CMA Students Newsletter (For Intermediate Students)

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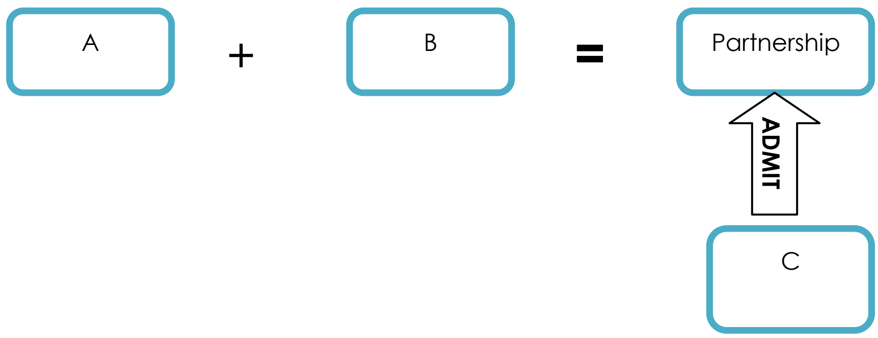
ADMISSION OF PARTNERS – ADJUSTMENT IN PROFIT SHARING RATIO

When firm requires additional capital or managerial help or both for the expansion of its business a new partner may be admitted to supplement its existing resources.

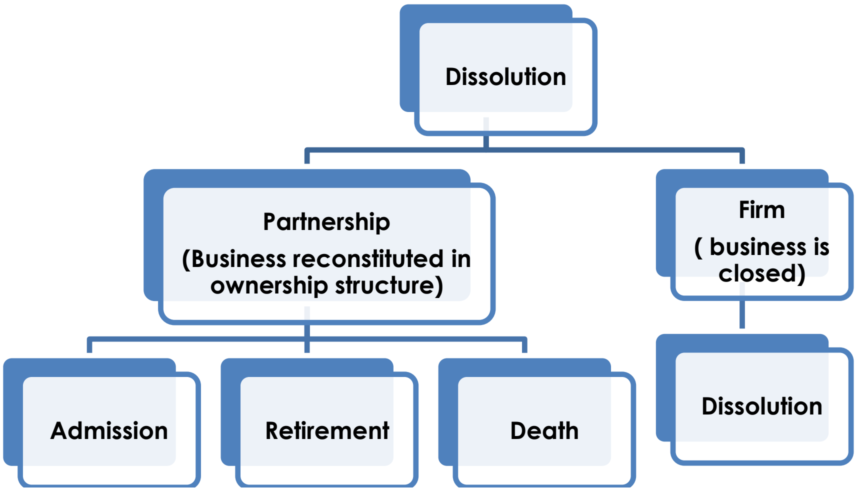
According to Indian Partnership Act 1932, A Partner can be admitted only with the consent of all the Existing Partners unless otherwise agreed upon.

On admission of a new partner, the partnership firm is reconstituted with a new agreement. For example, A and B are partners, they admitted C, and the formation of partnership is:



From the above diagram, we can say that **"A, B & C"**– partnership **is formed** and **"A & B"** – partnership **dissolves**.

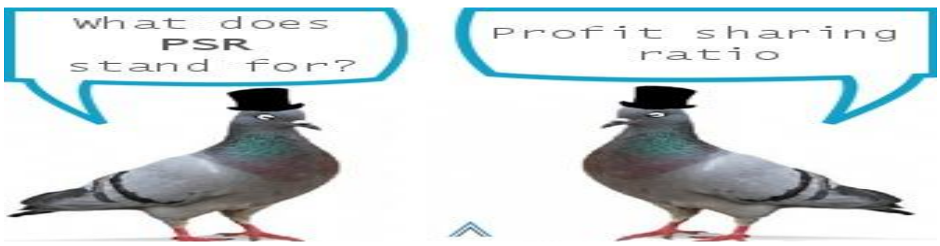
So, Admission is "**Dissolution of Partnership**" and **"not dissolution of Firm"**



At the time of such admission, the usual adjustments required for:

1. Adjustment in Profit Sharing Ratio;
2. Adjustment of Revaluation Account (regarding revaluation of Assets and Liabilities);
3. Adjustment for Goodwill;
4. Adjustment for Capital Contribution of New partner and Capitals of existing partners.

1. Adjustment in Profit Sharing Ratio (PSR)



When a new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The incoming partner acquires his/her share of future profits either incoming from one or more existing partner. The existing partners sacrifice a share of their profit in the favour of new partner; hence the calculation of new profit sharing ratio becomes necessary.

Sacrificing Ratio

At the time of admission of a partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice.

Sacrificing Ratio is calculated as follows:

Sacrificing Ratio = Existing Ratio – New Ratio

AGAIN

Total of Sacrificing Ratio = Share of New Partner

Following cases may arise for the calculation of new profit sharing ratio and sacrificing ratio:

Case 1: Only the new partner's share is given

In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio. Sacrificing ratio is calculated by deducting new ratio from the existing ratio.

Illustration 1:

X and Y were partners sharing profit/losses as 3: 2. They admit as a new partner giving him 1/5th share of future profits.

What should be the new profit sharing ratio and Sacrificing Ratio?

Solution:

Assume total profit is 1.

Z's share = 1/5 Balance = 1 – 1/5 = 4/5

X's share = 4/5 x 3/5 = 12/25;

Y's share = 4/5x2/5 = 8/25;

Z's share = 1/5 = 5/25.

The new profit sharing ratio = 12 : 8 : 5.

Sacrificing Ratio = Old Ratio (-) New Ratio

X = (3/5 – 12/25) = 3/25

Y = (2/5 – 8/25) = 2/25

The new profit sharing ratio = 12 : 8 : 5.

