

Answer to PTP_Intermediate_Syllabus 2012_Dec2013_Set 3

Paper 7 - Direct Taxation

Full Marks – 100

Time – 3 Hours

Section A

(Question No. 1 is COMPULSORY and any FOUR from Question Nos. – 2 to 6)

1.

- (a) Mr. Gill was retrenched from service of S Ltd. He received retrenchment compensation of ₹9,00,000 during the previous year 2012-13. The scheme of retrenchment is approved by the Central Government. Calculate the tax liability.

Answer:

When retrenchment compensation is received in accordance with any scheme, which is approved by the Central Government, it is fully exempted from tax [Section 10(10B)].

- (b) R Ltd. incurred ₹5,00,000 for Agricultural Extension Project during the previous year 2012-13. State the allowability of that expenditure.

Answer:

Allowable Expenditure on Agricultural Extension Project = Amount incurred × 150%
= ₹5,00,000 × 150% = ₹7,50,000

- (c) Chitra received ₹4,00,000 on 11.05.2012 as scholarship for her PHD in Chemistry. She requested you to calculate her income tax liability for the assessment year 2013-14. She has no other income during the year.

Answer:

Amount received by Chitra as scholarship is fully exempted u/s 10(16).

- (d) Mr. Aman took a loan of ₹3,00,000 from his employer on 5th October, 2012 for medical treatment (specified in Rule 3A) of his wife. Hospital bill was ₹3,00,000. He also received ₹1,00,000 from mediclaim. Calculate the amount chargeable to tax.

Answer:

In the given case, the loan was taken for medical treatment (specified in Rule 3A). Only interest on ₹1,00,000 (i.e. amount received from mediclaim) chargeable to tax in the hands of Mr. Aman.

- (e) Kakun, a sikkimese individual, has earned ₹2,15,000 during the previous year 2012-13. The source of her income is in Sikkim only. Determine her tax liability for the assessment year 2013-14.

Answer:

Kakun's income is exempted u/s 10(26AAA) as she is a sikkimese individual and the source of her income is in Sikkim only. Hence, her tax liability is nil.

- (f) If a machine costing ₹1,00,000, on which depreciation of ₹80,000 was written off is sold for ₹15,000, calculate terminal depreciation.

Answer:

The machine was costing ₹1,00,000, on which depreciation of ₹80,000 was written off is sold for ₹15,000. Terminal depreciation will be ₹5,000 [i.e. (₹1,00,000 – ₹80,000) – ₹15,000].

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- (g) Sanjeev has an agricultural land in urban area. Do you consider this as a capital asset for the purpose of the capital gains computation? Justify your answer.

Answer:

Yes, the agricultural land in urban area is a capital asset. Agricultural land in rural area is only excluded.

- (h) Sandip, a salaried employee, received Tribal Area Allowance of ₹300 per month. Calculate the taxable amount of Tribal Area Allowance.

Answer:

Taxable Tribal Area Allowance of Sandip = ₹(300 – 200) = ₹100 p.m.

If we assume that he received the allowance for the whole year, then his Taxable Tribal Area Allowance = ₹100 × 12 = ₹1,200 for the whole year.

- (i) What is the due date of filing the return of income of SD Ltd., if it is required to furnish a report in Form No. 3CEB u/s 92E for the assessment year 2013-14?

Answer:

The due date of filing the return of income of SD Ltd. which is required to furnish a report in Form No. 3CEB u/s 92E is 30th November, 2014 for the assessment year 2013-14.

- (j) Mention the time limit within which, any amount of tax (other than Advance Tax) specified as payable in a notice of demand u/s 156, be paid?

Answer:

Within 30 days from date of serving the notice u/s 156 at the place and to the person mentioned in the notice, the amount of tax so demanded is to be paid.

- (k) What will be the amount of penalty, if Karan fails to maintain books of accounts as required u/s 44AA?

Answer:

If Karan fails to maintain books of accounts as required u/s 44AA, Penalty of ₹25,000 u/s 271A will be levied.

- (l) Mr. Roy borrowed ₹5,00,000 on mortgage of his house property for his daughter's marriage. Is the interest on that amount paid deductible from the income of the house property?

Answer:

Merely because the loan is charged on the property, interest does not become deductible, because the amount is not borrowed for purpose of acquiring or constructing or repairing or renewing the property.

- (m) On 03.02.2013, an investment of ₹15,00,000 in the name of Mr. R is found which cannot be explained by him. In which previous year will it be included in the total income of R, if the date of investment is 01.01.2011?

Answer:

Previous Year in which the amount of investment will be included in the total income of R is the year in which the investment is made i.e. 2010-11.

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[13×1]

2.

- (a) Determine residential status for the assessment year 2013-14, of Vijay, an Indian Citizen who left India for employment in London on 1st November, 2012.

Answer:

Vijay was in India for 215 days in 2012-13 (April 2012: 30 days; May 2012: 31 days; June 2012: 30 days; July 2012: 31 days; August 2012: 31 days; September 2012: 30 days; October 2012: 31 days and November 2012: 1 day).

Vijay is an Indian citizen, leaving India to take up a job. 'Hence he will get the extended limit of 182 days' stay in India during 2012-13. He was in India for more than 365 days during the four years preceding the previous year. Hence, Vijay will be a resident.

As he satisfies all the conditions of section 6(6), he is resident and ordinarily resident.

Note: As the problem is silent about the previous years' status of Vijay, we assume that he left India for the first time on 1st November, 2012 and hence he was ordinarily resident in India in all the previous year.

- (b) Samir is a member of BOI. He borrows a sum of ₹2,00,000 from market with interest rate of 12% and advances it to the BOI. The BOI pays Interest @ 16% p. a. to Samir. Determine the amount to be disallowed.

Answer:

BOI has paid ₹32,000 to Samir as interest being 16% of ₹2,00,000. Samir in turn has paid interest of ₹24,000 being 12% on ₹2,00,000 on the funds borrowed by him. Disallowance of interest u/s 40(ba) will be limited to ₹8,000 being net interest paid to Samir [32000-24,000].

