

PAPER 7: DIRECT TAXES
MAY 2005

Answer **all** Questions.

Question 1

SK Private Limited is engaged in the business of Civil Construction. The profit and loss account of the company for the year ended 31st March, 2005 is as under: **(16 Marks)**

| | Rs. | | Rs. |
|-------------------------------------|------------------|--|------------------|
| Opening stock of building materials | 40,000 | Receipts from the business of Civil Construction contracts | 37,60,000 |
| Salary to workers and employees | 4,10,00 | Rent of godown | 80,000 |
| Purchase of building materials | 24,00,000 | Surplus from insurance compensation received for loss of plant and machinery by fire | 2,00,000 |
| Interest on loan | 3,20,00 | Interest on company deposits | 25,000 |
| Office administration expenses | 2,60,000 | Dividend from companies | 50,000 |
| Traveling expenses | 1,40,000 | Closing stock of building materials. | 25,000 |
| Municipal taxes on godown | 12,000 | | |
| Insurance premium for godown | 8,000 | | |
| Directors' remuneration | 2,53,000 | | |
| Depreciation on plant and machinery | 65,000 | | |
| Provision for tax: | | | |
| Current tax | 1,00,000 | | |
| Deferred tax | 43,000 | | |
| Net profit | 89,000 | | |
| | 41,40,000 | | 41,40,000 |

The following additional information is also available :

- (i) Municipal Tax of godown includes Rs.3,000 not paid by the company.
- (ii) The book value of the plant and machinery , which was insured against fire, was Rs.4,20,000. the written down value of plant and machinery block U/s. 43(6) as on 31st March, 2004 was Rs.1,85,000.
- (iii) The entire building materials were purchased from a firm in which the managing directors of this company is a partner. The fair market value of the materials purchased is Rs.20,00,000.
- (iv) Interest on loan includes Rs.15,000 being interest on loan taken for investment in shares of various companies.
- (v) Office administration expenses include Rs.90,000 paid as a donation to a charitable organisation recognized U/s. 80G.
- (vi) The prescribed rate of depreciation under the Income Tax Rules for plant and machinery is 25%.
- (vii) The company has decided to follow the presumptive tax provision in respect of its business income.

Compute the total income of SK Private Ltd., for the assessment year 2005-06. Your answer should include explanations of your treatment of various items. Ignore the provision of minimum alternate tax U/s. 115JB.

Question 2

- (a) Mr.X bought 10,000 equity shares of TT Ltd., listed in stock exchanges in India and abroad and a constituent of BSE 500 on 15th March, 2003 @ Rs.2,250 per share. He sold the shares at Rs.5,000 per share on 31st December, 2004. The brokerage and securities transactions tax deducted were at 0.5% and 0.075% respectively. Examine the liability of Mr.X to income tax for the assessment year 2005-06. Will your answer be different, if instead of selling the shaers in the market Mr.X privately transferred the shares to his son at the same price? (Cost Inflation Factors : 2002-03 – 447; 2004-05 – 480). **(6 Marks)**

- (b) Gangaram Public Charitable Trust runs a hospital, which derived income of Rs.250 lakhs, from its operational activities. Expenses incurred to earn such income are Rs.55 lakhs. Depreciation on various assets used in the hospital is Rs.15 lakhs. Out of the income of Rs.250 lakhs, the amount accrued but not received as on 31-03-2005 is Rs.20 lakhs. The institution earmarked and set apart Rs.30 lakhs in March, 2005 to give as advance for a building intended to be taken on lease for expansion of the hospital, but the amount was paid on 7th April, 2005, as the lease agreement could not be signed by 31st March, 2005. The trust has got an ERP package developed and installed by an IT company during the year. The total cost to the trust on account of the ERP package was Rs.85 lakhs. Advise the trust on its total income, if the trust has incurred Rs.12 lakhs for purchase of a number of desktop and laptop computers for use in the hospital. **(8 Marks)**

Question 3

- (a) Mr. Gavaskar sought voluntary retirement from a Government of India undertaking and received compensation of Rs.40 lakhs on 31st January, 2005. He is planning to use the money as capital for a business dealership in electronic goods. The manufacturer of the product requires a security deposit of Rs.15 lakh, which would carry interest at 8% p.a. Gavaskar's wife is a graduate and has worked as marketing manager in a multinational company for 15 years. She does not look for a change in employment. She is willing to join her husband in running the business. She expects an annual income of Rs.3 lakhs. Mr. Gavaskar would like to draw a monthly remuneration of Rs.40,000 and also interest @10% p.a. on his capital in the business. Mr. Gavaskar has approached you for a tax efficient structure of the business. **(8 Marks)**

Discuss the various issues, which are required to be considered for formulating your advice. Computation of income or tax liability is not required.