New Ratio between X:Y

= 12 : 8

= 3:2

Same old Profit Sharing Ratio maintained by X and Y as between them

Case 2: The new partner purchases his/her share of the profit from the Existing partner in a particular ratio.

In this case, the new profit sharing ratio of the existing partners is to be ascertained after deducting the sacrifice agreed from his share. It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

Illustration 2:

A, B & C were partners sharing profits/loses as 3 : 2: 1. They admitted D as a new partner giving him 1/6th share of future profits. D acquired 3/24th share from A and 1/24th share from B. Calculate New Profit Sharing Ratio.

Solution:

New Ratio = Old Ratio – Sacrifice Ratio

A = 3/6 – 3/24 = 12/24 – 3/24 = 9/24;

B = 2/6-1/24 = 8/24 – 1/24 = 7/24;

C = 1/6 – Nil = 4/24 – Nil = 4/24;

D=3/24 + 1/24=4/24

The new ratio = 9 : 7 : 4 : 4.

Case 3: Existing partners surrender a particular portion of their share in favour of a new partner.

In this case, sacrificed share of the each partner is to be ascertained. This ascertained by multiplying the existing partner share in the ratio of their sacrifice. The share sacrificed by the existing partners should be deducted from his existing share. Therefore, the new share of the existing partners is determined. The share of the incoming partner is the sum of sacrifice by the existing partners.

Illustration 3

Hitesh and Raj shared profits in the ratio of 5:3. Jolly was admitted as a partner. Hitesh surrendered 1/5 of his share and Raj 1/3 of his share in favour of Jolly. Calculate the new profit sharing ratio.

Solution:

Hitesh surrenders 1/5 of his share, i.e., = 1/5 of 5/8 = 1/8

Raj surrenders 1/3 of his share, i.e., = 1/3 of 3/8 = 1/8

So, sacrificing ratio of Him and Raj is 1/8 : 1/8 or equal.

Hitesh's new share = 5/8 – 1/8 = 4/8

and Raj's new share = 3/8 – 1/8 = 2/8

Jolly's New share = 1/8 + 1/8 = 2/8

New profit sharing ratio of Hitesh, Raj and Jolly is

= 4/8 : 2/8 : 2/8 or 4 : 2 : 2 or 2 : 1 : 1.

WHAT IS CAPITAL GAINS

(A) Charging sections - Sections 45, 46 and 46A

The charging section explains the subject matter of taxation – i.e. which income will be taxed and classified under which head. For income taxable under the heads, charging section is section 15 of the Income-tax Act, 1961 ("the Act"). For income from house property, it is section 22, The charging sections for business income and income from other sources are sections 28 and 56 respectively. Thus, there is one charging section for each head of income for salaries, income from house property, business income and income from other sources. However, for capital gains, as held in certain judicial decisions, there are three independent and separate charging sections:

(i) Section 45 - Capital gains

(ii) Section 46 - Capital gains on distribution of assets by companies in liquidation

(iii) Section 46A - Capital gains on purchase by company of its own shares or other securities

Section 45 is the general provision while sections 46 and 46A are special provisions.

The following incomes are taxable as 'capital gains':

(a) Any profits and gains arising from the transfer of a capital asset effected in the previous year [Section 45(1)] including those referred to in sub-sections (2) to (5) of,section 45

(b) Any profits and gains arising from the receipt of any money or other assets under an insurance from an insurer on account of damage to, or destruction of, any capital asset, as a result of (i) flood, typhoon, hurricane, cyclone, earthquake or other convulsion of nature; or (ii) riot or civil disturbance; or (iii) accidental fire or explosion; or (iv) action taken by an enemy or in combating an enemy (whether with or without declaration of war) - [Section 45(1A)]

(c) Capital gains in respect of any money or other assets (market value of assets on date of distribution) received by shareholder of a company from the company on its liquidation as reduced by deemed dividend u/s 2(22)(c) - [Section 46(2)]

(d) Difference between (i) value of consideration received by shareholder or holder of specified securities from company on buyback of its own shares or other specified securities; and (ii) cost of acquisition [Section 46A]

(B) Distinction between capital gains and business income

The following table shows the broad distinguishing features of business income versus capital gains:

Business income	Capital gains
The subject matter of sale less the expenditures (both direct and indirect) is taxable as business income.	Sale consideration less cost of acquisition/indexed cost of acquisition is taxable as capital gain /long term capital gain.
Acquisition or payment towards stock in trade in violation of section 40A(3) would result in disallowance of expenditure. However, exceptions are given in rule 6DD.	Acquisition of capital asset is not regulated as regards the mode of payment and the acquisition could be by any mode. Even where no expenditure is incurred but inherited, the fair market value or cost to the previous owner could be adopted for computing capital gains.
The assessee can claim expenses incurred such as administrative, interest and other incidental expenses while computing income.	The assessee can claim only expenditures incurred wholly and exclusively in connection with the transfer such as brokerage and arrive at net consideration.
Withholding of stock in trade over a period of time has no consequence in deciding the taxable income. However, if held for too long a period of time< a question would arise whether it really was held for its stated purpose - Le. as stock-in-trade and not as a capital asset	A capital asset held for more than 36 months is eligible for indexation benefit and concessional rate of tax. In the case of shares and securities, the period of holding is 12 months for treating the asset as long term.
Income from business is taxable in the regular manner at normal rates of tax.	Income from capital gains is taxable at flat rate of tax subject to certain reduction if the total income (excluding capital gains) is below taxable limit.
Deduction under Chapter VI-A could be claimed.	No deduction under Chapter VI-A could be claimed against long term capital gains.