- (c) Raj, a resident individual, provides the following details for the previous year 2012-13:

Particulars	₹
Income from Business	4,00,000
Income from House Property	45,000
Income from Other Sources	55,000

Calculate tax liability of Raj for the assessment year 2013-14.

Show if there will be any difference in the tax liability for that year if he also has Agricultural income ₹2,00,000.

Answer:

Statement showing calculation of Tax Liability of Raj for the assessment year 2013-14
(If he has no agricultural income)

	₹
Total Income (₹4,00,000 + ₹45,000 + ₹55,000)	5,00,000
Tax on Total Income	30,000
Add: Education Cess and SHEC @3%	900
Tax Liability	30,900

Statement showing calculation of Tax Liability of Raj for the assessment year 2013-14
(If he has agricultural income)

	₹
Total Income (₹4,00,000 + ₹45,000 + ₹55,000 + ₹2,00,000)	7,00,000
Tax on Total Income	70,000
Add: Education Cess and SHEC @3%	2,100

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Tax (a)	72,100
Agricultural Income plus Basic Exemption	4,00,000
Tax on above	20,000
Add: Education Cess and SHEC @3%	600
Tax (b)	20,600
Tax Liability [(a) – (b)]	51,500

From the above it can be seen that if agricultural income is taken as totally exempt, tax liability would be ₹30,900 as against ₹51,500 worked out above. This implies that agricultural income is indirectly taxed.

- (d) A & L Ltd. incurs expenses on scientific research related to its business during the financial year 2007-08 and onwards @ ₹50,000 per year. It has commenced the business during the financial year 2012-13. Discuss the allowability of expenses incurred on scientific research.**

Answer:

As per Section 35 of the Income Tax Act, 1961, expenses for the financial year 2012-13 (year in which the business was commenced) and three financial years prior to that viz. 2009-10, 2010-11 and 2011-12 amounting in all to ₹2,00,000 will be allowed as deduction in the assessment year 2013-14.

[3+2+6+2]

3.

- (a) Ciba Ltd., an existing Indian company, engages in developing and providing computer software services. It set up a new unit and incurred the following expenditure in connection with the setting up of new unit. The project was completed in March, 2013.**

Determine the amount of deduction admissible u/s 35D.

Particulars	₹
Preparation of project report	2,50,000
Market survey	5,00,000
Legal charges for issue of additional capital for the new unit	3,25,000
Engineering services by the company not approved by CBDT	5,00,000
Cost of the Project	70,00,000
Capital employed in the new unit	60,00,000

Answer:

Particulars	₹	₹
Preparation of project report		2,50,000
Market survey		5,00,000
Legal charges for issue of additional capital for the new unit		3,25,000
Engineering services by the company not approved by CBDT – not considered as not approved		—
Actual Cost		10,75,000
Gross Qualifying Amount:		
5% of the cost of the project-(5% X 70,00,000)	3,50,000	
5% of capital employed in the new unit (5% X 60,00,000)	3,00,000	
Gross Qualifying Amount the higher of the above two		3,50,000

Qualifying Amount:

Net qualifying amount will be lower of the following:

(a) Gross qualifying amount: ₹3,50,000 or

(b) Actual amount of preliminary expenses: ₹10,75,000

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The lower of the two being ₹3,50,000 is the net qualifying amount.

Amount of Deduction: 1/5th of the net qualifying amount ($1/5 \times ₹3,50,000$) or ₹70,000 for each of the 5 assessment from A.Y. 2013-14 onwards.

- (b) Amir, a resident individual, is physically handicapped (75%). During the previous year 2012-13, he earned a net income of ₹4,78,000 from a consultancy business run by him. Compute his total income for the A.Y. 2013-14. Also calculate his tax liability.

Answer:

Statement showing calculation of total income and tax liability of Amir for the A. Y. 2013-14

Particulars	₹
Business income	4,78,000
Deductions u/s 80U	1,00,000
Total Income	3,78,000
Tax on Total Income	17,800
Add: Education Cess and SHEC @3%	534
Tax Liability	18,334

- (c) "Taxes can be classified on the basis of form, nature, aim and method of taxation"- Discuss.

Answer:

1. As to subject matter or object

- Personal, poll or capitation** – tax of a fixed amount on individuals residing within a specified territory, without regard to their property, occupation or business.
- Property** – imposed on property, real or personal, in proportion to its value, or in accordance with some reasonable method or apportionment.
- Excise** – imposed upon the performance of an act, the enjoyment of a privilege, or the engaging in an occupation, profession or business.

2. As to who bears the burden of the tax

- Direct** – the tax is imposed on the person who also bears the burden thereof.
- Indirect** – imposed on the taxpayer who shifts the burden of the tax to another.

3. As to determination of amount

- Specific** – imposed and based on a physical unit of measurement as by head number, weight, length or volume.
- Ad Valorem** of a fixed proportion of the value of the property with respect to which the tax is assessed.

4. As to purpose

- General, fiscal, or revenue** – imposed for the general purpose of supporting the Government.
- Special or regulatory** – imposed for a special purpose, to achieve some social or economic objective.

In addition to the above, taxes can further be classified as National (imposed by the National Government), Municipal or local (imposed by Municipal Corporations or Local Governments) on the basis of scope or authority imposing the tax and Proportional, Progressive and graduated, Regressive, Degressive on the basis of graduation of rates.

[6+4+3]

4.

- (a) Mr. Sinha purchased 200 equity shares of Tody Ltd. on 01.04.1988 @ ₹250 per share and incurred ₹400 on brokerage. On 01.08.1990, he got bonus shares in the ratio of 1:1. On

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01.09.1995, he got 300 right shares @ ₹150 per share. On 27.12.2012, he sold all shares @ ₹600 per share and incurred expenditure of ₹2,000 on brokerage. Compute his taxable capital gain.

