

Suggested Answer_Syll2012_Dec2014_Paper_7

INTERMEDIATE EXAMINATION

GROUP I

(SYLLABUS 2012)

SUGGESTED ANSWERS TO QUESTIONS

DECEMBER 2014

Paper- 7: DIRECT TAXATION

Time Allowed : 3 Hours

Full Marks : 100

The figures in the margin on the right side indicate full marks.

Wherever required, the candidate may make suitable assumptions and state them clearly in the answers.

Working notes should form part of the relevant answers.

All sub-divisions of a question should be answered continuously.

All the questions relate to the assessment year 2014-15 and the provisions stated relate to the Income-tax Act, 1961, unless stated otherwise in the question.

Section A

[Question No. 1 is compulsory and answer any four from Q. No. 2 to 6 in this section.]

1. (a) Fill up the blanks: 1x8=8
- (i) Deduction under section 80G for donation to National Children's Fund is _____ per cent.
 - (ii) Life Insurance premium paid in excess of _____ per cent of the actual capital sum assured is not deductible under section 80C, in respect of policies issued on or after 01.04.2012.
 - (iii) Commodities transaction tax is _____ even if it is incurred in the course of business.
 - (iv) Buy back of unlisted shares by a company is _____ in the hands of the shareholder.
 - (v) Rebate under section 87 is to be calculated _____ the levy of education cess.
 - (vi) Rate of income-tax applicable for foreign institutional investors in respect of income from notified bonds and government securities is _____.
 - (vii) The due date for furnishing Annual Information Return is _____.
 - (viii) Sale of gold coin in excess of _____ is liable for tax collection at source.
- (b) Choose the most appropriate alternative: 1x5=5
- (i) Deduction for investment in new plant or machinery under section 32AC is applicable for
 - (A) all assesses
 - (B) companies
 - (C) partnership firms

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- (D) individuals
- (ii) Income of securitization trust from the activity of securitization is
(A) Exempt [section 10(23DA)]
(B) Taxable at 20%
(C) Taxable at 5%
(D) Taxable at the regular rates
- (iii) Royalty paid by State Government undertaking to the State Government is
(A) Deductible
(B) Inadmissible
(C) 50% deductible
(D) 20% deductible
- (iv) Time limit for setting up undertaking for generation of power to avail deduction under section 80-IA is available upto
(A) 31.03.2017
(B) 31.03.2016
(C) 31.03.2013
(D) 31.03.2014
- (v) The maximum deduction under Rajiv Gandhi Equity Savings Scheme is
(A) ₹ 10,000
(B) ₹ 50,000
(C) ₹ 1,00,000
(D) ₹ 25,000

Answer:

1. (a) (i) 100
(ii) 10
(iii) Deductible
(iv) Exempt
(v) Before
(vi) 20%
(vii) 31st August
(viii) ₹ 2 lakhs
- (b) (i) (B) Companies
(ii) (A) Exempt
(iii) (B) Inadmissible
(iv) (C) 31.03.2013
(v) (D) 25,000
2. (a) What are "profits in lieu of salary" as per section 17(3) of the Income Tax Act, 1961? 3
(b) Mr. Mahim was retrenched from service of ABC Limited. He received retrenchment compensation amounting to ₹ 8,75,000. Amount of compensation determined under the Industrial Disputes Act, 1948 is ₹ 4,80,000. The scheme of retrenchment is not approved by the Central Government. Compute the taxable retrenchment compensation. 4
(c) Mr. Singhania constructed a residential house property in Kanpur. Construction was completed on 1st April, 2013. The house was vacant from 1st April, 2014 to 31st July, 2014. The house was let out at rent of ₹ 7,500 per month from 1st August, 2013. Mr. Singhania obtained loan for the purpose of construction. Interest paid on such loan during two

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years prior to completion of construction amounted to ₹ 30,000. Interest paid during the year 2013-14 is ₹ 16,000. Fire Insurance premium paid is ₹ 2,000. Municipal value of the property has been assessed at ₹ 40,000. Annual corporation tax paid ₹ 3,000.