Loss if any could be set off against any income except salary.	Loss under the head "Capital gains" is eligible for set off only against capital gains. Long-term capital loss cannot be set off against short-term capital gain.
Replacement of stock-in-trade will not reduce taxable income	Reinvestment of capital gain or net consideration as the case may be would aid in reducing taxable capital gain.
Depreciation on assets could be claimed against business income.	No such deduction could be claimed though in reality expenditures are incurred for maximizing realization value of capital asset.
Discontinued business loss carried forward could be set off against business income.	Loss under the head Capital gains carried forward could be set off only against capital gains.
Business loss can be set off even against speculation business income. However, speculation business loss cannot be set off against any other income except speculation income.	Capital gain is available for set off of loss from business/profession. But Loss under the head Capital gains cannot be set off against income under any head including speculation income. Loss under the head "Capital gains" can be set off only against capital gain.

Immovable property: A transaction of purchase or sale of land cannot be assumed, without more, to be an adventure in the nature of trade. Further, mere ownership of an immovable property, even if purchased from a source which was originally employed in the money-lending business, does not automatically make such property a part of such business. Therefore, merely because a money-lender acquires an immovable property 'in lieu of an advance' made by it, such immovable property cannot straightaway assume the character of stock-in-trade, unless it is shown that it was, in fact, converted into stock-in-trade. Thus, profits realised from sale of such immovable property is assessable as capital gains and not as business income.

In CIT v. Simpson General Finance Co. Ltd [1998] 96 Taxman 172 (Mad.) the assessee acquired land from an allied concern and retained it for more than a decade. Later, the lands were sold to parent company and to allied concerns. A small portion was also sold to an outsider. The assessee claimed that the transfer of land to parent company is not a transfer as per section 47(v) whereas the Assessing Officer wanted to tax the gain under the head 'Business/profession'. The Court held (i) that the assessee acquired land from allied concern and retained it for more than a decade; (ii) sale of land to parent company is also a sale to allied concern; (iii) from the conduct of assessee it is clear that the acquisition of land was not for business purpose like stock-in-trade; and (iv) the price at which the lands in question were sold was not at market price. These evidences prove that the assessee was not a dealer in land and the transfer was only relating to a capital asset and the transaction with the parent company is covered by section 47(v) which applies to transfer of capital assets (not stock-in-trade) and hence any gain arising from transfer (other than transfer to parent company) is taxable under the head 'Capital gains'.

(C) Conditions to be fulfilled for taxing capital gains

According to section 45(1), any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in sections 54, 54B, 54D, 54E, 54EA, 54EB, 54F, 54G and 54H, be chargeable to income-tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.

In Asstt. CIT v. Dr. B.V. Raju [2012] 135 ITD 1 (Hyd.) (SB), the ITAT held that for attracting charge to tax under the head 'Capital gain'; the following conditions are necessary to be fulfilled, viz.:

(a) There must be a capital asset;
(b) There should be a transfer of the capital asset other than an exempted transfer;
(c) The capital asset should be something which can be acquired by paying a cost i.e. the cost of acquisition of the capital asset should be determinable.
(d) There must be accrual of consideration for transfer of capital asset.

The following points are important:

- The above conditions apply in the context of the general charging provisions in section 45(1) and not in the context of special charging provisions in sections 45(1A), 46 and 46A. In cases of income chargeable to tax under sections 45(1A), 46 and 46A, it is sufficient that conditions under those sections be satisfied even though one or more of the conditions in (a) to (d) above are not fulfilled.
- Any capital gain falling within the ambit of section 45(1) will be out of the tax net if :
  (i) asset transferred is an 'excluded capital asset'

  (ii) transfer is an exempted transfer under section 47

  (iii) capital gain is exempt from tax under section 10(3 7)/10(38)

  (iv) capital gain is exempt under sections 54 to 54H

  (v) cost of acquisition is not capable of being determined

(vi) consideration is not capable of being determined or calculated - this requirement applies upto A.Y. 2012-13. With effect from A.Y. 2013-14, if consideration is not capable of being determined or calculated, fair market value shall be deemed to be the consideration.

(D) Tax-free capital gains

In the following cases, income from Capital gains is specifically exempted:

(i) Income from transfer of a unit of the Unit Scheme, 1964 referred to in Schedule I to the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002 and where the transfer of such asset takes place on or after 1-4-2002.

(ii) Capital gains of a political party subject to provisions of section 13A of the IT Act, 1961.

(iii) In the case of an individual or HUF, capital gains arising from the transfer of agricultural land, where such land is situated in any area falling within the jurisdiction of a municipality or a cantonment board having population of at least 10,000 or in any area within such distance, not being more than 8 kms., from the local limits of any municipality or cantonment board. Such land should have been used for agricultural purposes during the period of two years immediately preceding the date of transfer. Further, such transfer should be by way of compulsory acquisition under any law and the said capital gains should have arisen from the compensation received on or after 1st April, 2004.

(iv) Capital gains arising from the transfer of a long-term capital asset, being an equity share in a company or unit in an equity oriented fund where such a transaction is chargeable to securities transaction tax and takes place on or after 1st October, 2004.

(v) Clause (43) inserted in section 10 by the Finance Act, 2008 exempts from tax "any amount received by an individual as a loan, either in lump sum or in instalment, in a transaction of reverse mortgage".

(e) Whether situs/location of a capital asset matters for taxability of capital gains?

The situs/location of capital asset matters only for non-resident assessees and not ordinarily resident assessees (i.e. resident but not ordinarily resident assessees). In the cases of these assessees, if capital asset located outside India is transferred outside India and sale proceeds are received outside India, no taxability to capital gains arises in view of section 5 of the Act. Such assessees will be liable to be taxed under section 9(1)(i) in respect of capital gains accruing or arising "through the transfer of any capital asset situate in India".

