other assets, the asset which is acquired with sale consideration of original asset, is also eligible for exemption—CWT v. K.O. Mathews [2003] 133 Taxman 418 (Ker.).

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Section C

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

Question 9.

- (a) What is the full form of OECD?**
- (b) State the meaning of “safe harbour”.**
- (c) Give few examples of marketing related intangibles.**
- (d) What is Advance Pricing Agreement (APA)?**
- (e) Which is meant by “bilateral agreement” in the context of Advance Pricing Agreement?**

[5 × 1]

Answer:

- (a)** The full form of OECD is Organization for Economic Co-operation and Development.
- (b)** The term “safe harbour” means circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee.
- (c)** The examples of marketing related intangibles are Trademarks, Trade names, Service marks, Collective marks, Certification marks, Internet domain names, Non-competitive agreements etc.
- (d)** Advance Pricing Agreement (APA) is an agreement between a taxpayer and a taxing authority on an appropriate transfer pricing methodology for a set of transactions over a fixed period of time in future.
- (e)** The term “bilateral agreement” means an agreement between the Board and the applicant, subsequent to, and based on, any agreement referred to in rule 44 GA between the competent authority in India with the competent authority in the other country regarding the most appropriate transfer pricing method or the arms' length price.

Question 10.

Either

- (a) PQ Medical Equipments Inc. (PQ) of Canada has received an order from a leading UK based Hospital for development of a hi-tech medical equipment which will integrate the best of software and latest medical examination tool to meet varied requirements. The order was for 3,00,000 Euros. To execute the order, PQ joined hands with its subsidiary Prestige Components Inc. (PCI) of USA and Chemicals India Ltd (CIL), an Indian Company. PCI holds 30% of CIL. PQ paid to PCI and CIL Euro 90,000 and Euro 1,00,000 respectively and kept the balance for itself. In the entire transaction, a profit of Euro 1,00,000 is earned. Chemicals India Ltd. incurred a total cost of Euro 75,000 in execution of its work in the above contract. The relative contribution of PQ, PCI and CIL may be taken at 30%, 30% and 40% respectively. Compute the Arm's Length Price and the incremental Total Income of Chemicals India Ltd., if any due to adopting Arms Length Price.**
- (b) Which are the steps to be followed in the Comparable Uncontrolled Price method in computation of arm's length price?**
- (c) T Ltd. is an Indian company. It has a manufacturing unit in Kerala. It is a subsidiary company of M Ltd., a US company. M Ltd. gets royalty from T Ltd. on supply of technical information which is used by T Ltd. for manufacturing goods in its unit in Kerala. For similar transfer of technical information to any unrelated entity M Ltd. charges ₹ 8,000 per year. However, from T Ltd. it charges (a) \$ 11,000 or \$ 6,000 per year which is subject to tax deduction by T Ltd.**

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Exchange rate is ₹ 49 per US dollar. Income of T Ltd. for the assessment year 2014-15 before deducting payment for technical information to T Ltd. is ₹ 76,00,000. Find out the income of M Ltd. and T Ltd.

[8+4+8]

Or

(a) Compute the 'arm length price' (ALP) in the following cases:

- i) Shisha Instruments Ltd. is a 100% Indian subsidiary of a US company. The parent company sells one of its products to the Indian subsidiary at a price of US\$ 100 per unit. The same product is sold to unrelated buyers at a price of US\$ 130 per unit.
- ii) The US parent company sells the same product to an unrelated company in India @ US\$ 80 per unit.

(b) Explain the applicability and the different steps for computation of Arm's Length Price (ALP) by Comparable Uncontrolled Price Method (CUPM)?

(c) Write a note on Compliance Audit of Advance Pricing Agreement.

(d) Describe the tax planning measures in relation to tax liability of Indian collaborators for payments made.

[(2+2)+(2+5)+6+3]

Answer:

Either

(a) A. Share of each of the Associates in the Value of the Order

Particulars	Euros [€]
Value of the order	3,00,000
Share of CIL (given)	1,00,000
Share of PCI (given)	90,000
Share of PQ [Amount retained = 3,00,000 – 1,00,000 – 90,000]	1,10,000

B. Share of each of the Associates in the profit of the order

Particulars	Euros [€]
Combined Total Profits	1,00,000
Share of CIL [Contribution of 40% × Total Profit € 1,00,000]	40,000
Share of PCI [Contribution of 30% × Total Profit € 1,00,000]	30,000
Share of PQ [Contribution of 30% × Total Profit € 1,00,000]	30,000

C. Computation of Incremental Total Income of CIL

Particulars	Euros [€]
Total Cost to Chemicals India Ltd	75,000
Add: Share in the Profit to CIL (from B above)	40,000
Revenue of CIL on the basis of Arm's Length Price	1,15,000
Less: Revenue Actually received by CIL	(1,00,000)
Increase in Total Income of CIL	15,000

(b) The steps to be followed in the Comparable Uncontrolled Price method in computation of arm's length price are as follows:

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Step I: Identify the price charged/ paid for property transferred or services provided in a comparable uncontrolled transaction(s).

Step II: Adjust the price derived in Step I above for differences, if any, which could materially affect the price in the open market.