Compute income under the head "Income from House Property" for Assessment year 2014-15. 6

Answer:

2. (a) As per section 17(3), "profits in lieu of salary" includes –
- (i) The amount of any compensation due to or received by the assessee from his employer or former employer at or in connection with the termination of his employment or the modification of the terms and conditions, relating thereto;
 - (ii) Any payment (other than gratuity, commuted pension, compensation received under the Industrial Disputes Act or any other Act, etc., any payment from a provident fund to which the Provident Funds Act, 1925 applies, accumulated balance in recognized provident fund, payment from approved superannuation fund or house rent allowance) to the extent to which it does not consist of contributions by the assessee or interest thereon or any sum received under a Keyman insurance policy including bonus allocated under such policy.

(b) Computation of Taxable Retrenchment Compensation

Particulars	₹	₹
Amount of retrenchment compensation received		8,75,000
Less: Exemption under section 10((10B)		
(i) Actual amount received	8,75,000	
(ii) Amount determined under the Industrial Disputes act, 1948	4,80,000	
(iii) Maximum Limit	5,00,000	
Least of above is exempt		4,80,000
Taxable Retrenchment Compensation		3,95,000

(c) Computation of Income from house property of Mr. Singhania for Assessment Year 2014-15

Particulars	₹	₹
Municipal Value		40,000
Annual rent (₹ 7,500 x 12)		90,000
Higher of Municipal Value and Annual rent		90,000
Less: Vacancy allowance (₹ 90,000 x 3/12)		<u>22,500</u>
Gross Annual Value		67,500
Less: Corporation tax paid		<u>3,000</u>
Net Annual Value		64,500
Less: Deductions under section 24		
(i) Standard deduction at 30% of net annual value (₹ 64,500 × 30%)	19,350	
(ii) Interest on loan for prior period (₹ 30,000 / 5)	6,000	
(iii) Interest on loan for current year	<u>16,000</u>	41,350
Income from house property		23,150

3. (a) The Profit & Loss Account of M/s. Saxena & Chaturvedi, Cost Accountants, shows a net profit of ₹ 25,50,000 after debiting/crediting the following items:
- (i) Interest of ₹ 1,40,000 on capital of Mr. Saxena, partner calculated at 14% per annum.
 - (ii) Remuneration ₹ 35,00,000 to Mr. Saxena and Mr. Chaturvedi, who are working

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- partners.
- (iii) Salary of ₹ 40,000 to Mr. Chatterjee, Manager for February, 2014 was paid by bearer cheque on 1st March, 2014.
- (iv) Depreciation ₹ 1,20,000.
- (v) Professional fee of ₹ 45,000 was paid to a lawyer for obtaining a legal opinion. No tax was deducted at source.
- (vi) A sum of ₹ 30,000 was paid to a trainee as a special award for ranking first in Final Examination of the Institute of Cost Accountants of India.
- (vii) Refund of penalty ₹ 35,000 paid in the financial year 2011-12 relating to delayed payment of service tax, after decision of the appellate authority in favour of the assessee.
- (viii) Interest on Fixed Deposit ₹ 5,00,000.
- The firm is entitled to depreciation of ₹ 1,45,000 under section 32.
- Compute total income of the firm for the assessment year 2014-15. 9

- (b) State the provisions of the Income Tax Act, 1961 relating to interest on compensation or enhanced compensation on compulsory acquisition of property. 4

Answer:

3. (a) Computation of total income of M/s Saxena & Chaturvdi for Assessment Year 2014-15.