(i) Taxability of "indirect transfers" of any capital asset situate in India - Legislative History

The above section along with sections 2(14) (definition of capital asset), 2(47) (definition of transfer) and section 195(1)(TDS on payments to non-residents) were Authoritatively interpreted by the Supreme Court in Vodafone International Holdings B.V. v. UOI [2012] 17 taxmann.com 202. The facts of the case involved a transaction of "indirect transfer" of a capital asset situate in India whereby the ultimate foreign company which held an Indian subsidiary through a chain of foreign subsidiaries transferred outside India to another foreign company the shares of a foreign subsidiary which held the shares of the Indian subsidiary. Revenue sought to invoke section 9(1)(i) of the Act to tax the resulting capital gains since one of the limbs of section 9(1)(i) provided for taxing capital gains arising "through the transfer of any capital asset situate in India". The Court ruled in favour of the assessee and held as under:

- A controlling interest is an incident of ownership of shares in a company, something which flows out of the holding of shares. A controlling interest is, therefore, not an identifiable or distinct capital asset independent of the holding of shares. The control of a company resides in the voting power of its shareholders and shares represent an interest of a shareholder which is made up of various rights contained in the contract embedded in the Articles of Association. The right of a shareholder may assume the character of a controlling interest where the extent of the shareholding enables the shareholder to control the management. Shares, and the rights which emanate from them, flow together and cannot be dissected.
- A legal right is an enforceable right. Enforceable by a legal process. The question is what is the nature of the "control" that a parent company has over its subsidiary. It is not suggested that a parent company never has control over the subsidiary. For example, in a proper case of "lifting of corporate veil", it would be proper to say that the parent company and the subsidiary form one entity. But barring such cases, the legal position of any company incorporated abroad is that its powers, functions and responsibilities are governed by the law of its incorporation. No multinational company can operate in a foreign jurisdiction save by operating independently as a "good local citizen". A company is a separate legal persona and the fact that all its shares are owned by one person or by the parent company has nothing to do with its separate legal existence. If the owned company is wound up, the liquidator, and not its parent company, would get hold of the assets of the subsidiary. In none of the authorities have the assets of the subsidiary been held to be those of the parent unless it is acting as an agent. Thus, even though a subsidiary may normally comply with the request of a parent company it is not just a puppet of the parent company. The difference is between having power or having a persuasive position. Though it may be advantageous for parent and subsidiary companies to work as a group, each subsidiary will look to see whether there are separate commercial interests which should be guarded. When there is a parent company with subsidiaries, is it or is it not the law that the parent company has the "power" over the subsidiary. It depends on the facts of each case. For instance, take the case of a one-man company, where only one man is the shareholder perhaps holding 99% of the shares, his wife holding 1%. In those circumstances, his control over the company may be so complete that it is his alter ego. But, in case of multinationals it is important to realise that their subsidiaries have a great deal of autonomy in the country concerned except where subsidiaries are created or used as

a sham. Of course, in many cases the courts do lift up a corner of the veil but that does not mean that they alter the legal position between the companies. The directors of the subsidiary under their Articles are the managers of the companies. If new directors are appointed even at the request of the parent company and even if such directors were removable by the parent company, such directors of the subsidiary will owe their duty to their companies (subsidiaries). They are not to be dictated by the parent company if it is not in the interests of those companies (subsidiaries). The fact that the parent company exercises shareholder's influence on its subsidiaries cannot obliterate the decision-making power or authority of its (subsidiary's) directors. They cannot be reduced to be puppets. The decisive criteria is whether the parent company's management has such steering interference with the subsidiary's core activities that subsidiary can no longer be regarded to perform those activities on the authority of its own executive directors. Applying the test of enforceability, influence/persuasion cannot be construed as a right in the legal sense. One more aspect needs to be highlighted. The concept of "de facto" control, which existed in the Hutchison structure, conveys a state of being in control without any legal right to such state. This aspect is important while construing the words "capital asset" under the income-tax law. As stated earlier, enforceability is an important aspect of a legal right.

- Applying the test of enforceability, influence / persuasion of parent company over its subsidiary cannot be construed as a right in the legal sense since capital asset covers 'property' of any description and a right has to be legally enforceable to be 'property' and 'capital asset' within the meaning of section 2(14).
- On transfer of shares of a foreign company to a non-resident offshore, there is no transfer of shares of the Indian Company, though held by the foreign company, in such a case it cannot be contended that the transfer of shares of the foreign holding company, results in an extinguishment of the foreign company control of the Indian company and it also does not constitute an extinguishment and transfer of an asset situate in India. Transfer of the foreign holding company's share off-shore, cannot result in an extinguishment of the holding company right of control of the Indian company nor can it be stated that the same constitutes extinguishment within the meaning of section 2(47) and transfer of an asset/management and control of property situated in India-Vodafone International Holdings B.V. v. UOI [2012] 17 taxmann.com 202 (SC).
- The Legislature has not used the words "indirect transfer" in section 9(1)(i). If indirect transfer of a capital asset is read into section 9(1)(i) then the words capital asset situate in India would be rendered nugatory. Similarly, the words underlying asset do not find place in section 9(1)(i). Thus, the words directly or indirectly in section 9(1)(i) go with the income and not with the transfer of a capital asset (property). The Direct Tax Code (DTC) Bill, 2010 proposes to tax income from transfer of shares of a foreign company by a non-resident, where the fair market value of the assets in India, owned directly or indirectly, by the company, represents at least 50% of the fair market value of all assets owned by the company. This proposal indicates in a way that indirect transfers are not covered by the existing section 9(1)(i) of the Act. [Per CJI S.H. Kapadia]. On a comparison of section 64 and section 9(1)(i) what is discernible is that the Legislature has not chosen to extend section 9(1)(i) to "indirect transfers". - Vodafone International Holdings B.V. v. UOI [2012] 17 taxmann.com 202 (SC).

- Section 195 would apply only if payments made from a resident to another non-resident and not between two non-residents situated outside India - Vodafone International Holdings B.V. v. UOI [2012] 17 taxmann.com 202 (SC).