- (b) GK Ltd., filed its return of income for the assessment year 2002-03 on 1.4.2003. The assessing officer levied a penalty of Rs.5,000 U/s. 271F. The assessee makes a submission to the CIT(Appeals) that he has furnished the return of Income within the due date specified in sec.139(4) and hence no penalty should be levied under 271F. Discuss. **(3 Marks)**

Question 4

- (a) What is the legislative objective of bringing into existence the provisions relating to transfer pricing? **(3 Marks)**
- (b) Your client, Ashavari Ltd., has two industrial undertakings – one engaged in production of audio music CDs and cassettes and the other engaged in production of video CDs. As a restructuring drive the company has decided to sell its undertaking producing video CDs as a going concern by way of slump sale for Rs.450 lakhs to a new company called Tori Ltd., in which it holds 75% equity shares. The balance sheet of Ashavari Ltd., as on 31st March, 2005 reads as follows:

| | Rs. in lakhs | |
|-----------------------|--------------|------------|
| | Audit unit | Video unit |
| Fixed Assets | 150 | 225 |
| Debtors | 150 | 112.5 |
| Inventories | 75 | 37.5 |
| Liabilities | 42 | 75 |
| Paid up share capital | Rs.378 lakhs | |
| General reserve | Rs.222 lakhs | |
| Share premium | Rs.33 lakhs | |
| Revaluation reserve | Rs.140 lakhs | |

The company set up the video unit on 1st April, 2001. The written down value of the block of assets for tax purpose as on 31st March, 2005 is Rs.200 lakhs of which is Rs.85 lakhs are attributable to video unit.

- i. Determine the tax liability, which would arise to Ashavari Ltd., from slump sale; **(5 Marks)**

- ii. Suggest modification of the restructuring plan of Ashavari Ltd., without changing the amount of consideration so as to make it more tax efficient. **(3marks)**

Question 5

- (a) Alap Ltd., has made payments on various dates in financial year 2004-05 to Vilambit Ltd., towards work done under different contracts as follows: **(4 Marks)**

| Contract number | Date of payment | Amount (Rs.) |
|-----------------|-----------------|--------------|
| 1 | 5.5.2004 | 13,000 |
| 2 | 6.6.2004 | 15,000 |
| 3 | 8.8.2004 | 20,000 |
| 4 | 10.9.2004 | 20,000 |
| 5 | 10.10.2004 | 10,000 |

Alap Ltd., claims that it is not liable to deduction of tax at source U/s. 194C. Examine the correctness of the claim made by the company. What would be the position if the value of the contract no.5 is Rs.1,000 only and there is no other contract during the year.

- (b) The profit and loss account of East West Bank Ltd., operating in India for the financial year 2004-05 contains, interalia, the following particulars: **(10 Marks)**

(Rs. in crores)

| | |
|---|-----|
| Profit before taxation | 100 |
| Depreciation as per books | 25 |
| Depreciation admissible as per income tax rules | 40 |
| Corporation tax disputed by the Bank and not paid | 10 |
| Bad debts not written off | 45 |
| Provision for non-performing assets as per prudential norms of RBI. | 250 |
| Provision for standard assets at 2% of such advance as per the above norms | 5 |
| Net depreciation on investments under "held-for-trading" and "availability-for-sale" categories calculated on lower of cost price or market price basis as per guidelines of RBI. | 30 |

Other information:

- (a) In assessment year 2003-04 provision for doubtful debts allowed in assessment amounted to Rs.35 crores only.
- (b) The assessment for assessment year 2004-05 resulted in a loss and unabsorbed depreciation amounting to Rs.30 crores and 40 crores respectively and the Bank was not allowed deduction on account of provision for doubtful debts.
- (c) Unrealized interest income not recognized in the accounts in financial year 2004-05 in respect of non-performing assets as per asset classification norms of RBI amounts to Rs.65 crores.
- (d) The aggregate average rural advances calculated as per sec.36(1)(viii) read with Rule 6 ABA amounts to Rs.30 crores.

From the above information compute total income of the Bank for the assessment year 2005-06.

Question 6

- (a) Arif, a resident both in India and Malaysia in previous year 2004-05, owns immovable properties (including residential house) at Malaysia and India. he has earned income of Rs.50 lakhs from rubber estates in Malaysia during the financial year 2004-05. He also sold some property in Malaysia resulting in short term capital gain of Rs.10 lakhs during the year. Arif has no permanent establishment of business in India. however, he as derived rental income of Rs.6 lakhs from property let out in India and he has a house in Lucknow where he stays during his visit to India. The Article 4 of the double taxation avoidance agreement between India and Malaysia provides that where an individual is a resident of both the Contracting States, then he shall be deemed to be resident of the Contracting State in which he has permanent home available to him. If he has permanent home in both the Contracting States, he shall be

deemed to be a resident of the Contracting State with which his personal and economic relations are closer (Centre of vital interests). **(6 Marks)**

You are required to state with reasons whether the business income of Arif arising in Malaysia and the capital gains in respect of sale of the property situated in Malaysia be taxed in India.

