

INTERMEDIATE EXAMINATION GROUP I (SYLLABUS 2012)

SUGGESTED ANSWERS TO QUESTIONS JUNE 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 necessary, the candidate may make suitable assumption and state the same clearly in the answer.

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

SECTION A

[Answer Question No. 1 which is compulsory and any four from Q. Nos. 2 to 6]

1. (a) Fill up the blanks: 1x8=8
- (i) Mr. A, a senior citizen, has total income of ₹ 8 lacs, earned by way of interest from secured debentures. The advance tax payable by him is ₹ _____ .
- (ii) A partnership firm will be treated as non-resident, only if the _____ of the control and management of its affairs is situate outside India.
- (iii) An employee of a partnership firm is treated as "specified employee" if the income under the head "Salaries", excluding non-monetary perquisites exceeds ₹ _____ .
- (iv) The maximum amount of retrenchment compensation exempt u/s 10 (10B) in the hands of a person, when received from a private scheme not approved by the Board, is ₹ _____ .
- (v) Where any unrealized rent, earlier allowed as deduction is realized subsequently, the deduction available therefor is _____ .
- (vi) In the case of a payee not having PAN for whom tax is to be deducted at source u/s 194A, the rate applicable is _____ .
- (vii) Net wealth tax computed to be rounded off to the nearest multiple of _____ .
- (viii) Section _____ of the Wealth Tax Act provides for exemption from wealth tax to section 25 companies, co-operative societies, social clubs, etc.
- (b) Choose the most appropriate alternative: 1x5=5
- (i) For an employee in receipt of fixed medical allowance, the maximum amount which is exempt is ₹ _____
- (A) 12,000 (B) 15,000 (C) 18,000 (D) Nil
- (ii) Disallowance for expenditure incurred in relation to exempt income is made under section _____
- (A) 14A (B) 14 (C) 80A (D) 10(33)
- (iii) Where any land is located within aerial distance of 7 kms from municipal limits, to be regarded as capital asset u/s 2(14), the population of the municipality as per last census done before 1.3.2013 should be more than _____
- (A) 9 lacs (B) 8 lacs (C) 10 lacs (D) None of these
- (iv) To avail exemption u/s 54, an individual should purchase a new residential house within _____ years from the date of sale

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- (A) 2
(B) 3
(C) 1
(D) 4
- (v) For an assessee engaged in manufacturing activity, additional depreciation u/s 32(1)(ii) for second-hand machinery costing ₹ 3 lacs, installed on 12.5.2013 is ?
- (A) 30,000
(B) 45,000
(C) 60,000
(D) Nil

Answer:

1. (a) (i) Nil
(ii) Whole
(iii) 50,000
(iv) 5,00,000
(v) Nil
(vi) 20%
(vii) One rupee
(viii) 45
- (b) (i) D
(ii) A
(iii) C
(iv) A
(v) D
2. (a) There exists no difference in the treatment of income claimed as exempt u/s 10 with those entitled to deduction under chapter VI-A of the Income Tax Act, 1961. Do you agree with the statement? Justify your answer: 3
- (b) Briefly explain the deduction allowable u/s 37 of the Income Tax Act, 1961 in respect of income from business or profession. 4
- (c) Ram and Shyam are members of a firm "R and S" and also joint owners (50% each) of a two storied house property (of equal area), the details of which are as follows:
- (i) Ground Floor—let out at a monthly rent of ₹ 20,000/-.
- (ii) First Floor—used for partnership business of Ram and Shyam.
- (iii) Ram and Shyam received the following amounts in respect of another property which they had sold it on 31.03.2013:
- * Unrealised Rent pertaining to FY 2012-13— ₹ 50,000/-
 - * Arrears of rent pertaining to FY 2012-13— ₹ 1,00,000/-
- (iv) Municipal taxes paid for the entire house property—₹ 15,000/- p.a.
- (v) Interest on borrowings for the entire house property (Joint loan taken from HDFC)— ₹ 3,00,000/-
- Compute the income from house property and also explain how such income will be assessed in the hands of R and S. 6

Answer:

2. (a) The statement is not correct. There are differences between the two.