The Finance Act, 2012 made retrospective amendments w.r.e.f. 1-4-1962 to sections 2(14) (definition of capital asset), 2(47)(definition of transfer), section 9(1)(i) ("income deemed to accrue or arise in India") and section 195(1) to overcome the decision of the Supreme Court in Vodafone (supra). These retrospective amendments are as under :

- Explanation has been inserted below section 2(14) (definition of 'capital asset') which clarifies that "property" includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever. While the new Explanation makes "any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever" a distinct and independent capital asset-distinct from the shares from which they are derived, it does nothing to change the Supreme Court's interpretation of the word 'right'. A mere power of persuasion cannot be a "right" legal enforceability is the soul of a right. It appears that these retrospective amendments do nothing to change the definition of 'right' to include power of persuasion of a holding company over its subsidiary.
- Explanation below section 2(47) (definition of "transfer") renumbered as Explanation 1 and new Explanation 2 inserted with retrospective effect from 1-4-1962 to clarify that "'transfer" includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India'.
- Two new Explanations Explanation 4 and Explanation 5 inserted in clause (i) of sub-section (1) of section 9 with retrospective effect from 1-4-1962. New Explanation 3 seeks to clarify that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".
- Section 195(1) has been amended with retrospective effect from 1-4-1962 to clarify that obligation to comply with sub-section (1) and to make deduction thereunder applies and shall be deemed to have always applied and extends and shall be deemed to have always extended to all persons, resident or non-resident, whether or not the non-resident has:—
  (a) a residence or place of business or business connection in India; or
  (b) any other presence in any manner whatsoever in India.

The Explanatory Memorandum to the Finance Bill, 2012 explains the rationale for the above amendments as follows :

"Section 9 of the Income-tax provides cases of income, which are deemed to accrue or arise in India. This is a legal fiction created to tax income, which may or may not arise in India and would not have been taxable but for the deeming provision created by this section. Sub-section (1)(i) provides a set of circumstances in which income accruing or arising, directly or indirectly, is taxable in India. One of the limbs of clause (i) is income accruing or arising directly or indirectly through the transfer of a capital asset situate in India. The legislative intent of this clause is to widen the application as it covers incomes, which are accruing or arising directly or indirectly. The section codifies source rule of taxation wherein the state where the actual economic nexus of income is situated has a right to tax the income irrespective of the place of residence of the entity deriving the income. Where corporate structure is created to route funds, the actual gain or income arises only in consequence of the investment made in the activity to which such gains are attributable and not the mode through which such gains are realized. Internationally this principle is recognized by several countries, which provide that the source country has taxation right on the gains derived of offshore transactions where the value is attributable to the underlying assets.

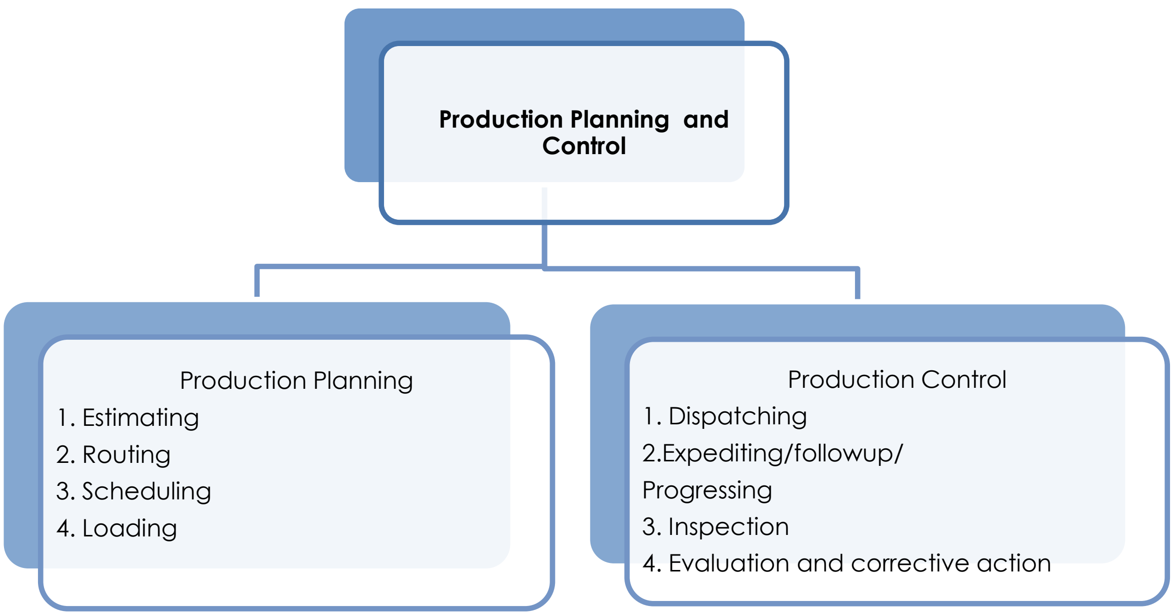
Section 195 of the Income-tax Act requires any person to deduct tax at source before making payments to a non-resident if the income of such non-resident is chargeable to tax in India. "Person", here, will take its meaning from section 2 and would include all persons, whether resident or non-resident. Therefore, a non-resident person is also required to deduct tax at source before making payments to another non-resident, if the payment represents income of the payee non-resident, chargeable to tax in India. There are no other conditions specified in the Act and if the income of the payee non-resident is chargeable to tax, then tax has to be deducted at source, whether the payment is made by a resident or a non-resident. Certain judicial pronouncements have created doubts about the scope and purpose of sections 9 and 195. Further, there are certain issues in respect of income deemed to accrue or arise where there are conflicting decisions of various judicial authorities."