(i) between the international transaction and the comparable uncontrolled transactions, or

(ii) between the enterprises entering into such transactions.

Step III: Arm's Length Price = Step I Add/Less: Step II

(c) Computation of Income

	Situation (a) ₹	Situation (b) ₹
Arm's length price (\$ 8000 X 49) (a)	3,92,000	3,92,000
Income of T Ltd.		
Income	76,00,000	76,00,000
Less: Payment to M Ltd. at recorded price [\$11,000 x 49, \$6,000 x 49] (b)	5,39,000	2,94,000
Income as per books of account (c)	70,61,000	73,06,000
Add: Recorded price	(+)5,39,000	(+)2,94,000
Less: Arm's length price [i.e., (a)]	(-) 3,92,000	(-) 3,92,000
Total (d)	72,08,000	72,08,000
Taxable income [(d), but it cannot be lower than (c), as per section 92(3)]	72,08,000	73,06,000
Income of M Ltd.		
Actual payment [i.e., (b)] as tax has been deducted by the payer [see Note]	5,39,000	2,94,000

As per second proviso to section 92C(4), where income of payer has been recomputed by applying the arm's length price, then the income of payee associate enterprise shall not be recomputed if tax has been deducted or is deductible on such payment. Therefore, income of M Ltd. shall not be reduced in situation (a).

Or

(a)

(i) Though the ALP is US\$ 130 per unit; however, since the adoption of ALP will result in decrease in total income of Indian subsidiary (the cost of purchase being higher), therefore, the price of US\$ 100 per unit shall be admissible.

(ii) However, in his case, the ALP = price to unrelated buyers = US\$ 80 per unit; and since its adoption increases taxable income in India, hence, the same shall be adopted.

(b) Arm's Length Price (ALP) with Comparable Uncontrolled Price Method:

(1) Applicability: This method is particularly good where an independent enterprise sells the same product or service as is sold between two associated enterprises. The uncontrolled transactions should reflect goods of a similar type, quality and quantity as those between the associated enterprises, and relate to transactions taking place at a similar

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time and stage in the production/distribution chain, with similar conditions applying.

(2) Steps : The steps involved in the application of this method are :

- (i) Identify the price charged or paid for property transferred or services provided in comparable uncontrolled transaction or a number of such transactions;
- (ii) Adjust such price to account for the differences, if any, between the international transaction and the comparable uncontrolled transaction or between enterprises entering into such transaction which could materially affect the price in the open market;
- (iii) The adjusted price is taken to be the arm's length price;
- (iv) The arm's length price is compared with the price charged in the international transaction;
- (v) If the price charged in the international transaction is lower than the arm's length price or the price paid in the international transaction is higher than the arm's length price then an adjustment is to be made to the price charged or paid in the international transaction by the amount of such variance.

(c) Compliance Audit of Advance Pricing Agreement (Rule 10P):

- (1) The Transfer Pricing Officer having the jurisdiction over the assessee shall carry out the compliance audit of the agreement for each of the year covered in the agreement.
- (2) For the purposes of sub-rule(1), the Transfer Pricing Officer may require –
 - (i) the assessee to substantiate compliance with the terms of the agreement, including satisfaction of the critical assumptions, correctness of the supporting data or information and consistency of the application of the transfer pricing method;
 - (ii) the assessee to submit any information, or document, to establish that the terms of the agreement has been complied with.
- (3) The Transfer Pricing Officer shall submit the compliance audit report, for each year covered in the agreement, to the Director General of Income Tax (International Taxation) in case of unilateral agreement and to the competent authority in India, in case of bilateral or multilateral agreement, mentioning therein his findings as regards compliance by the assessee with terms of the agreement.
- (4) The Director General of Income Tax (International Taxation) shall forward the report to the Board in a case where there is finding of failure on part of assessee to comply with terms of agreement and cancellation of the agreement is required.
- (5) The compliance audit report shall be furnished by the Transfer Pricing Officer within six months from the end of the month in which the Annual Compliance Report referred to in rule 10 O is received by the Transfer Pricing Officer.
- (6) The regular audit of the covered transactions shall not be undertaken by the Transfer Pricing Officer if an agreement has been entered into under rule 10L except where the agreement has been cancelled under rule 10R.

(d) While entering into foreign collaboration agreement, the Indian collaborator should plan his tax affairs in a manner that ensures maximum after-tax profits and return on investment. The following tax planning measures may be helpful -

- (1) Installation expenses to be capitalized:** Cost of installation, including the supervision expenses charged by the collaborator should be capitalised and depreciation should

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be claimed thereon. Further, expenses relating to the collaboration agreement are eligible for capitalisation if they are incurred after the date of the setting up of the business.

- (2) **Purchase of spares will be treated as revenue expenditure:** The Indian collaborator should receive the spares necessary for plant in the year subsequent to the year of commissioning of the plant and a separate contract should be executed in this behalf. In that case the Indian collaborator may be eligible for deduction of the whole of the amount of spares as revenue expenditure.
- (3) **Plans, drawings etc, are eligible for depreciation:** Acquisition of plans, drawings etc. by the Indian collaborator from abroad are eligible for depreciation u/s 32 as intangible assets. Hence, depreciation must be claimed thereon.