The differences in the treatment of income claimed u/s 10 with those Chapter VI_A of the Income Tax Act, 1961 are as follows:

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 in the calculation of gross total income	It is a deduction from gross total income. Hence, the impugned income might enter the calculation upto gross total income.

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Income exemption is normally subject to certain conditions	Deduction is normally allowed based on payment or fulfillment of certain conditions
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- (b) In computing the taxable income under the head "Profit and gains of business or profession", the assessee is entitled to deduct u/s 37, subject to following conditions:
- (a) The expenditure should not be one covered in sections 30 to 36.
 - (b) The expenditure must have been incurred wholly and exclusive for the purpose of earning income.
 - (c) The expenditure should not be in the nature of capital expenditure or in the nature of personal expenses.
 - (d) There must be clear nexus between the expenditure incurred and income sought to be earned.
 - (e) The expenditure should be incurred in the previous year.
 - (f) Any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.

(c)

Computation of income from House Property

	₹	₹
Annual Rent Received (Ground Floor - ₹ 20,000 x 12)	2,40,000	
Less: Municipal taxes paid (50% of total tax of house property - 50% of ₹15,000)	7,500	
Net Annual Value (NAV)		2,32,500
Less: Standard Deduction u/s 24(a) @ 30% of NAV	69,750	
Less: Interest on Borrowed Capital u/s 24(b) - Actual amount ₹ 3,00,000 But, maximum deduction restricted upto a maximum of 50% of ₹ 3,00,000 = ₹ 1,50,000, since remaining 50% is used for business purpose	1,50,000	(2,19,750)
Net Income from House Property		12,750
Add: Unrealised Rent received		50,000
Add: Arrears of Rent received	1,00,000	
Less: Standard deduction @ 30% of arrears of rent	30,000	
		70,000
Total Income from House Property		1,32,750

Note:

- (a) Though R and S in an AOP, the income from House Property will not be assessed as income of the AOP but will be included in the hands of the individual members as per Section 26 since the share of each member is definite and ascertainable. Hence, Ram and Shyam would show ₹ 66,375/- each in their individual total income as income from house property.
- (b) The balance 50% municipal taxes and interest on borrowed capital is allowed as a business expenditure in their business income.
- (c) Both unrealized rent and arrears of rent received during the year would be taxable in the hands of the assessee whether or not the assessee is the owner of the property (Section 25AA and Section 25B)
- (d) 30% of the amount of arrears of rent shall be allowed as deduction whereas no deduction shall be allowed for unrealized rent.
- (e) The portion of property used for business purposes, will not be considered for

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computing income from house property, business done by a partnership firm is business done by a partner of the firm. Hence, the Annual Let-out Value of the floor used for partnership business will not be considered while computing income from house property.

3. (a) Mr. Raghu joined a company at Chennai on 01.07.2013 and was paid the following emoluments:
- (i) Basic salary ₹ 50,000 per month.
 - (ii) Dearness allowance 50% of basic salary (eligible for retirement benefits).
 - (iii) Furnished accommodation owned by company was provided at Chennai.
 - (iv) Value of furniture in the accommodation ₹ 2,00,000 (cost).
 - (v) Motor car owned by the employer (with engine capacity less than 1.6 litres) given for exclusive personal use. Self-driven by Raghu. Expenses incurred by employer on its running and maintenance ₹ 55,950.
 - (vi) Educational facility for two children provided free of cost. The school is owned by the company. Tuition fee per month ₹ 600 and ₹ 1200 respectively.
 - (vii) Annual membership fee for Gymkhana Club paid by the employer ₹ 20,000.
- Compute the income from salary of Mr. Raghu for the assessment year 2014-15. 7
- (b) Mr. Somu placed a deposit of ₹ 20,00,000 in LMN Bank on which he is eligible for interest of ₹ 1,90,000 for the year. He also borrowed ₹ 7,00,000 from the bank on the security of the deposit. The amount borrowed was used for his medical expenses and daughter's education. Interest on the amount borrowed was ₹ 63,000. He offered net interest income of ₹ 1,27,000 under the head 'income from other sources'. Is he correct? 3
- (c) What is reverse merger? Explain the reasons for resorting to the same by the assesseees. 3

