Answers

Marks

1 (a)

Mrs S
Assessment year 2007 – 08
Statement of total income

Income from		Rs.	Rs.	Marks
Property				
(i) Let out property (House No 1) Municipal valution Rs.1,80,000; Fair rent Rs.2,00,000; standard rent Rs.2,00,000; Rentals received Rs.2,16,000				
Since actual rentals received are higher than the other figures, the actual receipts are adopted for determining the annual municipal value	**Rs.**			
Annual municipal value	2,16,000			1·5
less municipal taxes paid – only actual payments are recognised	(81,000)			1·0
	1,35,000			
Less standard deduction 30%	(40,500)	94,500		0·5
(ii) Self-occupied property (House no 2)	**Rs.**			
Annual value under s.23(2)	Nil			1·0
Deduct interest on the loan taken out for repairing the property	(24,000)			1·0
Municipal taxes are not to be deducted separately in this case, since the annual value has been taken as 'nil' though one half can be claimed as a business expense	–			
	(24,000)			
Half of this property has been used by Mrs S for her profession and hence 50% of the loss, relating to the business use, can be claimed under the head 'business or profession'	12,000	(12,000)	82,500	1·0
Business or profession: Mrs S has been maintaining her books on a cash basis. This is a regularly maintained system and can be accepted				1·0
Gross receipts Note: No adjustment for opening and closing business receivables needs to be made since the taxpayer is following the cash method of accounting.		2,50,000		1·0

	Rs.	Rs.	Rs.	*Marks*
Deduct				
Salaries to staff (include the full payment (for 13 months) as Mrs S is adopting the cash method of accounting)	(1,56,000)			0·5
Conveyance and travel expenses (it is assumed that all the expenses relate to her business/profession and no personal expenses have been included)	(60,000)			0·5
Books and periodicals relate to business/profession and hence are allowable	(25,000)			0·5
Municipal taxes paid for the portion of her property relating to business use (50%)	(7,000)			1·0
Note: Depreciation on the written down value of the part of the building used for business can also be claimed. But, since the written down value has not been given, no deduction is included.				1·0
Interest on loan on self-occupied property – see above	(12,000)			1·0
		(2,60,000)		
Loss from business		(10,000)		
Add amount received from a client in appreciation of good work – this will be treated as a business receipt		80,000		
			70,000	1·5
Other sources:				
(a) interest on savings bank accounts		12,000		0·5
on fixed deposits		62,500		0·5
(b) interest on post office deposit		1,35,000		0·5
(c) gifts received at the time of her 62nd birthday – since individual contributions did not exceed Rs.1,000 and the gifts were received from relatives – no portion of this is taxed. See s.56 (2)(v)		–		1·5
			2,09,500	
Capital gain on house in Delhi – long term:				
Sale proceeds		90,00,000		0·5
Less indexed cost $15,00,000 \times \frac{519}{100}$		(77,85,000)		1·5
Capital gain		12,15,000		
Amount invested in the new house		75,00,000	nil	1·0
			3,62,000	
Deductions under s.80C				
Investment in Public Provident Fund Rs.1,00,000 limited to Rs.70,000		70,000		1·0
Infrastructure bonds		30,000	(1,00,000)	1·0
Total income			Rs.2,62,000	22

			Marks
	Rs.		
(b) Tax payable:			
Income Rs.2,62,000			
Mrs S will get a basic exemption of Rs.1,35,000 being a woman aged under 65			1·0
On balance (21,500 + 30% × (2,62,000 – 2,50,000))	25,100		0·5
No surcharge	–		0·5
Education cess at 2% × 25,100	502		1·0
Total tax payable	Rs.25,602		3
			25

2 (a)

PQR Limited
Assessment year 2007 – 08
Statement of total income

Income from	**Rs.**	**Rs.**	
Property			
Arrears of rent received – will be chargeable to tax under the head 'income from property' even if the assessee did not own the property at the time of the receipt of the arrears of rent. The arrears are taxable to income tax on a receipts basis. Hence the arrears received are treated as income.	60,000		1·0
Less allowance under s.25B – 30% of the receipt	(18,000)		
		42,000	0·5
Business			
Net profit – per profit and loss account	8,40,000		