(ii) Taxability of "Indirect transfers" - Legal provisions

Explanation 5 inserted by the Finance Act, 2012 in section 9(1)(i) clarifies that an asset or capital asset, being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be situated in India if the share or interest derives, directly or indirectly, its value substantially from the assets located in India. The existing provisions related to indirect transfers are so widely worded that even if a single share (constituting less than 1% of total shareholding) of a foreign company having substantial assets in India is transferred outside India, then the gains arising on such a transfer, would be taxable in India. That would lead to undue hardship considering the fact that a single shareholder may not be in the know of all the global assets of the company. In view of this, the Expert Committee under the Chairmanship of Dr. Parthasarathi Shome had recommended that transfer of small shareholdings in a foreign company should not be subject to undue hardship as it does not result in the transfer of a controlling interest in the Indian assets. The Committee recommended threshold exemption to give relief to small shareholders of foreign company .The Committee had also recommended that the law must clarify as to when it can be said that the share or interest derives its value substantially from the assets located in India. In other words, law must define the word 'substantially' used in Explanation 5.

PRODUCTION PLANNING AND CONTROL

Planning and control are essential ingredients for success of an operation unit. For efficient, effective and economical operation in a manufacturing unit of an organization, it is essential to integrate the production planning and control system. Production planning and subsequent production control follow adaption of product design and finalization of a production process.



Production planning is dealing with basic concepts of what to produce, when to produce, how much to produce, etc. It involves taking a long-term view at overall production planning.

Objectives of production planning are as follows:

- To ensure right quantity and quality of raw material, equipment, etc. are available during times of production.
- To ensure capacity utilization is in tune with demand forecasted at all the time.

Benefits of production planning

- Organization can deliver a product in a timely and regular manner.
- Suppliers are informed well in advance for the requirement of raw materials.
- It reduces investment in inventory.
- It reduces overall production cost by driving in efficiency.

Functions of production planning

1. 

Estimating involves deciding the quantity of products to be produced and cost involved in it on the basis of sales forecast. Estimating manpower, machine capacity and materials required to meet the planned production targets are the key activities before budgeting for resources.

2.  **Routing** is the process of determining the sequence of operations to be performed in the production process. Routing determines what work must be done, where and how? Routing information is provided by product or process engineering function and it is useful to prepare machine loading charts and schedules.
Route Sheet defines each step of the production operation and lays down the precise path or route through which the product will flow during the conversion process.

3.  

Scheduling involves fixing priorities for each job and determining the starting time and finishing time for each operation, the starting dates and finishing dates for each part, sub assembly and final assembly. Scheduling lays down a time table for production indicating the total time required for the manufacture of a product and also the time required for carrying out the operation for each part on each machine or equipment.

4. 

Facility **loading** means loading of facility or work centre and deciding which jobs to be assigned to which work centre or machine. Loading is the process of converting operation schedules into practice. Machine loading is the process of assigning specific jobs to machines, men or work.

A machine loading chart (Gantt chart) is prepared showing the planned utilization of men and machines by allocating the jobs to machines or workers as per priority sequencing established at the time of scheduling.

Loading ensures maximum possible utilization of productive facilities and avoids bottle neck in production.

Production Control looks to utilize different type of control techniques to achieve optimum performance out of the production system as to achieve overall production planning targets.

Objectives of production control are as follows:

- Regulate inventory management
- Organize the production schedules
- Optimum utilization of resources and production process

Advantages of robust production control are as follows:

- Ensure a smooth flow of all production processes
- Ensure production cost savings thereby improving the bottom line
- Control wastage of resources
- It maintains standard of quality through the production life cycle.

Production control is dependent upon the following factors:

- Nature of production (job oriented, service oriented, etc.)
- Nature of operation
- Size of operation

Production control functions are:

1.  Dispatching may be defined as setting production activities in motion through the release of orders (work order, shop order) and instructions in accordance with the previously planned time schedules and routings.

2.  Expediting or progressing ensures that the work is carried out as per plan and delivery schedules are met. Progressing includes activities such as status reporting, attending to bottlenecks or holdups in production and removing the same, controlling variations or deviations from planned performance levels, following up and monitoring progress of work through all stages of production, co-ordinating with purchase, stores, tool room and maintenance departments and modifying the production plans if necessary.

   Need for expediting arises due to the following:
   - Delay in supply of materials
   - Excessive absenteeism
   - Changes in design specifications
   - Changes in delivery schedules initiated by customers
   - Breakdown of machines or tools, jigs and fixtures
   - Errors in design drawings and process plans.

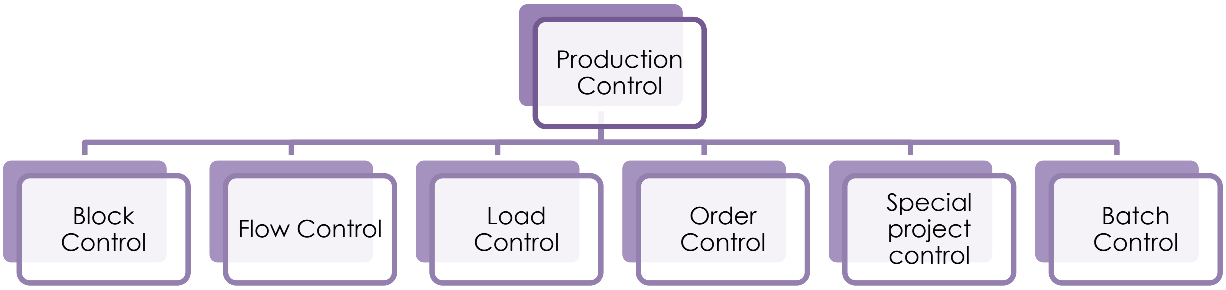
3. 

Inspection is conducted during the production process. This approach of inspection helps to control the quality of products by helping to fix the sources of defects immediately after they are detected, and it is useful for any factory that wants to improve productivity, reduce defect rates, and reduce re-work and waste.

4. 

It focuses on the systematic investigation of the root causes of identified problems or identified risks in an attempt to prevent their recurrence.