Particulars	₹	₹
Profit & gains from business or profession		
Net profit as per Profit & Loss Account		25,50,000
Add: Interest to Mr. Saxena in excess of 12% p.a., disallowed under section 40(b) (₹ 1,40,000 x 2/14)	20,000	
Remuneration to partners considered separately	35,00,000	
Disallowance under section 40A(3) for payment of salary to the manager otherwise than by account payee cheque or account payee bank draft	40,000	
Depreciation as per books	1,20,000	
Disallowance under section 40(a)(ia) for payment of lawyer's fee without deduction of tax at source	<u>45,000</u>	<u>37,25,000</u>
		62,75,000
Less: Refund of penalty not taxable (Note 1)	35,000	
Interest on fixed deposit considered under other head	5,00,000	
Depreciation under section 32	<u>1,45,000</u>	<u>6,80,000</u>
Book Profit under section 40(b)		55,95,000
Remuneration admissible under section 40(b):		
On first ₹ 3,00,000: 90% of book profit or ₹ 1,50,000, whichever is higher	2,70,000	
On balance of book profit (i.e., 55,95,000 – 3,00,000) at 60%	<u>31,77,000</u>	<u>34,47,000</u>
Business Income		<u>21,48,000</u>
Income from other sources		
Interest on fixed deposit		<u>5,00,000</u>
Total income		26,48,000

Notes:

1. Penalty for infraction of law is never allowed as deduction under section 37(1). Therefore, penalty for delayed payment of service tax was disallowed in assessment year 2012-13. As penalty was disallowed, refund of such penalty as a result of

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favourable appeal order does not attract deeming provision of section 41(1). Hence, it is not taxable.

2. Special award was given to trainee for excelling in final examination of the institute to motivate him and in recognition of his caliber. Payment was made to boost his morale so that he could contribute more to the assessee firm. Thus it has a nexus with the profession carried on by the firm and hence, the same is allowable deduction under section 37(1). As it is debited to profit & loss account, no further adjustment is required.

- (b) As per section 145A (b), interest received by an assessee on compensation or enhanced compensation, as the case may be, shall be deemed to be the income of the year in which it is received irrespective of the method of accounting followed by the assessee. Such interest is taxable under the head "income from other sources" as per the provision of section 56.

In respect of such interest, the assessee shall be entitled under section 57 to claim deduction of a sum equal to 50% of such interest. No other deduction shall be allowed under any other provision of the Income-tax Act.

Key Points:

- (i) Regardless of the method of accounting;
- (ii) Interest on compensation/enhanced compensation is taxed in the year of receipt;
- (iii) It is taxed as income from other sources;
- (iv) 50% of such interest is allowable as expenditure.

4. (a) Mr. Ahuja purchased one plot of land in 1995-96 at a cost of ₹ 1,00,000 in Delhi. The land was held by him as capital asset. He converted the plot into his stock in trade on 1st April, 2012, on which date the fair market value of the plot was ₹ 15,50,000.

He started constructing a building consisting of eight flats of equal size and dimension on the plot on 1st April, 2012. Cost of construction of each flat is ₹ 6,00,000. Construction was completed in June 2013. He sold five flats at ₹ 12,00,000 per flat from June, 2013 to March, 2014. The remaining three flats were held as stock on 31st March, 2014.

Compute Capital Gain and Business Income arising from above transactions for Assessment year 2014-15. 9

(Cost Inflation Index:

1995-96: 281

2012-13: 852

2013-14: 939)

- (b) Ajay purchased a house for ₹ 6 lacs from Anup Properties, a property dealer on 1st June, 2013, for his residential purpose. He paid stamp duty on value of ₹ 10 lacs assessed by Stamp Valuation Authority.

Examine the tax implications in the hands of Ajay and Anup Properties. 4

Answer:

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4. (a) Computation of Capital Gain for Assessment Year 2014-15

Particulars	₹
Proportionate Fair market value of land-deemed consideration under section 45(2): ₹ 15,50,000 x 5 / 8 (Note 1)	9,68,750
Less: Proportionate indexed cost of acquisition (₹ 1,00,000 x 852 / 281 x 5 / 8 (Note 2)	<u>1,89,502</u>
Long term capital gain	<u>7,79,248</u>

Computation of Business Income for Assessment Year 2014-15

Particulars	₹	₹
Sale proceeds of 5 flats : ₹ 12,00,000 x 5		60,00,000
Less: Proportionate fair market value of land	9,68,750	
Cost of construction (₹ 6,00,000 x 5)	30,00,000	39,68,750
Business Income		20,31,250

Notes:

- Capital gain arising on conversion of capital asset into stock-in-trade is taxed in the year in which the converted asset is transferred. Therefore, capital gain in respect of proportionate land for 5 flats is chargeable to tax in assessment year 2014-15.
- Although tax liability for capital gain is taxed in the year of actual transfer, cost inflation index of the year in which capital asset is converted is to be used for determining capital gain, as transfer under section 2(47) is recognized in the year of conversion.