Answer:

3. (a)

Computation of income from salary of Mr. Raghu for F.Y. 2013-14

	₹	₹
Basic Salary ₹ 50,000 x 9		4,50,000
Dearness Allowance @ 50% of Basic Salary		2,25,000
Value of Furnished Accommodation @ 15% of Salary In this problem, Salary = Basic Salary + D.A.(forming part of retirement benefit) = 4,50,000 + 2,25,000 = 6,75,000 x 15%	1,01,250	
Add: Value of perquisite for furniture provided (2,00,000 x 10% x 9/12)	15,000	
		1,16,250
Add: Value of perquisite for motor car - running and maintenance expenses incurred by employer but car exclusively used for personal use		55,950
Add: Value of perquisite for educational facility provided to children of employee in a school owned by employer		
Child 1 - Tuition Fee ₹600 per month (since not exceeding ₹1,000 per month)	Exempted	
Child 2 - Tuition Fee ₹1,200 per month (exceeding ₹1,000 per month) . Taxable Value of perquisite per month = ₹(1,200 - 1,000) = ₹ 200 x 9 months	1,800	
		1,800
Add: Club Membership fee paid by employer		20,000
Gross Income from Salary		8,69,000

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- (b) Under Section 57 any expenditure (not being capital expenditure) expended to earn income chargeable under the head "Income from other sources" will be allowed as deduction against such income.

Interest on bank fixed deposit was income in the hands of the assessee but interest on loan taken on that deposit is not an allowable expenditure.

Therefore, in the given case, the action of Mr. Somu is not correct; the interest of ₹ 1,90,000 is taxable and the interest paid on loan is not deductible. In result, the income chargeable would be ₹ 1,90,000.

- (c) Generally a profit making company will take over / absorb a loss making company. However, the conditions of section 72A are to be fulfilled in order to avail such benefit.

Section 72A says that accumulated loss and unabsorbed depreciation of the amalgamated company shall be deemed to be the accumulated loss and unabsorbed depreciation of the amalgamated company in order to be eligible for carry forward and set off. However, the conditions given in section 72A are not that easy to fulfill.

In order to overcome the difficulties of section 72A, the loss making company will amalgamate or absorb the profit making company. In result, the loss making company will continue to exist. Such merger is called "reverse merger".

The procedural requirements of section 72A could be circumvented in the case of reverse merger.

4. (a) **Powell Ltd. filed its return of loss beyond the 'due date' prescribed in section 139(1) read with section 80 of the Act. It has business loss of ₹ 20,50,000. It approaches you for advice regarding the course of action to be taken to secure the benefit of carry forward of business loss for set off against future profits. Advise suitably.** 3
- (b) **Write a brief note on the deduction available under section 80DDB.** 4
- (c) **Mr. Nifin owns two houses, both of which are occupied by him for residential purpose. The details are given below:**

	House—I	House—II
Fair rent	7,20,000	6,30,000
Municipal value	5,00,000	5,00,000
Standard rent	6,00,000	6,00,000
Date of completion	01.01.2002	01.07.2008
Municipal tax paid	10%	12%
Date of loan	01.07.1998	01.05.2005
Interest on loan for the financial year 2013-14	1,10,000	1,70,000

Compute his income from house property and advise which house should be opted by him as self occupied. 6

Answer:

4. (a) Generally, return filed beyond the due date specified in section 139 (1) would deprive the taxpayer the benefit of carry forward of business loss. However, in extraordinary circumstances, the CBDT has the powers to condone the delay in filing return having carry forward of business loss to the future years. [Associated Electro Ceramics v. CBDT 201 ITR 501 (Kar)]. As per Circular No. 8 of 2001 monetary limits have been prescribed for condonation of delay in filing loss returns. In cases where the refund is less than ₹ 10,000, the Assessing Officer can condone the delay with the approval of CIT. for refunds from ₹ 10,001 to ₹

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1,00,000 the Assessing Officer can condone the delay with the approval of CCIT/DGIT. Where the refund claim exceeds ₹ 1,00,000 only the CBDT has the power to condone the delay.