Basic types of Production Control:



Block Control is most prominent in textiles and book and magazine printing.

Flow Control is commonly applied in industries like chemicals, petroleum, glass and some areas of food manufacturing and processing.

Load Control is typically found wherever a particular bottleneck machine exists in the process of manufacturing.

Order Control is commonly employed in companies with intermittent production systems, the so-called job-lot shops.

Special Project Control is necessary in certain projects like the construction of bridges, office buildings, schools, colleges, universities, hospitals and any other construction industries.

Batch Control is frequently found in the food processing industries.

Requirements of Effective Production Planning and Control System

- Sound organizational structure with mechanism for proper delegation of authority and fixation of responsibility at all levels.
- Information feedback system should provide reliable and up-to-date information to all persons carrying out production planning and control functions.
- Standardisation of materials, tools equipments, labour, quality, workmanship etc.
- Trained personnel for using the special tools, equipments and manufacturing processes.
- Flexibility to accommodate changes and bottle-necks such as shortage of materials, power failures, machine break downs and absenteeism of employees.
- Appropriate management policies regarding production and inventory levels, product – mix and inventory turnover.
- Accurate assessment of manufacturing lead times and procurement lead times.
- Plant capacity should be adequate to meet the demand. The plant should be flexible in order to respond to the introduction of new products, changes in product-mix and production rate.

INTERPRETATIVE RULES OF CETA

The Central Excise Tariff Act, 1985, contains a set of six general rules for the interpretation of the Tariff Schedule. These rules for interpretation are identical to those contained in the HSN (Harmonised System of Nomenclature). Accordingly, the Explanatory Notes issued for these interpretative rules under HSN are also relevant for Central Excise purposes. However, the Supreme Court in the case of CCE v. K.W.H. Heliplastics Ltd. – 1998 (97) E.L.T. 385 (S.C.), held that classification of goods under a particular heading depends upon description, purpose and use of goods. Therefore, before resorting to the interpretative rules, it is required to look at the nature, description, purpose and usage of the goods. The rules to be applied sequentially. Following are the steps of classification of a product:

Rule 1: Titles are for reference: It provides that the titles of sections, chapters and sub-chapters are provided for ease of reference and headings along cannot be used for classification. The determination as to where the goods fall would be dependent on the relevant section and chapter notes contained in the tariff.

Rules for interpretation are not invokable if the section and chapter notes clearly determine the classification.

Example - Mr. Sen manufactured wooden table. There is no ambiguity or confusion while classifying the said product. Hence, the said product can be classified as wooden table.

Rule 2(a): Principle for classification of incomplete or unfinished goods — It specifies that if the incomplete or unfinished goods have the essential characteristics of the complete or finished goods, then such goods would be classified in the same heading as the complete goods. Complete or finished goods would cover goods removed in unassembled or disassembled form.

Example – Motor vehicle not yet fitted with wheels, battery or tyres, Bicycles without saddles and tyre – but not forgings and castings.

Rule 2(b): Mixture or Combinations of goods falls under different classifications — Any reference in a heading to a material or substance shall be taken to include a reference to mixtures or combinations of that material or substance with other materials or substances.

Any reference to goods of a given material or substance shall be taken to include a reference to goods consisting wholly or partly of such material or substance. The classification of goods consisting of more than one material or substance shall be according to the principles of rule 3.

Example – ‘Article of gold’ will include an article which is made partly of gold.

Rule 3(a): If ambiguity persists, find out which heading is specific and which heading is more general. Prefer specific heading.

Example – VIP bag is a 'Plastic Article' in common parlance, but if there is a specific entry 'suitcases', that entry will prevail over general entry 'plastic articles'.

Rule 3(b): If problem is not resolved by Rule 3(a), find which material or component is giving 'essential character' to the goods in question.

Example - if a set consists of drawing instruments (90.17), pencil (96.06) and pencil sharpener (82.14), put up in a leather case (4201.90); the set will be classifiable under 90.17 i.e., drawing instrument.

Rule 3(c): If both are equally specific, find which comes last in the numerical order in the Tariff and take it.

Example – Electrical insulating self adhesive tape can be classified as self adhesive tape under 39.19 and electrical insulator under 85.46. Hence, later serial number, i.e. 85.46 will prevail.

Rule 4: In case where the goods cannot be classified based on the above principles, they would be classified under the head appropriate to the goods to which they are most akin.

Example – In the case of Commissioner of Central Excise, Mumbai v. Garware Polyster Ltd. – 2004 (164) E.L.T. 344 (Tri.-Mumbai), in which photographic film waste having base of polyester was classified under 39.15.The base material being the polyester film, impugned goods most akin to waste/ scrap classifiable under heading 39.15 of Central Excise Tariff Act, 1985.

Rule 5: Packing material is to be classified in the heading in which the goods packed are classified.

Example – Packing material used as cases for camera classifiable as camera product.

Rule 6: Goods compared at the same level of sub-headings — The classification of goods in the subheadings of a heading shall be determined according to the terms of those sub-headings and any related sub-heading Notes and, mutatis mutandis, to the above rules, on the understanding that only sub-headings at the same level are comparable. For the purposes of this rule the relative Section and Chapter Notes also apply, unless the context otherwise requires.

Example – In case of CCEx., Bhubaneshwar v. Champdany Industries Ltd. – 2009 (241) E.L.T. 481 (SC), the Apex Court held that in various decisions Supreme Court has observed that when specific heading exists, goods should not be classified under a residuary heading and such principle hardened into a rule of law by reason of consistent view taken by the Court.