Answer:

Particulars	₹	₹
Sale Consideration [(200+200+300)×₹600]		4,20,000
Less: Expenses on transfer		2,000
Net Consideration		4,18,000
Less: Indexed cost of acquisition –		
$[(200 \times ₹250) + 400] \times \frac{852}{161}$	2,66,713	
200 Bonus Shares	Nil	
$300 \times ₹150 \times \frac{852}{281}$	1,36,441	4,03,154
Long Term Capital Gains		14,846

(b) Do you think “Deemed Assessee” and “Assessee in Default” are same? Justify your answer.

Answer:

“**Deemed Assessee**” means a person who is treated as an assessee under the Income tax Act. This would include –

- (i) Trustee of a trust
- (ii) Legal representative of deceased person u/s 159,
- (iii) Representative Assessee of a Non- resident u/s 160 (2) (Agent of a non – resident),
- (iv) Legal Guardian or Manager entitled to receive the income on behalf of a Minor, Lunatic or Idiot,
- (v) Court of wards/Officials Trustee/ Receiver entitled to receive income on behalf of any other person.

“**Assessee in Default**” includes person who –

- (i) Fails to deduct and remit TDS (Sec.191)
- (ii) Fails to pay tax and other sum demanded (Sec. 220).

(c) B, a resident individual, resides in Mumbai. During the previous year 2012-13, he was in receipt of basic salary of ₹65,000, Dearness Allowance (considered for Retirement Benefit) of ₹35,000 and HRA of ₹25,000. He paid the actual rent of ₹15,000 per annum. Calculate the amount of HRA exempt u/s 10(13A).

Answer:

Exemption of HRA will be the least of the following:

- a. Actual HRA ₹25,000
- b. Rent paid in excess of 10 % of salary: ₹5,000
 $\{ \text{Actual Rent} - 10\% \text{ of salary plus DA} \}$
 $= ₹15,000 - \{ 10\% (65,000+35,000) \}$
- c. 50% of salary ₹50,000

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Hence, HRA of ₹5,000 will be exempt. Balance of ₹20,000 (i.e. ₹25,000 – ₹5,000) will be taxable.

- (d) M Ltd. incurred ₹1,00,000 (excluding ₹5,50,000 incurred for acquiring land) on skill development project during the previous year 2012-13. Determine the amount to be allowed as deduction u/s 35CCD.

Answer:

Amount allowed as deduction u/s 35CCD = Actual Expenditure × 150% = ₹1,00,000 × 150% = ₹1,50,000.

Note: Expenditure incurred for acquiring land is not allowable.

[5+3+4+1]

5.

- (a) Bhim has a Gross Total Income of ₹9,00,000 for the A.Y. 2013-14. He took a life insurance policy of ₹3,00,000 and paid premium of ₹24,000. He also paid premium of ₹10,000 each for policies of his brother, who is dependent on him and his son, who is employed in a company. Bhim also paid ₹24,000 for Unrecognized Provident Fund, ₹12,000 towards Public Provident Fund and ₹20,000 in Unit Linked Insurance Plan. During the year he has repaid housing loan taken from SBI Bank for ₹80,000 and ₹20,000 towards outstanding interest. He paid ₹4,000, ₹5,000 and ₹6,000 respectively as school fees of his three children. Calculate the taxable income of Bhim.

Answer:

Computation of Total Income of Bhim for the Assessment Year 2013-14

Particulars	₹	₹
Gross Total Income		9,00,000
Insurance for himself (8% of sum assured)	24,000	
Insurance for son – dependence not relevant	10,000	
Insurance for brother not allowed	Nil	
Unrecognised Provident Fund – Not allowed	Nil	
Public Provident Fund	12,000	
Unit Linked Insurance Plan	20,000	
Housing loan – Principal	80,000	
Interest allowable under income from house property		
School fee – two children – Higher figures considered [6,000+5,000]	11,000	
Total deduction u/s 80C	1,57,000	
Subject to maximum of ₹1,00,000		1,00,000
Total Income		8,00,000

- (b) R & Co. is a partnership firm carrying on a business, in which R, S and T are partners sharing profits and losses equally. In respect of assessment year 2013-14, it furnishes the following particulars:

- (i) Net loss as per P & L A/c after debiting remuneration/interest to partners ₹2,40,000
- (ii) Remuneration paid to partner – R ₹75,000, S ₹50,000 & T ₹25,000
- (iii) Interest paid to partners @ 20% per annum on their capital of ₹1,00,000 each as of 01.04.2012

You are required to work out the income of the firm and the partners R, S and T assuming that partners have no other income.

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Answer:

Computation of Total Income of Firm for the Assessment Year 2013-14

Particulars	₹
Net Profit as per Profit and Loss A/c (Loss)	(2,40,000)
Add: Remuneration to Partners (₹75,000 + ₹50,000 + ₹25,000)	1,50,000
Interest to partners [(₹1,00,000 × 20%)×3]	60,000
	(30,000)
Less: Max. Remuneration allowable in case of loss	1,50,000
Less: Interest allowable only up to 12% [(₹1,00,000 × 12%) × 3]	36,000
Loss	(2,16,000)

Taxable Income in the Hands of Partners for the Assessment Year 2013-14

	A	B	C
Salary	75,000	50,000	25,000
Interest	12,000	12,000	12,000
Total Income	87,000	62,000	37,000

- Salary allowed as deduction to firm ₹1,50,000 taxed in the hands of partners.
- Interest allowed to firm will also be taxed in the hand of the partners,
- Total Income of Partners i.e. Salary and Interest taxable as Profits and Gains from Business or Profession.
- Excess of salary and interest, which was disallowed in the hands of the firm, is not liable to be taxed in the hands of the partners.

[6+7]

6.

- (a) SW Ltd., an infrastructure capital company, issued 2,00,000 Zero Coupon Bonds (Face Value ₹100) on 21st October, 2012 at a price of ₹50. The redemption date of the bonds is 21st October, 2025. These bonds are notified by the Central Government as Zero Coupon Bond. You are required to compute the amount of discount allowable as deduction while computing business income of the SW Ltd.