Add as inadmissable:

(1) Cost of construction of property on leased land written off – the company had taken on a long lease on land with an old super-structure thereon. This building has been pulled down and a new one to suit the needs of PQR has been built costing Rs.12,00,000. The terms of the lease deed give freedom to PQR to build new structures on the land, subject to the condition that at the expiry of the lease the building reverts to the lessor or the lessee should pull it down giving vacant possession of the land. Whether such a building will constitute an asset or not was considered by the Supreme Court in *Madras Auto Service Private Limited's* case 2381TR 468, when the Court held that if the lease agreement provided for the demolition of the newly erected building at the end of the lease period then the entire cost of construction should be treated as revenue expenditure. If the agreement did not so provide, then the cost of construction must be capitalised and appropriate depreciation claimed thereon.

In the instant case, the lease was worded in such a manner as to deny ownership rights to the lessee – stating that the property would revert to the lessor, thus depriving any ownership rights to the lessee, or had to be pulled down. In such circumstances it can reasonably be concluded that the treatment of the cost of construction of Rs.12,00,000 as repairs has been properly done in the accounts. No adjustment is, therefore, called for. 2·0

It is also worth noting the explanation to s.31 added by the Finance Act 2004 which states that a deduction for current repairs permitted by that section cannot include any capital expenditure. It is, however, to be stated that the claim to the deduction of Rs.12,00,000 in this case can be made under s.37 of the Act, rather than under s.31. In the circumstances, the claim is allowed.

		Rs.	Rs.	Marks
	[If any candidate were to point out in the answer the provisions of the explanation to s.31 and argue on the inadmissibility of Rs.12,00,000 as a deduction, such an answer will also be treated as correct and granted marks]			
	One must also note the explanation to s. 32 (1) of the Act, which states that where the business or profession of a taxpayer is carried on in leased premises and the tax payer improves the premises by reconstruction, etc. the taxpayer will be entitled to depreciation on such cost – being treated as the owner thereof. This provision will not apply to the present case since there was no reconstruction or repair to an existing building in use. The existing building having been found unfit had to be pulled down and a fresh construction made over which PQR has no rights. Hence, again, the claim to treat the cost as revenue is acceptable.	–	–	1·0
(2)	Receipt of a royalty (technical fees) in the normal course of business – taxable as a business receipt		–	0·5
(3)	Refund of sales tax collection by the Government – Collections made in the regular course of business and paid to the Government are treated as allowable claims. In the present case, in the past assessment year(s) when the payments were made to the State Government, they would have been allowed as proper deductions. Now, on the law being held *ultra vires* by a proper court and a refund obtained, the receipts should be treated as ordinary business receipts and taxed. The credit to general reserve is incorrect. It is assumed that PQR will retain the money itself and not pass it on to the customers from whom the collections were made in the past. Hence treated as income	80,000		1·5
	Note: It can be argued as correct to exclude it since PQR might intend to refund to customers the taxes so collected. However, it should not have been credited to reserve but shown as a liability.			
	Interest on delayed payment of the refund is also to be treated as income	10,000		0·5
(4)	Instalment paid towards the purchase of the land from the Government – is capital expenditure and hence cannot be allowed as a deduction	1,20,000		0·5
	However, the periodic maintenance charges can be treated as an allowable deduction	–		0·5
(5)	Amount paid under an approved voluntary retirement scheme – Rs.6,00,000 – according to the terms of s.35 DDA, the amount has to be amortised over five years, including the current year. Hence only Rs.1,20,000 can be allowed and the rest has to be added back	4,80,000		1·5
(6)	Banking cash transaction tax paid Rs.10,000 is allowable as a deduction under s.36(1) (xiii)	–		1·0
	However, the fringe benefit tax paid is not allowed – see s.40 (a)(ic)	1,20,000		1·0
(7)	Advertisement in a souvenir published by a political party – will be disallowed as a business expenditure under s.37(2B)	50,000		1·0
	However, the same amount can be treated as a contribution given by PQR to a political party and allowed as a deduction under s.80GGB – this facility of deduction is available only to an Indian company (see below).			