(b) In the hands of Ajay

As per section 56(2)(vii), where an individual receives any immovable property, being his capital asset for a consideration, which is less than the stamp duty value of the property by an amount exceeding ₹ 50,000, then the excess of stamp duty value over such consideration shall be taxed in the hands of the individual under the head "income from other sources".

Therefore, the sum of ₹ 4 lacs (i.e., ₹ 10 lacs – ₹ 6 lacs) shall be taxed in the hands of Ajay under the head "income from other sources".

In the hands of Anup Properties

Anup Properties is a property dealer. So the property sold constituted his stock-in-trade. As per section 43CA, where the consideration on transfer by assessee of an asset (other than capital asset), being land or building is less than the stamp duty value assessed or assessable, such stamp duty value shall be deemed to be the full value of consideration for the purpose of computing profits and gains from transfer of such asset.

Therefore, sum of ₹ 10 lacs shall be taken to be the consideration on sale of the building to Ajay and the said sum shall be considered for determination of business income of Anup Properties.

5. (a) **India makes LLP reports a total income of ₹ 60,00,000 for the year ended 31.03.2014 after taking into account the following details/deductions:**

- Deduction of ₹ 9,00,000 under section 80JJAA.**
- It manufactures toothpaste in a factory located in the State of Sikkim. Eligible deduction under section 80-IE is computed at ₹ 8,00,000.**
- Gave a donation of ₹ 5,00,000 to Prime Minister National Relief Fund towards Uttarakhand disaster, eligible for deduction under section 80G.**
- Debited ₹ 15,00,000 being the cost of water pollution control equipments to profit and**

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loss account. These items are eligible for 100% depreciation.

Compute the Alternative Minimum Tax (AMT) applicable to the LLP for the assessment year 2014-15, as per the provisions of the Income Tax Act, 1961. 5

(b) State, with brief reason, whether disallowance is attracted under any provision of the Income Tax Act, 1961 in the following cases, while computing income under the head 'Profits and gains of business or profession':

- (i) Salary of ₹ 3,00,000 to each working partner by a firm without deduction of tax at source.
- (ii) Interest to a nationalized bank on term loan ₹ 72,000 of which the amount actually paid during the year was ₹ 40,000 and ₹ 15,000 was paid before the 'due date' for filing the return of income.
- (iii) Demerger expenses of ₹ 7,00,000 wholly debited to profit and loss account.
- (iv) Expenditure incurred towards issue of bonus shares ₹ 2,00,000. 4

(c) Mr. Vishal gifted a sum of ₹ 3 lacs to Miss Mrinal on 1.4.2013. Miss Mrinal got married to Mr. Vishal's son on 1.6.2013. Mrinal earned an interest of ₹ 22,000 from this gifted amount, for the year ended 31.03.2014. Can the interest income of ₹ 22,000 be clubbed in the hands of Mr. Vishal? 4

Answer:

5. (a) Computation of AMT for India Makes LLP for the A.Y. 2014-15

Particulars	Rs.
Total Income	60,00,000
Add:	
Deduction under section 80JJAA to be added back	9,00,000
Deduction under section 80-IE to be added back	8,00,000
Cost of Water Pollution Equipments eligible for depreciation at 100% debited to profit and loss account – no adjustment is required.	Nil
Adjusted Total Income	77,00,000

Adjusted Total Income on adjusted total income @18.5% = 14,24,500 (77,00,000 × 18.5%)
 Add: Cess @3% = 42,735 (14,24,500 × 3%)
 Total AMT liability = 14,67,235.

(b) (i) Salary paid to each working partner by a firm ₹ 3,00,000 without deduction of tax at source will not attract disallowance under section 40a(ia).

However, based on book profit of the firm and subject to the limits in section 40(b), disallowance may apply.