Answer:

Discount on Zero Coupon Bond is allowable to SW Ltd. on pro-rata basis.

Total Amount of Discount = (₹100 - ₹50) × 2,00,000 = ₹1,00,00,000

Date of issue: 21st October, 2012 [as it is more than 15 days, it shall not be ignored and date of issue will be taken as 31st October, 2012]

Date of redemption: 21st October, 2025 [as it is 15 days or more, it is taken as one month and so redemption date will be taken as 31st October, 2025]

Total life of the bond: 31st October, 2012 to 31st October, 2025 i.e. 156 months.

Prorated discount for one month = 1,00,00,000/156 = ₹64,103

Amount of discount allowable for the Previous Year 2012-13 = ₹(64,103 × 5) = ₹3,20,515.

Amount of discount allowable for the Previous Year 2013-14 to 2024-25 = ₹(64,103 × 12)
= ₹7,69,236.

Amount of discount allowable for the Previous Year 2025-26 = ₹(64,103 × 7) = ₹4,48,721.

- (b) "There exists no difference in the treatment of income claimed u/s 10 with those under Chapter VI-A of the Income Tax Act." – Do you agree with the statement? Justify your answer.

Answer:

The statement is not correct. The differences in the treatment of income claimed u/s 10 with those under Chapter VI-A of the Income Tax Act, 1961 are as follows:

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Exemption u/s 10	Deduction under Chapter VI - A
Income exempt does not form part of the total Income.	Income forms part of Total Income.
Expenditure in relation to income exempt not deductible.	Expenditure in relation to income deductible.
It will not enter the calculation of Total Income.	It is a deduction from Gross Total Income.
Income is normally subject to certain conditions.	Deduction is normally allowed based on payment or fulfillment of conditions.

- (c) **Shamim, a resident individual, sold a rural land situated in Pakistan for ₹5,00,000 on 31.12.2012. The land was purchased on 01.04.2011 at a cost of ₹3,00,000. Discuss the taxability of the sale.**

Answer:

Section 2(14) provides that only Rural Agricultural Lands in India are not a capital asset. In the given case, Shamim has sold Rural Agricultural lands in Pakistan and therefore, the transaction attracts capital gains as sale falls under the definition of capital gains. His Short Term Capital Gains for the assessment year 2013-14 = ₹5,00,000 – ₹3,00,000 = ₹2,00,000.

[8+3+2]

**Section B
(Answer ALL the Questions)**

7.

- (a) **Mr. Som owns only one house valued at ₹10,00,000. The house has been built on a land area of 490 sq. meters. Do you consider the house property as an asset for the calculation of net wealth under the Wealth Tax Act?**

Answer:

Mr. Som owns only one house the land area does not exceed 500 sq. meters, thus the value of house is exempt from wealth tax as value of one house is exempt u/s 5 (vi).

- (b) **SL Ltd. gifted a house property of ₹20,00,000 to one of its director only by making an entry in its books on 01.03.2013. State under whose hand the house property is assessable for the calculation of wealth tax.**

Answer:

As the house property was gifted only by making an entry in the books, it should be assessable in the hands of SL Ltd.

[1+1]

8.

(a)

- (i) **“Wealth tax is not payable by an assessee in respect of any property held under a trust or other legal obligation for any public purpose of a charitable or religious nature in India.” Do you agree with the statement? Justify your answer.**

Answer:

The statement is valid. This exemption is provided in section 5(i). However, this exemption shall not apply to any property forming part of any business carried on by the trust. In the following cases the assets, though held in business, shall continue to be exempt from wealth-tax:

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- A. Any property held under any trust or other legal obligation forming part of any business, other than the business referred to in section 11(4A)(a) or section 11(4A)(b) of the Income-tax Act, 1961 in respect of which separate books of accounts are maintained; or
- B. Any property forming part of a business carried on by an institution, fund or trust referred to in section 10(23B) or 10(23C) of the Income Tax Act, 1961.

- (ii) Compute the wealth tax liability of Ultra Ltd. (carrying on the business of running cars on hire and also dealing in jewellery) which furnishes the following particulars of its assets and liabilities as on 31.3.2013:

(₹ in Lakhs)

	Book value	Valued as per Schedule III
Assets		
(i) Fixed Assets:		
Plant & Machinery	12	10
Factory Building	20	25
Urban Land (460 sq. meters)	36	71
Motor Cars	16	10
(ii) Investments		
Jewellery	10	25
Plot of Land in Mumbai (490 sq. meters)	15	75
Equity shares in subsidiary companies	15	20
(iii) Current assets :		
Stock in Trade (Jewellery)	100	120
Sundry Debtors	15	15
Bank Balances	5	5
Cash	1	1
Liability		
(i) Current Liabilities	15	15
(ii) Loans secured on Fixed Assets (Urban Land)	20	20

Answer:

Assessee: Ultra Ltd.

Valuation Date: 31.03.2013

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Statement Showing computation of Wealth Tax Liability

Particulars	₹
Plant & Machinery	10,00,000
Factory Building	25,00,000
Urban Land (460 sq. meters)	71,00,000
Motor Cars	10,00,000
Jewellery	25,00,000
Plot of Land in Mumbai (490 sq. meters)	75,00,000
Equity shares in subsidiary companies (Not an asset)	Nil
Stock in Trade (Jewellery) (Not an asset)	Nil
Sundry Debtors (Not an asset)	Nil
Bank Balances (Not an asset)	Nil
Cash (Not an asset)	Nil
Total Wealth	2,16,00,000
Less: Loans secured on Fixed Assets (Urban Land)	20,00,000
Net Wealth	1,96,00,000
Less Basic Exemption	30,00,000

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Taxable Net Wealth	1,66,00,000
Wealth Tax Liability	1,66,000

[2+6]

or

(b)