		Rs.	Rs.	*Marks*
(8)	Damages received from regular suppliers of raw materials to the company for delayed shipments – is treated as a business receipt and is taxed. Since the receipt has been credited to the interest received account, which is otherwise treated as a normal part of business receipts, no adjustment is necessary in this case.	–		1·0
(9)	Fees paid for an increase of authorised capital will be treated as a capital expense and disallowed	25,000		1·0
	Note: These fees cannot be covered by s.35 D and treated as preliminary expenses subject to write off over a period of 5 years. The deduction under s.35 D is given only to such companies as are newly set up or those existing companies that extend their industrial undertaking by setting up new industrial units.			
(10)	Interest paid to a non-resident – no tax deducted at source – therefore, not allowed as a deduction [refer s.40 (a)(1)]	1,00,000		1·0
(11)	Family planning expenses on behalf of the company's employees – Rs.60,000 capital expense – s.36(1)(ix) – only one-fifth to be allowed this year – the rest, to be amortised equally over the next four years, is added back.	48,000		1·5
(12)	Expenses incurred in cash – under s.40A (3) only such expenses as are in excess of Rs.20,000 are to be regulated – in this case, since the payment was for Rs.20,000 only, no disallowance is called for	–		1·0
(13)	Rent arrears – this has to be included under income from property – hence excluded here	(60,000)		0·5
(14)	Write off of investments on the basis of a directive from the Government is allowed as a proper claim for deduction. Since the amount has been adjusted for in the books against the general reserve, the deduction is made here.	(2,10,000)		1·0
(15)	Expenditure on scientific research – in house development – s.35 (2AB) eligible project 50% extra to be allowed	(1,00,000)		1·0
	Deduction under s.80GGB – for donation to political party – see note (7) above	(50,000)		1·0
	Income from business	14,53,000		
	Adjustment for claims brought forward:			
	Business loss of the assessment year 1995–96 cannot be deducted because of the expiry of eight years.			1·0
	Business loss of the assessment year 2003–04 can be deducted in full	13,60,000		1·0
		93,000		
	Unabsorbed depreciation carried forward – Rs.5,20,000 – partly set off	93,000	Nil	1·0
	The balance of unabsorbed depreciation of Rs.4,27,000 will be carried forward			
	The long term capital loss of Rs.1,10,000 can be set off only against long term capital gains and hence will be carried forward to assessment year 2008–09			0·5
	Total income		Rs.42,000	25

		Rs.	Rs.	Marks
(b)	Tax payable			
	Normal basis			
	Tax payable on Rs.42,000 at 30%	12,600		
	Surcharge at 10%	1,260		
		13,860		
	Education cess at 2%	277		
		14,137		1·0
	Liability to minimum alternative tax:			
	Net profit – as per profit and loss account	8,40,000		0·5
	Add amount credited to reserves – sales tax refund and interest	90,000		1·0
		9,30,000		
	Against this, the debit balance brought forward in the books [Rs.3,00,000] or unabsorbed depreciation [Rs.5,20,000] whichever is less has to be adjusted. Since the carried forward loss is lower, it is adjusted	(3,00,000)		1·0
	Adjusted book profits under s.115 JB	6,30,000		
	Minimum alternate tax payable at 10%	63,000		
	Surcharge at 10%	6,300		
		69,300		
	Education cess at 2%	1,386		
	Tax payable under s.115 JB	70,686		1·0

Since this is larger than the tax payable under the normal procedure, PQR will be required to pay minimum alternative tax (MAT) of Rs.70,686 0·5

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3 (a)

	Rs. in lakhs	Marks
Net worth of the agricultural implements division:		
Fixed assets (WDV)	45·00	
Current assets	20·00	
	65·00	
Less liabilities	(10·00)	
Net worth	55·00	2

The business had been held for more than 36 months and hence is a long term asset, since this is a case of a slump sale as contained in s.50 B, the benefit of cost inflation will not apply. 2