(ii) Interest paid to a nationalized bank on term loan during the year ₹ 40,000 and the amount paid before the 'due date' for filing the return ₹ 5,000 are eligible for deduction as there will be no disallowance u/s 43B.

The balance of ₹ 17,000 will be disallowed under section 43B.

(iii) Demerger expenses applicable for companies contained in section 35DD of ₹ 7,00,000 is deductible in five equal annual installments. Therefore, ₹ 1,40,000 is allowable and ₹ 5,60,000 would be disallowed.

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(iv) Expenditure incurred towards issue of bonus shares ₹ 2,00,000 is deductible and would not attract any disallowance. Issue of bonus shares would not bring any fresh inflow of funds or increase in capital employed, hence, the expenditure is fully deductible. CIT v. General Insurance Corporation (2006) 286 ITR 232 (SC).

(c) Clubbing of income u/s 64

In computing the total income of an individual, the income arising from assets transferred by an individual, directly or indirectly, otherwise than for adequate consideration, to the son's wife, will be clubbed u/s 64(1).

As on the date of such transfer for inadequate consideration (i.e., gift), the relationship of father-in-law/daughter-in-law should exist.

In the instant case, Mr. Vishal gave the gift, will before the marriage of Mrinal with Mr. Vishal's son.

Hence, the interest income of ₹ 22,000 earned from such gifted amount cannot be clubbed in the hands of Mr. Vishal.

6. (a) From the following information, compute the income taxable under the head 'Capital gains' and 'Income from other sources' in the hands of Sachin:

(i) Sehwaq gifted a vacant site to his friend Sachin on 23.05.2013 on the occasion of latter's birthday.

(ii) Sehwaq had acquired the said vacant site in May, 2009 for ₹ 30,00,000.

(iii) The fair market value of the site for stamp duty purposes on the date of gift i.e., on 23.05.2013 was ₹ 60,00,000.

(iv) Sachin sold the vacant site on 15.03.2014 for a consideration of ₹ 70 lakhs when its stamp duty value on the date of sale was ₹ 90 lakhs.

For capital gains, state with reason, whether it is short-term or long-term.

Also compute the capital gains chargeable to tax in the hands of Sehwaq. 4

(b) (i) Mr. A (non-resident) aged 66 has total income (computed) ₹ 2,10,000 comprising income from house property and income from other sources. Is he required to file his return of income for the assessment year 2014-15? Also compute the total amount of tax payable by him. 3

(ii) X Co. Ltd. filed its return for the assessment year 2014-15 on 10.12.2014, declaring a business loss of ₹ 12,00,000 and unabsorbed depreciation of ₹ 6,00,000. How much of loss and/or depreciation is eligible for carry forward? 3

(c) State the conditions to be satisfied by political party to avail income-tax exemption. 3

Answer:

6. (a)

Computation of total income in the hands of Sachin A.Y. 2014-15

Particulars	₹
Capital gains:	
Sale consideration – Stamp duty valuation, as per section 50C	90,00,000
Less: Cost of acquisition	60,00,000
Short term capital gain	30,00,000
Income from other sources:	
Stamp duty value of the property on the date of receipt of gift i.e., 23.05.13	60,00,000
Total income	90,00,000

Note: Where a property is received without consideration, the FMV i.e., stamp duty valuation is the value taxable under the head 'income from other sources' in the hands

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of Sachin.

The holding period in the hands of Sachin shall be from the date of receipt of property and not from the date of acquisition by the previous owner. Since it was received on 23.05.2013 and sold on 15.03.2014 it is a short-term capital asset and the resultant gain is short-term capital gain.

The donor Sehwaag is not subject to capital gains as the property was not transferred but is gifted which is not regarded as transfer under section 47.

- (b) (i) Mr. A is a senior citizen but non-resident. The basic exemption limit applicable to him is ₹ 2,00,000 and not ₹ 2,50,000.

As the total income exceeded the basic exemption limit, he is liable to file his return of income.

Mr. A is required to pay tax of Rs. 1,030.