- (i) **An Association of Persons, comprising of two members A and B, owns an urban land valued at ₹70,00,000 on the valuation date 31.03.2013. Examine the tax implications under the Wealth Tax Act.**

Answer:

The tax implications of an asset owned by an association of persons under the Wealth tax Act are as follows:

- (I) As per section 3, only individuals, Hindu Undivided Families and Companies are liable to wealth tax. Therefore, an Association of Persons (AOP) is not chargeable to wealth-tax.
- (II) However, as per section 4(1)(b), the value of interest of a member of an AOP in the assets of the AOP is to be included in his net wealth. Schedule III lays down the manner of determination of the value of such interest.
- (III) Section 21AA deals with a situation where the shares of the members of an AOP are indeterminate or unknown. Where assets chargeable to wealth-tax are held by an AOP and the individual shares of the members are indeterminate or unknown on the date of formation or at any time thereafter, wealth tax is to be levied in the like manner and to the same extent as applicable to an individual.

In the given case, shares of the members A & B are unknown. Hence, the AOP is chargeable to Wealth Tax on ₹70,00,000 for the assessment year 2013-14.

- (ii) **Abasan Co-operative Society, formed for construction of residential flats for its members, acquired a large area of urban land at a cost of ₹5,00,00,000 on 31.01.2013. The Society had 10 members having equal shares. The Assessing Officer proposes to tax urban land in the hands of the Society.**

You are required to answer the following questions:

(A) What do you mean by "Urban Land"?

(B) Is the action of the Assessing Officer correct?

(C) Can the members of the Society be assessed on their share in the value of the urban land?

Answer:

(A) Urban land means :

Any land within the Jurisdiction of a Municipality or Cantonment Board with population of not less than 10,000 as per latest published census prior to valuation date.

Or

Any area situated within 8 kms from limits of such Municipality or Cantonment Board as notified by the central Government.

However, it does not include the following:

- A. Land on which construction of a building is not permitted by any law for the time being in force.

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- B. Land occupied by any building which has been constructed with the approval of the appropriate authority.
- C. Unused land held by the assessee for industrial purposes for two years from the date of its acquisition by him.
- D. Land held by the assessee as stock in trade for 10 years from the date of its acquisition by him.

(B) Assessing Officer's action: As per section 45, Co-operative Society is specifically excluded from the assessment of wealth tax. Therefore, the action of the Assessing Officer is wrong.

(C) Taxability of members:

- (I) Member's interest in open plot of land held by a co- Operative society is **exempt from tax. Kishore B Setalvad vs. CWT (2002) 256 ITR 637.**
- (II) **Only member's share in House Property** allotted by society/ Company/AOP is deemed as an asset and taxable. Share in Plot of Land allotted to members is not taxable.
- (III) Therefore, the members of the society cannot be assessed on their in the value of Urban land.

[3+(2+1+2)]

Section C (Answer ALL the Questions)

9.

(a) "Return on Asset Ratio is one of the profitability ratios" – Explain.

Answer:

The Return on Assets Ratio measures the amount of EBIT per rupee of asset invested. This is a profitability ratio measuring each company's operational efficiency, that is, how efficiently the assets have been deployed by the company.

(b) What do you mean by Residual Profit Split?

Answer:

Residual Profit Split is the residual profit which is apportioned to each party based on ownership of non-routine intangibles (i.e. network reach, efficiency of Sales & Marketing team, etc).

(c) How has OECD Guidelines defined Transactional Net Margin Method?

Answer:

Transactional Net Margin Method has been defined as a transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that an assessee realizes from a controlled transaction (or transactions that it is appropriate to aggregate).

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(d) When is an arrangement termed as Impermissible Avoidance Arrangement?

Answer:

An arrangement whose main purpose (or one of the main purposes) is to obtain a tax benefit (and which also satisfies at least one of the specified four tests), can be declared as an "Impermissible Avoidance Arrangement".

(e) In which form shall withdrawal of the application for advance pricing agreement be filed?

Answer:

Withdrawal of the application for advance pricing agreement shall be filed in Form No. 3CEE.

[5×1]

10.

(a)

(i) Elaborate whether adjustment is required in the context of transfer pricing provisions where the transfer price adopted for an international transaction concluded is ₹36 Lakhs whilst the Arm's Length Price determined using most appropriate method are ₹32 Lakhs and ₹42 Lakhs.

Answer:

Arithmetical Mean: Where more than one price is determined by the most appropriate method, the Arm's Length Price (ALP) shall be taken to be arithmetical of such prices.

Deemed ALP: If the variation between the ALP and the price at which the international transaction has been undertaken does not exceed the notified % of the actual price, then the Actual Price at which the international transaction has been undertaken shall be deemed to be ALP.

Analysis and Conclusion:

- (a) Since in the given case, there are 2 prices of ₹32 Lakhs and ₹42 Lakhs determined by the most appropriate method, the average price of ₹37 Lakhs $[(32 + 42) \div 2]$ shall be considered as ALP.
- (b) But, as the variation between the average price (₹37 Lakhs) and the actual price (₹36 Lakhs) is less than 5% of the actual price (i.e. 1 Lakhs < 1.85 Lakhs = 37 Lakhs x 5%), the actual price of ₹36 Lakhs shall be considered as the Arm's Length Price.

(ii) Briefly explain the deeming provisions in respect of cross border transaction.

Answer:

The major provisions laying down the source rule are contained in sections 9(1)(vii), 44D, 44DA and 115A of the Income Tax Act, 1961. There are some specific provisions also related to imposing tax liability on cross-border services, which are, Sections 44B, 44BB, 44BBA, 44BBB.