Therefore, the loss return of Powell Ltd. could be condoned by CBDT. However, Powell Ltd has to file a condonation petition to the CBDT to carry forward the business loss.

(b) Aspects to be satisfied for availing deduction under section 80DDB:

- **Eligible assessee:** Individual and HUF
- **Condition:** The amount should be actually paid for the medical treatment of specified diseases.
- **Maximum deduction:** ₹ 40,000 and in the case of expenditure to senior citizens the limit is ₹ 60,000 [See note below].
- **Procedure:** The assessee must furnish a certificate in Form No. 10-I along with the return of income.

Note: If the assessee has received any amount from insurer or reimbursement from employer for the medical treatment referred to in this section, the amount so received will reduce the quantum of deduction.

(c)

Computation of income from house property of Mr. Nitin for the A. Y. 2014-15

	House - I	House - II
Option - I	Let out	Self occupied
Gross annual value	6,00,000	Nil
Less: Municipal tax	50,000	Nil
	5.50,000	Nil
Less: Deduction U/s. 24		
Statutory deduction @ 30%	1,65,000	Nil
Interest on loan	1,10,000	1,50,000
Income from house property	2,75,000	(1,50,000)
Total = ₹ 1,25,000		

	House - I	House - II
Option - II	Self occupied	Let out
Gross annual value	Nil	6,00,000
Less: Municipal tax	Nil	60,000
	Nil	5,40,000
Less: Deduction U/s. 24		
Statutory deduction @ 30%	Nil	1,62,000
Interest on loan (taken before 01.04.1999)	30,000	
Interest on loan		1,70,000
Income from house property	(30,000)	2,08,000
Total = ₹ 1,78,000		
<p>Note: The assessee must opt for option - I i.e., taking House - I as let out and House-II as self occupied. In which case the income from house property chargeable to tax would be ₹ 1,25,000.</p>		

5. (a) Write short notes on deduction under section 80TTA in respect of interest from banks.

4

(b) ABC LLP furnishes you the following details pertaining to the financial year 2013-14:

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Particulars	₹
Net Profit as per Profit and Loss Account	90,00,000
Depreciation debited in Profit and Loss Account	7,00,000
Depreciation allowable under section 32	9,00,000
Inadmissible/disallowable expenses	5,00,000
Deduction under section 10AA (computed)	12,00,000
Deduction under section 80IA (computed)	60,00,000

Compute total income, adjusted total income under section 115JC and tax liability of ABC LLP for the assessment year 2014-15. 6

(c) Explain the term "substantial interest" defined in section 2(32) and its application in at least two situations. 3

Answer:

5. (a) Deduction under section 80TTA in respect of bank interest

- **Eligible assessee:** Individual & HUF having income by way of interest on deposits (not being time deposit) in a savings bank account.
- **Interest from:** A banking company to which the Banking Regulation Act, 1949 applies; a co-operative society engaged in the business of banking including a co-operative land mortgage bank or co-operative land development bank; a post office.
- **Quantum:** Where the amount of such income does not exceed ₹ 10,000, the whole of such amount; and in any other case, ₹ 10,000.
- **Limitation:** In respect of any interest from any deposit held by or on behalf of a firm, an AOP or BOI no deduction will be allowed for such interest in computing the total income of any partner of the firm, any member of the association or any individual of the body.

(b)

Computation of adjusted total income under section 115JC in the case of ABC LLP.
A.Y. 2014-15

	(₹ in lakhs)
Net Profit as per Profit and Loss Account	90
Add: Depreciation debited to Profit and Loss Account	7
Inadmissible/ disallowable expenses	5
	102
Less: Depreciation allowable under section 32	9
	93
Less: Deduction under section 10AA	12
Gross Total Income	81
Less: Deduction U/s. 80-IA	60
Total Income	21
Adjustments for computing adjusted total income under section 115JC	
Add: Deduction under section 10AA	12
Deduction under section 80-IA	60
Adjusted total income	93

Note: As the adjusted total income is more than ₹ 20,00,000 the provisions of section 115JC will be applicable.