Upto Rs. 2,00,000	Nil
Next Rs. 10,000@10%	1,000
Add: EC + SHEC (3%)	30
Total tax liability	1,030

He is not eligible for rebate under section 87A because it is applicable to resident assessee (ordinary or not ordinary) only.

- (ii) The assessee, in order to carry forward business loss, has to file the return of income before the 'due date' prescribed in section 139(1). Section 80 debars carry forward of business loss to subsequent assessment years unless the return of income in which it has loss, is filed within due date specified in section 139(1).

However, the embargo contained in section 80 will not apply to carry forward of depreciation, both current year and that brought forward of preceding years.

In view of the above, X Co. Ltd. cannot carry forward business loss of ₹ 12,00,000 but it can carry forward unabsorbed depreciation to future years for set off.

- (c) Section 13A deals with tax exemption for incomes of political parties.

Any income of a political party which is chargeable under the head 'income from house property', 'income from other sources', 'capital gains' or any income by way of voluntary contribution from any person is not to be included in the total income of such political party if the following conditions are satisfied:

- (i) The political party maintains such books of account and other documents as would enable the assessing officer to properly reduce its income from there.
- (ii) The political party keeps and maintains a record of each voluntary contribution in excess of ₹ 20,000 and of the names and addresses of the persons who have made such contribution.
- (iii) The accounts by political party are audited by an accountant as defined in the Explanation to section 288(2).
- (iv) The treasurer of the political party or any other person so authorized in each financial year prepares a report in respect of contribution received by the political party in excess of ₹ 20,000 from any person or company in that year and submits it before the due date of submission of return of income, to the Election Commission.

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Section B

This section relates to Wealth Tax.

[Answer all questions]

7. (a) State with brief reasons, whether the following statements are true or false in the context of Wealth Tax Act, 1957: 1x5=5

- (i) All registered political parties are liable to pay wealth tax.
- (ii) One residential house owned by an individual, regardless of its value or period of let out, is exempt from wealth tax.
- (iii) A warehouse let out for 100 days after construction is an asset.
- (iv) Guest house beyond corporation limits is not liable for wealth tax.
- (v) Recorded cash in excess of ₹ 50,000 is an asset for HUF.

(b) Mr. Sarath has a residential house property at Chennai which is let out from 01.10.2013 and prior to that it was self-occupied by him. The annual value of the property is fixed at ₹ 3,00,000 and the municipal tax levied by the local authority was ₹ 15,000. Excess of unbuilt area over specified area, computed on the aggregate area is 18%.

Assuming that this is an asset chargeable to tax and that exemption will not be claimed in respect of this asset, compute the value of house property as per Schedule III. 5

Answer:

7. (a) (i) False: Political parties are not liable for wealth tax in view of section 45 of the Wealth Tax Act.
- (ii) True: As per section 5(vi) one house or part of a house is exempt from wealth tax.
- (iii) False: A warehouse is a property in the nature of commercial establishment hence not an asset regardless of the let out period.
- (iv) False: Guest house is always an asset liable for wealth tax regardless of the distance or location.
- (v) True: Cash in hand even though recorded if exceeds ₹ 50,000 it is liable to wealth tax.

(b)

Computation of value of house property as per Schedule III. Valuation date 31.03.2014

Particulars	₹	₹
Annual value		3,00,000
Less; Municipal tax	15,000	
15% of gross maintainable rent	45,000	60,000
Gross maintainable rent		2,40,000
Let out for only 6 months hence gross maintainable rent would be		1,20,000
Valuation by capitalization = GMR x 12.5		15,00,000
Add; 40% of the excess of unbuilt area over specified area of the aggregate area		6,00,000
Value as per Schedule III		21,00,000

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Section C

[Question No. 11 is compulsory, Answer any two out of the three questions in this Section.]

8. (a) What is 'impermissible avoidance arrangement' and state the four tests applied for deciding the same. 5
- (b) Can multi-year data be used for determination of ALP? 2
- (c) State whether the following are associated enterprises, one of them being non-resident: 3
- (i) X Co. Ltd. holds 12% partnership right in X Traders (firm).
- (ii) A Finance (non-corporate) guarantees loan taken by A & Co. (P) Ltd. for a term loan of ₹ 10 crores taken from a bank. A & Co. (P) Ltd. has a total borrowing of ₹ 20 crores.
- (iii) ABC Investments has advanced loan to DEF Ltd. which is more than 40% of book value of total assets of DEF Ltd.