Section	Details
9(1)(vii)	Fees for technical services paid by the Government or a resident is deemed to accrue or arise in India unless such services are utilized by a resident for business or profession carried on outside India or for the purpose of earning income from any source outside India. Fees for technical services paid by a non-resident is deemed to accrue in India only if such services are utilized in a business carried on in India by the non-resident or are utilized for the purpose of earning income

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	from any source in India						
44D	Restriction on the right of foreign company to claim deduction for expenses from income in the nature of royalties or fees for technical services received from the Government or an Indian concern as follows:						
	<table border="1" style="width: 100%;"> <tr> <td style="width: 50%;">Date of Signature of Agreement</td> <td>restriction on deduction for expenses</td> </tr> <tr> <td>Before April 1,1976</td> <td>deduction allowed upto 20% of gross amount of fees for technical services</td> </tr> <tr> <td>After 31st March,1976 but before April 1,2003</td> <td>No deduction allowed</td> </tr> </table>	Date of Signature of Agreement	restriction on deduction for expenses	Before April 1,1976	deduction allowed upto 20% of gross amount of fees for technical services	After 31st March,1976 but before April 1,2003	No deduction allowed
Date of Signature of Agreement	restriction on deduction for expenses						
Before April 1,1976	deduction allowed upto 20% of gross amount of fees for technical services						
After 31st March,1976 but before April 1,2003	No deduction allowed						
	This section is applicable to foreign companies only and not to any other non-residents						
44DA	<p>Specific provisions dealing with royalties/fees for technical services – after 31st March,2003</p> <p>Provisions laid down in this section emphasizes to harmonise the provisions relating to income from royalty or fees for technical services attributable to a fixed place of profession or permanent establishment in India with similar provisions in various tax treaties.</p> <p>In terms of the provisions of this section, deduction is available for expenses from royalty or fees for technical services to a non-resident if :</p> <ul style="list-style-type: none"> (I) Royalties or fees for technical services are received from Government or an Indian concern (II) Agreement is made after 31st March,2003 (III) Business is carried on in India through a permanent establishment (IV) Professional services are provided from fixed place of profession (V) Right, property or contract for which royalty/fees for technical services arises is effectively connected with the permanent establishment or fixed place of profession. <p>“Permanent Establishment is defined in Sec. 92F (iiia),which includes a fixed place of business through which the business of the enterprise is wholly or partly carried on”.</p> <p>There are three types of Permanent Establishments (PEs):</p> <ul style="list-style-type: none"> (I) Basic rule PE – a fixed place of business, office, branch, installation, etc (II) Service PE – presence of employees (III) Agency PE – presence of dependent agent 						
44C	<p>The provision starts with a 'non-obstante clause', i.e. “Notwithstanding anything to the contrary contained in section 28 to 43A.....”.</p> <p>This section overrides Sections 28 to 43A and accordingly the words “computation under the head profits and gains of business or profession in accordance with the provisions of ITA” would mean that deduction of head office expenses would be allowed subject to restrictions contained in Section 44C.</p>						
44DA	This section is inserted with a view to harmonize the provisions relating to the income from royalty or fees for technical services attributable to a fixed place of profession or a permanent establishment in India with a similar provisions in various DTAA's						

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(iii) "One can apply Profit Split Method in every situation" – Justify.

Answer:

The Indian Transfer Pricing Regulation (TPR) affirms that the Profit Split Method (PSM) may be applicable mainly in the following cases:

- (a) Transactions involving transfer of unique intangibles;
- (b) Multiple inter-related international transactions which cannot be evaluated separately for determining the Arm's Length Price (ALP) of any one transaction.
 - (I) The extent of economies of backward and forward integration, the existence of intangibles on both sides of the transaction, and complex functional and transactional structures may limit the use of standard approaches to economic analysis for transfer pricing purposes (i.e. performing comparable company searches to apply the TNMM). In those circumstances, the arm's length nature of transactions may be better evaluated by considering the transaction from an end-to-end perspective, and thus PSM can be applied.
 - (II) This method can be used in situations where economies of integration differentiate the tested party from the comparables, provided these are taken into account in the principle for allocating profits. The method enables accounting for valuable intangibles being developed on both sides of the transaction.
 - (III) The allocation of profit can be calculated based on principles that take into account the contribution of intangibles in the industry's or the group's value creation process.
 - (IV) This method is also well suited to complex transactions where several entities are involved in the same functions and it is not possible to define precisely the scope of functions and responsibilities. While this method has not been widely used, it has been somewhat popular in the financial services industry

(iv) R Ltd. has borrowed through a fixed instrument of 10%. The swap quote from the bank is 9.70/9.90. After some time the swap market changed to 8.90/9 and R Ltd. again reversed the original swap by entering into second swap opposite to that of the first one.

You are required to answer the following questions:

- (A) What does the structure of the first swap achieve?
- (B) What is the structure of second swap and what does it do?
- (C) Find the cost of funds for the company after the second swap?

Answer:

- (A) The company would undertake the transform the fixed rate liability to floating rate, as it possibly expects a decline in the interest rates.
- (B) The company would enter into a swap opposite to that of the first one. In the first swap, the firm received fixed and paid variable. Now in the second swap, it would pay fixed while receiving LIBOR. This would enable cancelling the floating leg. The company would gain the differential of the fixed legs of first and second swap.
- (C)

Pay fixed to borrowers	10.00
Receive fixed from bank (1st swap)	(9.70)
Pay fixed to bank (2nd swap)	9.00
Effective cost after 2nd swap	9.30

[4+7+4+(1+2+2)]

Or

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(b)

- (i) Tango Inc., British Company, holds 47% of the equity shares in the Indian company K Ltd. which is engaged in development of software and maintenance of software for customers across the globe. Its clientele includes Tango Inc. During the year, K Ltd. had spent 2,500 man hours for developing and maintaining software for Tango Inc. with each hour being billed at ₹1,200. Costs incurred by K Ltd. for executing work for Tango Inc. amount to ₹22,00,000.

K Ltd. had also undertaken developing software for Beta Ltd. for which K Ltd. had billed at ₹1,500 per man hour. The persons working for Beta Ltd. and Tango Inc. were part of the same team and were of matching credentials and caliber. K Ltd. had made a gross profit of 60% on the Beta Ltd.