Tax liability @ 18.5% plus 3% @ 19.055% on ₹ 93 = ₹ 17.72115

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Amount liability is more than the tax on total income as per normal provisions. Here the same will be the tax payable.

(c) Section 2(32) defines the term 'substantial interest'.

In relation to company, a person who has substantial interest in the company means a person, who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate profits) carrying not less than 20% of the total voting power.

In the case of a non-corporate entity, a person eligible for 20% or more of the profits of the assessable entity.

In the case of corporate, person having substantial interest would be liable to tax in respect of deemed dividend to the extent it is covered by section 2(22)(e).

In the case of non-corporate, expenditure incurred by way of transaction with a person having substantial interest, is covered by section 40A(2)(b) for disallowing excess of expenditure than the fair market price.

6. (a) Who are not 'Regular Workmen' u/s 80JAA of the Income Tax Act 1961? 3
 (b) State the provisions relating to claiming of exemption in order to reduce tax liability on short-term capital gains. 5
 (c) Discuss the taxability or otherwise of the following gifts received by Arun, an individual during the financial year 2013-14: 2
 (i) ₹ 50,000 each from his four friends on the occasion of his birthday.
 (ii) Wrist watch valued at ₹ 20,000 from his friend.
 (d) Mr. Rahim, Director in a MNC Ltd. is entitled to a motor car (1.8 ltrs.) to be used for both official and private purposes. 3
 Discuss the taxability of perquisite, if
 (i) The car is owned by the employee, expenses paid by employer and it is a Chauffeur-driven car.
 (ii) The car is owned by Mr. Rahim, expenses incurred ₹ 30,000 and chauffeur is paid a salary of ₹ 90,000 provided by the employer.

Answer:

6. (a) The following workmen are not Regular workmen U/s 80 JJAA of the Income Tax Act 1961.
 (i) A casual Workmen
 (ii) A workmen employed through contract labour or
 (iii) Any other workmen employed for a period of less than 300 days during the previous year.

(b) Provisions relating to claiming of exemption in order to reduce tax liability on short term capital gains

	Applicable for	Exemption U/S
(i)	Transfer of Agricultural land	54B
(ii)	Transfer byway of compulsory acquisition by Government	54D
(iii)	Shifting of industrial undertaking from urban to Rural area	54G
(iv)	Compulsory acquisition of Agricultural land by Central Government / RBI	10(37)
(v)	Transfer by companies engaged in power sector business	10(41)

(c) (i) ₹ 2,00,000 (50,000 x 4) from his four friends on the occasion of is birthday is taxable as income from other sources since friends are not relatives and the amount has

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exceeded ₹ 50,000.

(ii) Wrist watch is not covered by the expression "properly", only gift of property received from non- relative is taxable. Hence wrist watch of ₹ 20,000 is not taxable.

(d) As per notification No. 24 dated 18.12.2009 the taxable value of perquisite will be:

	Amount (₹)
(i) Actual expenses paid by the employer - ₹ 39,600 (ie. ₹ 3,300 × 12)	
(ii) Computation of taxable value of perquisite	
Amount of expenses	20,000
Add: Salary to chauffeur	90,000
	1,20,000
Less: Value of perquisite if the car was owned by the employer (₹ 2400 pm + ₹ 900pm for chauffer = ₹ 3300 × 12 = ₹ 39,600)	39,600
Taxable value of perquisite	80,400

Tutorial Note:

Had the car been owned by the employer in case of the above, case (i), the calculations would have been as follows:

Expenditure incurred + salary of chauffer (as per income – tax guidelines)

= ₹ 2400 pm + ₹ 900pm

= ₹ 3300 pm

= ₹ 39,600 per year.

Section B

All questions in this section relate to the Wealth Tax Act.

[Answer all questions.]