- (b) EIH Private Ltd.'s assessment for assessment year 1996-97 was completed U/s. 143(3) on 31st December, 1998. The company went in appeal to the Commissioner (Appeals) and the appeal was decided on 16th August, 2003 and the appeal effect was duly given by the assessing officer on 25th August, 2003. Thereafter, on 1st September, 2004 the assessing officer noticed a mistake in calculation of depreciation on a particular block of assets, which reduced the income by Rs.1.10 lakh. The assessing officer issued notice U/s. 154 for the purpose of rectifying the mistake. Is such rectification permissible? **(3 Marks)**
- (c) Can a person resident in India seek advance ruling from the Authority for Advance Ruling? **(3 Marks)**

Question 7

- (a) A Company submitted the return of income for assessment year 2002-03 on 10th October, 2002. The assessing officer served a notice U/s. 143(2) on the Company on 14th August, 2003 in order to make assessment U/s. 143(3). Thereafter on 1st September, 2003 the assessing officer issued an intimation U/s. 143(1). Such intimation shows a demand for Rs.10,500 towards tax and interest. The company argues that the issue of intimation U/s. 143(1) is bad in law. Discuss. **(3 Marks)**
- (b) The assessment of Ashok for assessment year 2001-02 was completed U/s. 143(3) on 15th January, 2004. The commissioner acting U/s. 263 directed the assessing officer to add certain amount appearing in the balance sheet in total income of Ashok. Ashok did not challenge the order of the commissioner U/s. 263 by filing appeal to the tribunal. The assessing office passed a fresh assessment order on 1st October, 2004 including the said amount in total income of Ashok pursuant to the order of the commissioner. Ashok disputed the fresh assessment order in appeal to commissioner (appeals) U/s. 246A. The commissioner (Appeals) dismissed the appeal on the ground that the assessing officer only complied with direction of the commissioner under the 263, which was not disputed by Ashok in appeal to tribunal. Examine the correctness of the stand taken by the commissioner (appeals). **(3 Marks)**

Question 8

- (a) Steel, Oil and Coal are partners in a firm engaged in the business of running a manufacturing unit in the municipal town of Siliguri having a population of more than 10,000 located in the State of West Bengal. Given below is the Balance Sheet of the firm as on 31st March, 2005:

| | | (10 Marks) | |
|---|--------------|---------------------------------------|--------------|
| | | Rs. in lakhs | |
| Partner's capital : | | Urban land | 300 |
| Steel | 300 | Urban land (construction not allowed) | 700 |
| Oil | 400 | Factory land | 200 |
| Coal | 200 | 900 Residential house | 300 |
| Cash credit from Bank (Secured by hypothecation of stock and debtors) | 200 | Plant (WDV) | 120 |
| Term loan taken from Bank (Secured by charge on gold and silver) | 1,200 | Factory shed | 400 |
| Creditors | 1,000 | Lorry (WDV) | 100 |
| Other liabilities | 600 | Stocks | 300 |
| | | Gold and silver | 800 |
| | | Sundry debtors | 180 |
| | | Advance tax | 200 |
| | | Cash at banks | 300 |
| | <u>3,900</u> | | <u>3,900</u> |

Two urban lands are valued by independent valuer at Rs.550 and Rs.50 lakhs respectively. The market value of gold and silver on the Balance Sheet Rs.1,10 lakhs. The value of residential house as per Rule 3 of schedule III is Rs.350 lakhs.

Term loan was taken for purchase of : (a) plant and machinery Rs.300 lakhs; (b) lands the plots are of equal size Rs.700 lakhs.

The residential house is occupied by partner steel, who looks after the production activity of the firm.

Partner oil is a non-resident for income –tax purposes.

The partners share the profits in the ratio of 2:2:1.

Details of personal assets of the partners as on 31st March, 2005 are as follows:

| Particulars | Rs. in lakhs | | |
|--|--------------|------|------|
| | Steel | Oil | Coal |
| Shares of companies | 40 | Nil | Nil |
| Cash in hand (in India) | Nil | 0.75 | Nil |
| Fixed deposit and other deposits with Banks | 35 | 32 | 40 |
| Loan taken for making investment in the firm | 30 | Nil | Nil |
| Residential house in Nairobi, Kenya | Nil | 400 | Nil |

You are required to determine the assessable wealth of each partner as at 31st March, 2005 stating clearly the reason for inclusion or exclusion of each item.