K Ltd.'s transactions with Tango Inc. are comparable to the transactions with Beta Ltd., subject to the following differences:

- (A) Tango Inc. gives technical know-how support to K Ltd. which can be valued at 5% of the normal gross profit. Beta Ltd. does not provide any such support.
 (B) Since the work for Tango Inc. involved huge number of man hours, a quantity discount of 15% of Normal Gross Profits was given.
 (C) K Ltd. had offered 90 days credit to Tango Inc., the cost of which is measured at 3% of the Normal Billing rate, no such discount was offered to Beta Ltd.

Compute ALP and the amount of increase or decrease in Total Income of K Ltd.

Answer:

Computation of Arm's Length Gross Mark Up

Particulars	₹	₹
Normal Gross Profit Mark up		60.00
Less : Adjustment for differences		
(a) Technical support [5% of Normal GP = 5% of 60%]	3.00	
(b) Quantity discount 15% of normal Gross profit [15% of 60%]	9.00	12.00
		48.00
Add: Cost of Credit to K Ltd. 3% of Normal Bill [3% × GP 60%]		1.80
Arm's Length Gross Profit mark-up		49.80

Computation of Increase in Total Income of K Ltd.

Particulars	₹	₹
Cost of services provided to Tango Inc.		22,00,000
Arm's length Billed Value [Cost / [(100 – Arm's Length mark up)] = ₹22,00,000 / (100% - 49.8%) [a]		43,82,470
Less: Billed amount [2,500 hours x ₹1,200 per hour] [b]		30,00,000
Therefore, Increase in Total Income of K Ltd. [a - b]		13,82,470

- (ii) "Indian Transfer Pricing Administration has witnessed several challenges in administration of Transfer Pricing Law" – What are they? Explain briefly.

Answer:

In administration of Transfer Pricing Law, Indian Transfer Administration has witnessed the following challenges:

- (a) **Challenges in the comparability analysis** – Increased market volatility and increased complexity in international transaction have thrown open serious challenges to comparability analysis and determination of arm's length price.
- (b) **Issue relating to risks** – A comparison of functions performed, assets employed and risks assumed is basic to any comparability analysis. India believes that the risk of a MNE is a by-product of performance of functions and ownership, exploitation or use of assets employed over a period of time. Accordingly, risk is not an independent element but is similar in nature to functions and assets. In this context, India believes that it is unfair to give undue importance to risk in determination of arm's length price in comparison to functions performed and assets employed.
- (c) **Arm's length range** – Application of most appropriate method may set up comparable data which may result in computation of more than one arm's length price. Where there may be more than one arm's length price, mean of such prices is considered. Indian transfer pricing regulations provide that in such a case the arithmetic mean of the prices should be adopted as arm's length price. If the variation between the arithmetic mean of uncontrolled prices and price of international transaction does not exceed notified percentage of such transfer pricing, then transfer price will be considered to be at arm's length. In case transfer price crosses the tolerance limit, the adjustment is made from the central point determined on the basis of arithmetic mean. Indian transfer pricing regulation do not mandate use of inter quartile range.
- (d) **Comparability adjustment** – Like many other countries, Indian transfer pricing regulations provide for "reasonably accurate comparability adjustments". The onus to prove "reasonably accurate comparability adjustment" is on the taxpayer. The experience of Indian transfer pricing administration indicates that it is possible to address the issue of accounting difference and difference in capacity utilization and intensities of working capital by making comparability adjustments. However, Indian transfer pricing administration finds it extremely difficult to make risk adjustments in absence of any reliable and robust and internationally agreed methodology to provide risk adjustment. In some cases taxpayers have used Capital Asset Pricing Method (CAPM).
- (e) **Location Savings** – It is view of the Indian transfer pricing administration that the concept of "location savings" which refer to cost savings in a low cost jurisdiction like India – should be one of the major aspects to be considered while carrying out comparability analysis during transfer pricing audits.
- Location savings has a much broader meaning; it goes beyond the issue of relocating a business from a 'high cost' location to a 'low cost' location and relates to any cost advantage. MNEs continuously search options to lower their costs in order to increase profits. India provides operational advantages to the MNEs such as labour or skill employee cost, raw material cost, transaction costs, rent, training cost, infrastructure cost, tax incentive etc.
- (I) Highly specialized skilled manpower and knowledge
 - (II) Access and proximity to growing local/regional market
 - (III) Large customer base with increased spending capacity
 - (IV) Superior information network
 - (V) Superior distribution network
 - (VI) Incentives
 - (VII) Market premium
- The incremental profit from LSAs is known as "location rents". The main issue in transfer pricing is the quantification and allocation of location savings and location rents among the associated enterprises.

Under arm's length pricing, allocation of location savings and rents between associated enterprises should be made by reference to what independent parties would have agreed in comparable circumstances.

The Indian transfer pricing administration believes it is possible to use the Profit Split Method to determine arm's length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available. In these circumstances, it is considered that the functional analysis of the parties to the transaction (functions performed, assets owned and risks assumed), and the bargaining power of the parties (which at arm's length would be determined by the competitiveness of the market availability of substitutes, cost structure etc) should both be considered as appropriate factors.

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

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

- (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 bundled along with tangible assets.
- (III) They are difficult to be detected.

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

- (g) **R&D activities** – Several global MNEs have established subsidiaries in India for research and development activities on contract basis to take advantage of the large pool of skilled manpower Taxation of International Transactions which are available at a lower cost. These Indian subsidiaries are generally compensated on the basis of routine and low cost plus mark up. The parent MNE of these R&D Centres justify low cost plus markup on the ground that they control all the risk and their subsidiaries or related parties are risk free or limited risk bearing entities.

The claim of parent MNEs that they control the risk and are entitled for major part of profit from R&D activities is based on following contentions:

- (I) Parent MNE designs and monitors all the research programmes of the subsidiary.
- (II) Parent MNE provides fund needed for R&D activities.
- (III) Parent MNE controls the annual budget of the subsidiary for R&D activities.
- (IV) Parent MNE controls and takes all the strategic decisions with regards to core functions of R&D activities of the subsidiary.
- (V) Parent MNE bears the risk of unsuccessful R&D activities.