TREATMENT OF PURCHASE AND CANCELLATION OF OWN DEBENTURES

When a company purchases its own debentures from the open market and cancels it immediately the following entries are passed:

Journal Entries

Situation 1. At the time of purchase of Own Debentures

Date	Particulars	Dr.(₹)	Cr.(₹)
?	Investment in Own Debentures A/c Dr.	XXXX	
	Interest on Own Debentures A/c (Interest up to date of purchase)Dr.	XXXX	
	To, Bank A/c		XXXX
	[Necessary treatment is to be given for cum-interest and ex-interest purchase transactions.]		

Situation 2. Recognition of Interest Expense on Debenture Liability and Interest Income of Investments in Own Debenture

Date	Particulars	Dr.(₹)	Cr.(₹)
?	Interest Expense A/c Dr.	XXXX	
	To, Interest Income on Own Debenture A/c		XXXX
	To, Bank A/c (Payment to Outsiders)		XXXX

Situation3. Cancellation of Own Debentures

Date	Particulars	Dr.(₹)	Cr.(₹)
?	Debentures A/c Dr.	XXXX	
	Profit & Loss A/c (Loss on Cancellation if any)		XXXX
	To, Interest Income on Own Debenture A/c		XXXX
	To, Profit & Loss A/c (Profit on Cancellation if any)		

Example:

On 1st April, 2014 MM Ltd. had outstanding in its books 2,00,000 Debentures of ₹100 each. Interest at 12% per annum. The Interest on Debentures was paid half yearly on 31st September and 31st March of every year. On 31st May, 2014 , the Company purchased 60,000 Debentures of its own at ₹98 (ex-interest) per Debenture. The company cancelled the Debentures purchased on 31st March, 2015.

Solution:

Date	Particulars	Dr.(₹)	Cr.(₹)
31.05.2014	Investment in Own 12% Debentures A/c (60,000 × ₹98) Dr. Interest on Own 12% Debentures A/c (60,000 ×100× 12% × 2/12) Dr. To, Bank A/c [Being purchase of 60,000 Own Debentures of ₹100 each at ex-interest Price of ₹98.]	58,80,000 1,20,000	 60,00,000
30.09.2014	Interest Expense A/c (2,00,000 × ₹100 × 12% for 6 months) Dr. To, Interest on Own Debentures A/c (₹60,00,000 × 12% ×½) To, Bank A/c [Being, Interest due on 2,00,000 debentures for 6 months, Interest on Own Debentures recognised and balance paid to Outsiders.]	12,00,000	 3,60,000 8,40,000
31.03.2015	Interest Expense A/c (2,00,000 × ₹100 × 12% for 6 months) Dr. To, Interest on Own Debentures A/c (₹60,00,000 × 12% ×½) To, Bank A/c [Being, Interest due on 2,00,000 debentures for 6 months, Interest on Own Debentures recognised and balance paid to Outsiders.]	12,00,000	 3,60,000 8,40,000
31.03.2015	12% Debentures A/c (Liability Reversed) Dr. To, Investment in Own Debentures (Cost reversed) To, Profit and Loss A/c (profit on Cancellation) (Bal. fig.) [Being, Profit on Cancellation of Own Debentures.]	60,00,000	 58,80,000 1,20,000

Example. 2

Orange Ltd. had ₹20,00,000, 8% Debentures of ₹100 each as on 31st March,2014. The company purchased Debentures in the Open Market following immediate cancellation:

On 01.07.2014: 2,000 Debentures at ₹97 (cum-interest).
On 29.02.2014: 3,600 Debentures at ₹99 (ex- interest).

Debenture Interest due dates are 30th September and 31st March.

Give Journal Entries in the books of the Company for the year ended 31st March, 2015.

Solution:

Journal Entries

Date	Particulars	Dr.(₹)	Cr.(₹)
01.07.2014	Investment in Own 8% Debentures A/c Dr. Interest on Own 8% Debentures A/c Dr. To, Bank A/c [Being, 2,000 Debentures purchased at ₹97 cum-interest. Payment = 1,94,000, Interest from 1st July to 30th September = 2,00,000 × 8% × ¼ = 4,000, hence, balance = Cost.]	1,90,000 4,000	 1,94,000
01.07.2014	8% Debentures A/c Dr. To, Investment in Own 8% Debentures A/c To, Profit on Cancellation of Own Debentures A/c [Being, Cancellation of Own Debentures.]	2,00,000	 1,90,000 10,000
30.09.2014	Interest Expense A/c Dr. To, Bank A/c (18,00,000 × 8% × ½) [Being, half yearly Debenture Interest paid on ₹18,00,000 for 6 months.]	72,000	 72,000
29.02.2015	Investment in Own Debentures A/c (3,600 × ₹99) Dr. Interest on Own 8% Debentures A/c Dr. To, Bank A/c [Being, 3,600 Debentures purchased at ₹99 ex-interest. Interest from 1st October to 29th February , i.e. for 5 months = 3,600 × 100 × 8% × $\frac{5}{12}$ = ₹12,000.]	3,56,400 12,000	 3,68,400
29.02.2015	8% Debentures A/c Dr. To, Investment in Own 8% Debentures A/c To, Profit on Cancellation of Own Debentures A/c [Being, cancellation of Own Debentures.]	3,60,000	 3,56,400 3,600
31.03.2015	Interest Expenses A/c Dr. To, Bank A/c (14,40,000 × 8% × $\frac{6}{12}$) [Being, Half-Yearly Interest paid on Debentures ₹14,40,000 for 6 months.]	57,600	 57,600
31.03.2015	Profit & Loss A/c To, Interest on Own 8% Debentures A/c To, Interest Expense A/c [Being, Interest Expense transferred to Profit & Loss A/c]	1,45,600	 16,000 1,29,600
31.03.2015	Profit on Cancellation of Owned Debentures A/c Dr. To, Profit & Loss A/c [Being, Profit on cancellation transferred to Profit & Loss A/c]	13,600	 13,600

- In the above case the Profit on Cancellation of Owned Debenture is routed through the **"Profit on Cancellation of Owned Debentures A/c"**.