	Rs. in lakhs	
Sale consideration	100·00	
Net worth of business transferred	55·00	
Long term capital gain	45·00	1

		Marks
Tax calculation:	**Rs. in lakhs**	
Long term capital gains tax at 20% on the above	9·00	
Surcharge at 10%	0·90	
	9·90	
Education cess at 2%	0·20	2
Total tax	10·10	7

(b) Modification of the scheme to keep the tax liability to a minimum

If M Company Limited, were to hold the entire (100%) equity capital of M (Amritsar) Limited, the new company will be the wholly held subsidiary of the seller. The transfer of a business made after the formation of a holding company to a subsidiary company wholly held by it, will not be treated as 'liable to capital gains tax' see s.47, subject to the following conditions. 3

Provided that within the period of eight years from the date of transfer of the business:

(i) the holding company does not cease to hold the whole of the issued shares of the subsidiary; or

(ii) the subsidiary company does not convert the capital assets into stock in trade. 3

If the above conditions are not satisfied, the transferor company will be subject to capital gains tax and the exemption, if any, granted will be withdrawn. 2

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4 **(a)** W is a regular taxpayer and apparently is assessed on his professional income, including profits from the clandestine business of tablet manufacture. In other words, the total business income – legal and illegal – is taxed. 1

The scheme of the Income Tax Act, is for the allowance of certain expenses/claims like repairs, bad debts, etc, by reference to certain specific provisions of the Act and leaves it to s.37 to deal with a host of claims not specifically covered – except that the claim must satisfy the two tests of being revenue in nature and wholly and exclusively incurred for business purposes. To avoid a deduction for expenses relatable to illegal business, an explanation was added to s.37 in 1998 stating that 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 purposes of a business. Strictly interpreting the explanation, it can be argued that since the business of manufacturing tablets in an unlicensed laboratory is illegal, any claim relatable to it cannot be treated as a proper business expense. 2

Following this interpretation, the Madhya Pradesh High Court in *Dr Qureshi's* case held that the value lost by confiscation and destruction of illegal drugs cannot be allowed as a deduction in computing business income. However, this view was not upheld by the Supreme Court, on appeal, and the case is reported in 257 ITR 547. The Supreme Court held on the facts of the case that the claim of the doctor was for deduction of losses and not for an expenditure and thus the explanation to s.37 (1) will not be applicable. In the view of the court, a claim for deduction of a loss is integral to business operations and is allowable under s.37 itself. It satisfies the twin tests of being not capital and impersonal in nature. The Supreme Court therefore, accepted the claim of the doctor and allowed the appeal. W's claim is, therefore, allowable. 2

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(b) Section 142 (2A) deals with the appointment of a special auditor to examine afresh the books of accounts of a taxpayer, where the assessing officer feels that having regard to the nature and complexity of the accounts of the taxpayer, the interest of revenues will be better served by such an audit. The special auditor has to be appointed by the Commissioner or Chief Commissioner on being approached by the assessing officer. Thus, from an administrative point of view the auditor was validly appointed. 1·5

However, in an identical case where the question of absence of an opportunity was raised, the Supreme Court held that the principles of natural justice must be followed and such principles were based on the two basic pillars viz., (i) nobody should be condemned unheard; and (ii) nobody shall be judge in his own case. According to the court, when an authority, be it administrative or quasi-judicial, passed an order that was appealable or subject to judicial review, it would be necessary to spell out the reasons therefor. In the circumstances, the court held that a reasonable opportunity must be granted to a taxpayer before the appointment of the special auditor. *Rajesh Kumar* v *CIT* 287 ITR 91 2·5

This specification has now been incorporated in the Act, through the Finance Act, 2007. Thus, X's contention is correct. 1·0

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Marks

(c) S.282 of the Act deals with substituted service. As per this provision, before resorting to substituted service, the court should be satisfied that there was reason to believe that the defendant was keeping out of the way for the purpose of avoiding service or that, for any reason, the summons could not be served in the ordinary way. In these circumstances, the court could order the summons to be served by affixing a copy thereof in some conspicuous place and also, in some conspicuous part of the house in which the person was known to have resided or carried on business or personally worked for a gain. 2