1x5=5

7. (a) What do you mean by "specified area" in case of valuation of immovable property in Delhi for the purpose of wealth tax?
(b) Do you consider motor boat used in fishing business as an asset?
(c) Is it correct to say that a guest house, regardless of its locations, is always an "asset"?
(d) Poonam, while computing net wealth, wants to claim deduction of outstanding income tax and wealth tax liabilities of proceeding years of ₹ 3,25,000. Can she do so?
(e) Gold Deposit Bonds are also assets as jewellery. Is this true?

Answer:

7. (a) In case of valuation for wealth tax purposes of immovable property in Delhi specified area means 60% of the aggregate area.
(b) Motor boat used in fishing business is not asset U/s 2(ea) of the Wealth Tax Act, as it is used for commercial purposes.
(c) Yes. This is correct. A guest houses, regardless of its location or distance from municipal or corporation limits, is always regarded as an asset.
(d) Income tax and wealth tax liabilities are not deductible while computing net wealth.
(e) No, Jewellery does not include Gold Deposit Bonds issued under the Gold Deposit Scheme 1999 notified by the Central Government. So these are not assets.

8.

EITHER

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Price Foundations has let out a warehouse with effect from 01.10.2013 for a monthly rent of ₹ 2 lacs. The lease is valid for 15 years and the tenant has made a security deposit equivalent to 6 months rent which bears interest @ 15%. The tenant has undertaken to pay the municipal taxes of the warehouse amounting to ₹ 3 lacs p.a. What will be the value of the property under Schedule III of the Wealth Tax Act? 5

OR

(i) An assessee being an Indian citizen, purchased an urban land for ₹ 3 crores, out of remittance from outside India on 01.01.2013. He returned to India with an intention to permanently reside in India on 10.10.2013. Discuss the liability under Wealth tax for F.Y. 2012-13 and F.Y. 2013-14. 2

(ii) Explain the procedure for valuation of interest of a partner in a firm. 3

Answer:

8. (a) First Alternative:

Computation of value of Let-out Property as per Schedule – III of Wealth Tax Act

Date: 31.03.2014

	₹	₹
Actual Annual Rent Receivable - ₹ 2 lacs x 12 months		24,00,000
Add: Municipal taxes borne by the tenant		3,00,000
Add: Interest on Security Deposit of 6 months' rent @15% p.a. [₹ 2,00,000 x 6 x 15% x 6/12]	90,000	
Less: Interest on deposits allowed to tenant @ 15% p.a. [₹ 2,00,000 x 6 x 15% x 6/12]	90,000	NIL
Gross Maintainable Rent (GMR)		27,00,000
Less: Municipal taxes paid		3,00,000
Less: 15% of GMR		4,05,000
Net Maintainable Rent (NMR)		19,95,000
Capitalization Factor = 8 (since lease hold property and period of lease not exceeding 50 years)		
Value of Property = NMR x Capitalization Factor = ₹19,95,000 x 8		1,59,60,000

OR

- (i) Exemption u/s 5(v) under Wealth Tax Act is available on assets purchased one year prior to the date of return. However, the exemption is available prospectively from the year of return i.e., 2013-14. Hence, urban land purchased is eligible for exemption for the previous year 2013 -14. However, the asset is taxable asset for the previous year 2012-13.
- (ii) (a) Net wealth equal to the amount of its capital is allocated among the partners.
 (b) Residue is allocated among the partners in accordance with the agreement of partnership.
 (c) Apportionment of net wealth is done in the proportion in which the partners are entitled to share the profits.
 (d) The sum total of the amounts allocated to the partner is taken as the value of interest of that partner in the firm.

Section C

All questions in this section relate to transfer pricing provisions

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under the Income-tax Act, 1961

[Answer all questions.]

1x5=5

9. (i) What is 'Arm's Length Price'?
(ii) What does 'uncontrolled transaction' mean?
(iii) Define 'safe harbour'.
(iv) What is the maximum period for which advance pricing agreement shall remain valid?
(v) Under what circumstance may, an advance pricing agreement, be declared to be void ab initio?