Answer:

8. (a) **Impermissible avoidance agreement**

An agreement whose main purpose or one of the main purposes is to obtain a tax benefit and which also satisfies at least one of the four tests, can be declared as an 'impermissible avoidance agreement'.

The four tests applied for deciding the same are –

- (i) The arrangement creates rights and obligations, which are not normally created between parties dealing at arm's length.
- (ii) It results in misuse or abuse of the provisions of tax laws.
- (iii) It lacks commercial substance or is deemed to lack commercial substance.
- (iv) It is carried out in a manner, which is normally not employed for bona fide purpose.

- (b) **Use of multi-year data**

Yes, as per rule 10B(4) the use of data relating to the financial year in which such international transaction has been entered into must be considered.

Data of earlier years may also be used, if such data reveals acts which could influence on the determination of transfer prices in relation to the transactions being compared.

- (c) **Associated enterprises**

- (i) Since X Co. Ltd. holds more than 10% interest in X Trader (firm) the relationship between the X Co. Ltd. and X traders is that of associated enterprises.
- (ii) When an assessee guarantees at least 10% of the total borrowings of another entity, the relationship of associated enterprise is established. Since the guarantee for the loan exceeds 10% of the total borrowings A Finance and A & Co. (P) Ltd. are associated enterprises.
- (iv) A loan advanced by one entity to another entity of at least 51% of book value of total assets would result in associated enterprise relationship. In this case, the loan advanced forms part of only 40% of book value of total assets of borrower DEF Ltd. Hence, they are not associated enterprises.

9. (a) **India has a Double Taxation Avoidance Agreement (DTAA) with USA. Mr. Murali, a resident Indian, has derived certain income in USA. Assume that as per the DTAA the said**

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income is taxable at the rate of 10%, whereas as per the provisions of the Income Tax Act, 1961, the same is taxable at 15%. Can Mr. Murali opt to be governed by the provisions of the DTAA, even though the DTAA deviates from the normal tax provisions? 2

Will your answer be different, if Mr. Murali were a non-resident? 1

(b) What is cross border transaction service? State the statutes primarily regulating the cross border transactions. 2

(c) MNO Ltd. and Roxy Inc. of USA are associated enterprises. MNO Ltd. imported 3000 motor bikes from Roxy Inc. at ₹ 50,000 per bike. These are sold in India at ₹ 55,000 per bike. Also, MNO Ltd. imported exactly similar motor bikes from Hold Inc. of Japan (unrelated party) and sold outside at a gross profit of 20% of sales.

Roxy Ltd. offered a quantity discount of ₹ 1,500 per motor vehicle. Hold Inc., however, offered only ₹ 500 per bike as quantity discount. The freight and insurance from Roxy USA cost MNO Ltd. ₹ 1,500 per bike whereas in respect of purchase from Hold Inc. MNO Ltd. had to pay ₹ 500 as freight charges and there was no insurance cost on the assessee.

Determine arm's length price and amount of increase in total income of MNO Ltd. 5

Answer:

9. (a) **DTAA**

As per section 90(1), India can enter DTAA with any country for granting tax reliefs. As per section 90(2), in relation to the assessee to whom such agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to that assessee. In other words, if the provisions of the DTAA are more favourable, the same shall apply.

Section 90(2) uses the word "assessee" and not "resident assessee". Hence, the answer will remain the same, even where the assessee is a non-resident.

(b) **Cross border transaction services**

Cross border transaction services means services related to transaction which involve two or more countries.

In India, there are two Acts which primarily seem to show the concern when a person undertakes cross border transaction. They are (a) Foreign Exchange Management Act, 1999; (b) Income-Tax Act, 1961.