In the present case, the assessing officer merely issued a letter and in the absence of a reply, finalised the assessment without affording a reasonable opportunity to Y to be heard. The assessing officer did not ascertain whether his direction was properly addressed and served on Y. Only on failure on Y's part to honour a properly served summons/notice could the assessing officer have proceeded to resort to substituted service under s.282. 2

Since the assessing officer did not record his reasons for resorting to a substituted service and since there was no record of a proper service of notice on Y seeking the information, the assessing officer's action to substituted service was not proper and was liable to be quashed. Y does therefore have an acceptable claim. 1

See decision in *Kisan Machines* v *ITO* (2006) Taxman 463

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5 **(a)** The basic conditions for a person to be treated as a resident of India for tax purposes are:

(i) he is in India for a period of 182 days or more in the previous year; or

(ii) he is in India for a period of 60 days or more during the previous year and 365 days or more during the four years immediately preceding the previous year.

If a person satisfies one of the two above conditions, he would be deemed to be a resident. 2·0

There are further conditions to be satisfied if a person is to be treated as resident and ordinarily resident, when all income that arises or accrues to him, wherever it does, so will be taxed in India. These are:

(i) he has been resident in India in at least two out of the ten previous years immediately preceding the relevant previous year; and

(ii) he has been in India for a period of 730 days or more during the seven years immediately preceding the relevant previous year.

Both these conditions have to be satisfied cumulatively. 2·0

Tested by the above specifics, it is seen that T has been in India for the previous year 2006–07 (relevant to assessment year 2007–08) for more than 60 days in that year and has been in India for more than 365 (actually 380 days) in the past four preceding previous years. Though he has not been in India for 182 days in a previous year at any time, under the second alternative condition, he will become a resident. 1·5

As regards the additional conditions to be satisfied to become a resident and ordinarily resident, T should have been a resident for at least two out of the previous ten years and should have been actually in India for a period or periods amounting to 730 days or more in the previous seven years. Since T does not satisfy the condition of being in India for 730 days in the previous seven years, T will be treated as a resident but not ordinarily resident for the assessment year 2007–08. 1·5

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(b) **(i)** Sec 64 (1)(vi) refers. If, after 31 May 1973, an individual transfers assets to his/her son's wife, either directly or indirectly, for otherwise than an adequate consideration, such a transfer would be considered to be ineffective and any income arising out of such a transfer will be taxed in the hands of the transferor. In the given case, C is the mother-in-law of L. She gifted, after the marriage, Rs.5,00,000 to her daughter-in-law which has been utilised by L to become a partner in a firm. 50% of the capital contributions come from the gift made by C. Proceeding on the basis that profits of the firm accruing to the partner have a direct relationship with the capital contribution, then 50% of the profits will be included in the income of C. Hence, for the assessment year 2007–08, C's income will include Rs.4,80,000 arising to L from the membership of the firm. 3

Marks

(ii) One of the essential conditions for the application of s.64(1)(vi) is that the relationship between the parties, in this case C and L, must subsist both at the time of the transfer of the asset and at the time of the accrual of the income. In other words, the impugned transfer must be to a relative. In the case of a gift made on 20 January 2004, before L married Q, C was a stranger and not L's mother-in-law yet. Hence, the provisions of s.64(1) (vi) will not apply. The share of profits accruing to L from the firm will, thus, not be taxable in C's hands for the assessment year 2007–08. 2

(c) A return of income must normally be signed by the individual himself to whom it relates. The Act however provides for exceptions to this general rule as follows:

Where the individual concerned is absent from India, the return can be signed by some person duly authorised by the individual on his behalf.

Where the individual is mentally incapacitated from attending to his affairs, the return can be signed by his guardian or by a person competent to act on his behalf.

Where for any other reason, it is not possible for the individual to sign the return, the return can be signed by any person duly authorised by him on his behalf. 3

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