Answer:

9. (i) "Arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.
- (ii) "Uncontrolled transaction" means a transaction between enterprises other than associated enterprises, whether resident or non-resident.
- (iii) "Safe harbour" means circumstances in which the income tax authorities shall accept the transfer price declared by the assessee. The determination arm's length price is subject to Safe Harbour Rules.
- (iv) An advance pricing agreement shall remain valid for such period not exceeding 5 consecutive previous years as may be specified in the agreement.
- (v) An advance pricing agreement can be declared by the CBDT as void ab initio with the approval of the Central Government, if the agreement has been obtained by the person by fraud or misrepresentation of facts.

10.

EITHER

- (a) State the reasons for cancellation of advance pricing agreement. 4
- (b) Narrate the procedure for furnishing Annual Compliance Report by the assessee, where advance pricing agreement has been entered into. 3
- (c) State the possible cases in which cost plus method is used for determination of arm's length price. 4
- (d) During the previous year 2013-14 ABC Associates, an Indian partnership firm made payment of ₹ 6 crores for purchase of raw materials from Mr. D, who is a close relative of Mr. A, a partner of the firm. Both Mr. D and Mr. A are residents in India. Explain whether transfer pricing provision is applicable to the said transaction. 3
- (e) Zenith Inc., a US company holds 30% shares in Intech Ltd. an Indian company. Zenith Inc. sells its goods to Intech Ltd. Zenith Inc. also sells similar goods to Logitech Ltd., an Indian company which is not an associated enterprise. Zenith Inc. sells 50,000 units at ₹ 12,000 per unit. The warranty in the case of sale of goods by Intech Limited is handled by Intech Limited. However, in case of sale of goods to Logitech Limited, Zenith Inc. is responsible for warranty for 6 months. Both Zenith Inc. and Intech Limited offer extended warranty at a standard rate of ₹ 1,000 per annum. Compute arm's length price under CUP method and the amount of increase or decrease in total income of Intech Limited. 6

OR

- (a) In case an advance pricing agreement is entered into, does it have any effect on the return of income of the assessee? 3

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- (b) What is the period for which an assessee has to keep and maintain the information and records relating to international transactions/specified domestic transactions? 2
- (c) X. Limited, an Indian company has borrowed certain sum from a financial institution, a resident of a Non Jurisdictional Area (NJA) notified by the Central Government. During the previous year, X Limited paid interest of ₹ 10 lacs to the financial institution. What authorisation is to be furnished by X. Limited? At what rate tax is required to be deducted source by X. Limited from payment of such interest? 4
- (d) What are the difficulties in applying arm's length principle? 5
- (e) P. Limited, an Indian company bought goods from its associated enterprise Q. Limited of UK at ₹ 3,050 per unit. Using Resale Price method, which is found to be the most appropriate method, the arm's length prices determined are ₹ 3,000, ₹ 3,050, ₹ 2,900 and ₹ 2,950.
- (i) Compute the arm's length price assuming tolerance variation notified by the Central Government to be 3%.
- (ii) Will your answer be different, if Q. Limited paid ₹ 3,080 per unit to P. Limited? 6

Answer:

Either (First Alternative)

10. (a) An agreement shall be cancelled by the CBDT for any of the following reasons:
- The compliance audit reveals failure in compliance with the terms of agreement.
 - The assessee has failed to file annual compliance report in time.
 - The annual compliance report furnished by the assessee contains material errors.
 - The assessee is not in agreement with the proposed revision.
- (b) The assessee shall furnish an annual compliance report in quadruplicate to DGIT (International Taxation) for each year covered in the agreement.
Annual compliance report shall be furnished within 30 days of the due date for filing return of income for that year or within 90 days of entering into an agreement, whichever is later.
The DGIT (International Taxation) shall send one copy of annual compliance report to the competent authority, one copy to Commissioner of Income Tax having jurisdiction of the assessee and one copy to the Transfer Pricing Officer having jurisdiction over the assessee.
- (c) Cost plus method is ordinarily used in the following cases:
- Where raw materials or semi-finished products are sold.
 - Where joint facility agreements are involved.
 - Long-term buy and supply arrangements.
 - Provision of services.
- (d) Where the assessee incurs any expenditure for which payment has been made or is to be made to person referred to in section 40A (2), such transaction is a specified domestic transaction under section 92BA. Relative of a partner is related person to the firm within the meaning of section 40A(2).
Disallowance under section 40A(2) is made by the Assessing Officer, if such payment is excessive or unreasonable having regard to the fair market value of goods or services received. However, such disallowance is not to be made, if such transaction is at arm's length price in accordance with section 92F.
In view of above provisions transfer pricing provisions shall apply to the instant transaction of purchase of raw materials for sum exceeding ₹ 5 crores from relative of the partner.