(c) (i) **Computation of arm's length price of products bought from Roxy Inc. USA and MNO Ltd., India.**

Particulars	Amount (₹)
Resale price of goods purchased from Roxy Inc.	55,000
Less: Adjustments for differences	
(a) Normal Gross profit margin @ 20% of sale price = 20% of ₹ 55,000	11,000
(b) Incremental quantity discount by Roxy Inc. (1,500 – 500)	1,000
(c) Difference in purchase related expenses (1,500 – 500)	1,000
Arm's length price	42,000

(ii) **Computation of Increase in total income of MNO Ltd.**

Particulars	Amount (₹)

Suggested Answer_Syll2012_Dec2014_Paper_7

Price at which actually bought from Roxy Inc. of USA	50,000
Less; Arms length price under resale price method	42,000
Decrease in purchase price per unit	8,000
Number of units purchased from Roxy Inc. = 3,000	
Increase in total income (3,000 units x ₹ 8,000)	240 lakhs

10. (a) State the difficulties in ALP determination of intangibles. 3

(b) When is profit split method (PSM) applied in international transactions for determination of ALP? 2

(c) Mr. Banerjee, a resident Indian, and 56 years old, has derived the following incomes during the previous year 2013-14.

Particulars	₹
Income from business in India	3,80,000
Commission (Gross) from a company in Hong Kong (Tax paid in Hong Kong ₹ 40,000)	2,00,000
Dividend (gross) from a company in Hong Kong (Tax paid in Hong Kong ₹ 22,500)	1,50,000
Interest on fixed deposit with banks in India.	1,80,000
India has no Double Taxation Avoidance Agreement (DTAA) with Hong Kong.	

Compute the income and tax payable by Mr. Banerjee for the assessment year 2014-15. 5

Answer:

10. (a) **Difficulties in ALP determination of intangibles**

Where the transaction involves intangible assets, the following difficulties arise in transfer pricing determination:

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

(b) **Profit split method**

This method is mainly applicable in international transactions involving transfer of unique intangibles; or

In multiple international transactions which are so inter-related that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction.

(c) Mr. Banerjee is entitled to relief under section 91.

He is eligible for relief under section 91, of a sum calculated on such doubly taxed income at the Indian rate of tax or at the Hong Kong rate of tax, whichever is lower, will be eligible for the relief.

Particulars	₹
Income from business in India	3,80,000

Suggested Answer_Syll2012_Dec2014_Paper_7

Commission received from a company in Hong Kong	2,00,000
Dividend received from a company in Hong Kong	1,50,000
Interest on fixed deposits with banks in India	1,80,000
Total income	9,10,000
Tax liability:	
Tax on ₹ 9,10,000	1,12,000
Add: Education cess and SAH cess @ 3%	3,360
Total tax liability before relief u/s 91	1,15,360
Average rate of income tax in India = ₹ 1,15,360 x 100/9,10,000 = 12.68%	
Average rate of income tax in Hong Kong = ₹ 62,500 x 100/3,50,000 = 17.86%	
Relief under section 91 shall be 12.68% which is less than the average rate of income tax of Hong Kong	
Relief u/s 91 : 12.68% of ₹ 3,50,000	44,380
Net Tax Liability	70,980

11. Answer the following:

1x5=5

- (a) What is international transaction?
- (b) Who can apply for Advance Pricing Agreement (APA)?
- (c) State the Form No. in which the accountant must certify the arm's length price after audit.
- (d) State any four filters applied in ALP determination.
- (e) What is the basic object of ALP determination?

Answer:

11. (a) International transaction means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property or any other transaction as may be prescribed.
- (b) Any person who (i) has undertaken an international transaction; or (ii) is contemplating to undertake an international transaction – shall be eligible to apply for advance pricing agreement.
- (c) The arms length price upon computation under any of the methods shall be audited and certified in Form No. 3 CEB vide rule 10E.
- (d) Turnover filter, export filter, related party filter, employee cost filter, onsite and offsite filter, fixed asset filter, R&D expenses filter, income-tax filter, service income filter, diminishing loss filter and different financial filter.
- (e) The basic objective of determining ALP is to find out where any addition to income is warranted or not by way of (i) selling goods below arm's length price; or (ii) buying goods at more than arm's length price.