The Indian transfer pricing administration always undertakes a detailed enquiry in cases of contract R&D Centres. Such an enquiry seeks to ascertain correctness of the functional profile of subsidiary and parent MNE on the basis of transfer pricing report filed by the taxpayers, as well as information available in the public domain and commercial databases. After conducting detailed enquiries, the Indian tax administration often reaches the following conclusions:

- (I) Most parent MNEs were not able to file relevant documents to justify their claim of controlling risk of core functions of R&D activities and asset (including intangible assets) which are located in the country of subsidiary or related party.

- (II) Contrary to the above, it was found that day to day strategic decisions and monitoring of R&D activities were carried out by personnel of subsidiary who were engaged in actual R&D activities and bore relevant operational risks.
- (h) **Marketing Intangibles** – Marketing related intangible assets are used primarily in the marketing or promotion of products or services. This includes: Trademarks; Trade names; Service marks; Collective marks; Certification marks; Trade dress; Newspaper mastheads; Internet domain names; Non-competitive agreements
- (i) **Customer-related intangible assets** – These are generated through inter-action with various parties such as customers, entities in complimentary business, suppliers , etc. these can either be purchased from outside or generated internally.
 - (I) Contractual basis: customer contracts and customer relationships; order or production backlog
 - (II) Non-contractual basis:- customer lists; non-contractual customer relationships;
- (j) **Artistic-related intangible assets** – These are rights granted by Government or other authorized bodies to the owners or creators to reproduce or sell artistic or published work. These are on a contractual basis. These includes: Plays, opera and ballets; Books, magazines, newspapers and other literary works; Musical works; Picture and photographs; Video and audio-video material.
- (k) **Intra-group Services** – Globalization and the drive to achieve efficiencies within MNE groups have encouraged sharing of resources to provide support between one or more location by way of shared services. Since these intra group services are the main component of “tax efficient supply chain management” within an MNE group, the Indian transfer pricing authorities attach high priority to this aspect of transfer pricing.

The tax administration has noticed that some of the services are relatively straight forward in nature like marketing, advertisement, trading, management consulting etc. However, other services may be more complex and can often be provided on standalone basis or to be provided as part of the package and is linked one way or another to supply of goods or intangible assets. An example can be agency sale technical support which obligates the licensor to assist the licensee in setting up of manufacturing facilities, including training of staff.

The Indian transfer pricing administration generally considers following questions in order to identify intra group services requiring arm's length remuneration:

- (I) Whether Indian subsidiaries have received any related party services i.e., intra group services?
- (II) Nature and detail of services including quantum of services received by the related party.
- (III) Whether services have been provided in order to meet specific need of recipient of the services?
- (IV) What are the economic and commercial benefits derived by the recipient of intra group services?
- (V) Whether in comparable circumstances an independent enterprise would be willing to pay the price for such services?
- (VI) Whether an independent third party would be willing and able to provide such services?

The answers to above questions enable the Indian tax administration to determine if the Indian subsidiary has received or provided intra group services which requires arms' length remuneration.

Determination of the arm's length price of intra group services normally involve following steps:

- (I) Identification of the cost incurred – by the group entity in providing intra group services to the related party.

- (II) Understanding the basis for allocation of cost to various related parties i.e., nature of allocation keys.
 - (III) Whether intra group services will require reimbursement of expenditure along with markup.
 - (IV) Identification of arm's length price of markup for rendering of services.
- (I) **Financial Transactions** – Inter-company loans and guarantees are becoming common international transactions between related parties due to management of cross border funding within group entities of a MNE group. Transfer pricing of inter-company loans and guarantees are increasingly being considered some of the most complex transfer pricing issues in India. The Indian transfer pricing administration has followed a quite sophisticated methodology for pricing inter-company loans which revolves around:
- (I) comparison of terms and conditions of loan agreement;
 - (II) determination of credit rating of lender and borrower;
 - (III) identification of comparables third party loan agreement;
 - (IV) suitable adjustments to enhance comparability.
- Transfer pricing administration is more than a decade old in India. However disputes are increasing with each transfer pricing audit cycle, due to the following factors:
- (I) Cross border transactions have increased exponentially in the last one decade.
 - (II) Lack of international consensus on taxation of certain group cross border transactions like intangible, financial transactions, intra group services etc.
 - (III) Difficulty in applying the arm's length principle to complex transactions like business restructuring.
 - (IV) Taxpayers in India can postpone payment of tax liability by resorting to litigation.
 - (V) Availability of multiple channels to resolve disputes in India.

(iii) Can Forward Contracts also be termed as Future Contract? Justify your answer.

Answer:

Fundamentally, forward and futures contracts have the same function: both types of contracts allow people to buy or sell a specific type of asset at a specific time at a given price.

However, it is in the specific details that these contracts differ. First of all, futures contracts are exchange traded and, therefore, are standardized contracts. Forward contracts, on the other hand, are private agreements between two parties and are not as rigid in their stated terms and conditions. Because forward contracts are private agreements, there is always a chance that a party may default on its side of the agreement. Futures contracts have clearing houses that guarantee the transactions, which drastically lowers the probability of default to almost never.

Secondly, the specific details concerning settlement and delivery are quite distinct. For forward contracts, settlement of the contract occurs at the end of the contract. Futures contracts are marked-to-market daily, which means that daily changes are settled day by day until the end of the contract. Furthermore, settlement for futures contracts can occur over a range of dates. Forward contracts, on the other hand, only possess one settlement date.

Lastly, because futures contracts are quite frequently employed by speculators, who bet on the direction in which an asset's price will move, they are usually closed out prior to maturity and delivery usually never happens. On the other hand, forward contracts are mostly used by hedgers that want to eliminate the volatility of an asset's price and delivery of the asset or cash settlement will usually take place.

[7+10+3]