(e)

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Price charged by Zenith Ltd. to Logitech Ltd.	11,000
Less: Cost of warranty included in the price charged to Logitech Ltd (₹ 1,000 x 6/12)	500
Arm's length price	10,500
Price per unit charged to Intech Ltd.	12,000
Difference per unit	1,500
Number units supplied to Intech Ltd.	50,000
Addition to be made in the computation of total income of Intech Ltd.	7,50,00,000

Second Alternative:

- (a) As per section 92CD, where any person has entered into advance pricing agreement, and he has already furnished return of income under section 139 for any assessment year to which such agreement applies, such person shall furnish a modified return of income within a period of 3 months from the end of the month in which the said agreement was entered into in accordance with and limited to the agreement.
- (b) The information and records relating to international transactions / specified domestic transactions shall be kept and maintained for a period of 8 years from the end of the relevant assessment year.
- (c) As per section 94A(3) X. Ltd. has to furnish authorization in the prescribed form authorizing the CBDT or any other income tax authority acting on its behalf to seek relevant information from the financial institution located in notified jurisdictional area on behalf of X. Ltd. otherwise, deduction shall not be allowed in respect of interest on loan.
Under section 94A(5) X. Ltd. is required to deduct tax at source from such interest at the highest of the following three rates –
- (i) Rate or rates in force;
 - (ii) Rate specified in the relevant provisions of the Income-tax Act;
 - (iii) 30%
- (d) Following difficulties are experienced in applying arm's length principle:
- (i) The most common problem is the requirement to find transactions between independent parties which can be said to be exactly comparable with controlled transaction.
 - (ii) In a multinational environment enterprise system, a group first identifies the goal and then goes on to create the associated enterprise and finally, the transactions are entered into. This procedure is not applicable to independent enterprises. For this reason, there may be transactions within one multinational group, which may not be between independent enterprises.
 - (iii) The reductionist approach of splitting a multinational group into its component parts before evaluating transfer pricing may mean that the benefits of economics of scale or integration between the parties, is not appropriately allocated between the multinational group.
 - (iv) Application of arm's length principle imposes a burden on business, as it may require the multinational group to do things that it would not have done otherwise, e.g., searching comparable transactions, robust documentations, etc.)
 - (v) Arm's length principle involves cost to the multinational group.
- (e) As per section 92C, where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetic mean of such prices.
In case variation between the ALP so determined and the actual transfer price does not exceed the notified percentage (maximum 3%) of the actual transfer price, then

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the actual transfer price is deemed to be the ALP.

Arithmetic mean of 4 ALPs = ₹ $(3,000 + 3,050 + 2,900 + 2,950) / 4 = ₹ 2,975$

Actual transfer price = ₹ 3,050

Percentage of variation = $(3,050 - 2,975) / 3,050 \times 100 = 2.46\%$

Notified variation = 3%

As the percentage of variation between actual transfer price and arithmetic mean does not exceed the notified variation percentage, actual transfer price i.e., ₹ 3,050 is to be deemed to be the ALP.

If the actual transfer price is ₹ 3,080, then the percentage of variation = $(3,080 - 2,975) / 3,080 \times 100 = 3.41\%$. This is more than the notified variation of 3%.

In that case, the ALP is ₹ 2,975, being the arithmetic mean.